

# Eligibility for Significant Savings From the Sale of Qualified Small Business Stock Under Internal Revenue Code Section 1202

Article

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If you own a small business, you may qualify for significant tax savings under section 1202 of the Internal Revenue Code of 1986, as amended (Section 1202). Owners or investors of certain C corporations (C corps) may be eligible to exclude up to 100 percent of gains from a sale of qualifying stock held for five years. In some cases, the availability of Section 1202 may also reduce or eliminate the burden of double taxation associated with an asset sale and distribution of proceeds. If you're preparing your company for future investors, Section 1202 qualification may also be an important factor that can make your company more attractive.

## What is the qualified small business stock gain exclusion under Section 1202?

Under Section 1202, owners and investors may be able to exclude all or a portion of capital gains from federal taxes in a sale of qualified small business stock (QSBS), provided specific conditions are met. The percentage of gain that can be excluded depends on the date the stock was issued. For QSBS issued after September 27, 2010, up to 100 percent of gain from stock held for five years can currently be excluded.

## How much gain can be excluded under Section 1202?

A taxpayer who sells QSBS can exclude up to the greater of (1) \$10 million (a cumulative limit reduced by amounts of eligible gain excluded in previous sales of QSBS for that corporation) or (2) 10 times the aggregated adjusted basis in the stock issued by the corporation and sold during that tax year (i.e., an annual exclusion). Because the 10 times basis limit is an annual limit while the \$10 million limit is cumulative, structuring can be done to maximize the exclusion. For example, you might consider selling low basis stock that can use up the \$10 million exclusion and in a later year sell high basis stock that can utilize the 10

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times basis limit. Since the exclusion is per taxpayer, other strategies include gifting QSBS to family members or trusts to multiply the gain amount that can be excluded.

### What are some basic requirements for my stock to be treated as QSBS?

The following describes some basic requirements.

1. **S. C Corporation Requirement.** To be QSBS, the stock generally has to be in a domestic C corp or LLC taxed as a C corp. If your company is currently not a C corporation for tax purposes, you may still be able to restructure to avail yourself of the benefits of Section 1202.
2. **Qualified Small Business Requirements.** The corporation must meet the following criteria:

(i) **\$50 Million Gross Asset Cap.** The corporation's gross assets cannot exceed \$50 million at any time before or immediately after the issue date of the stock. If the corporation's assets later exceed that amount, such stock will not be disqualified. The asset cap may become relevant to you if your company is considering equity financing and are close to the limit.

(ii) **Active Trade or Business.** For substantially all of the period an investor holds the stock, the corporation must use 80 percent or more of its assets in the active conduct of a trade or business other than an excluded business. Certain start-up activities for operating an active trade or business can also qualify for purposes of this test.

Congress designed these tax incentives for certain types of active businesses. Disqualified trade or businesses include certain professional services; any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees; any banking, insurance, financing, leasing, investing, or similar business; any farming business; any business involving mining, drilling, and extraction; and hospitality businesses.

A corporation will not meet the active business test if more than 10 percent of its assets are invested in (1) real estate that is not used in the active conduct of a qualified trade or (2) business or stock or securities of a non-subsidiary corporation. Additional rules also apply to certain tiered corporate structures.

Determination of whether a corporation meets the active business test is highly fact-specific. Given little guidance in some of the disqualified categories, there may be a lack of clarity regarding qualification of the trade or business.

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(iii) **Disqualifying Redemptions.** Restrictions apply to the amount of stock an issuing corporation can purchase from a taxpayer or redeem from all shareholders within certain time periods before and after the issuance of shares. These restrictions are intended to prevent a taxpayer from replacing stock that is not QSBS with stock from the same issuer that *is*. If a company is considering conducting any redemptions or recapitalizations, it is important to ensure those transactions are structured to avoid disqualification of the company's stock as QSBS. Investors in a corporation seeking QSBS treatment should seek to understand the company's redemptions history to ensure QSBS qualification.

### 3. **Stock Holder Requirements**

**Non-Corporate:** The Section 1202 exclusion is only available to *non-corporate* investors of QSBS.

**Five-Year Holding Period:** The holder of the QSBS must hold the stock for at least **five years** before selling to get the exclusion.

**4. Original Issuance Requirement.** An owner or investor must have acquired the stock at original issuance from the corporation in exchange for money, property, or services. "Original issuance" means the stock was issued directly from the corporation. Assuming the QSBS requirements are met, subsequent issuances of stock by the corporation after its incorporation can also qualify as QSBS.

This means that investors that acquire corporate stock from an existing shareholder will not satisfy the original issuance requirement. There are certain exceptions, however. For example, in a limited number of transactions, an owner of QSBS can transfer the stock to another eligible taxpayer who "steps into the shoes" of the transferor and treats the transferred stock as QSBS. These include transfers by gift, at death, from a partnership to a partner (but note, not vice versa), certain reorganizations, and tax-free contributions that meet certain requirements.

Is the tax benefit under Section 1202 subject to an all-or-nothing rule?

No, the Section 1202 benefit is not an all-or-nothing rule. An owner or stockholder may own some stock in a corporation that qualifies as QSBS and some that does not. For example, you may have acquired the stock in the early days of the company under Section 1202 and later obtained additional shares once the company no longer met the small business requirement. Your subsequent acquisition of additional stock should not automatically taint your previously-obtained stock.

### If I receive stock options or convertible stock, can they qualify as QSBS?

If a stockholder or investor acquires stock by exercising a stock option, such stock could be QSBS, but the holding period only begins on the *exercise date*, not on the date of grant. If an eligible taxpayer acquires convertible preferred stock that qualifies as QSBS and exercises the conversion feature, the stock received in exchange is treated as QSBS even though it fails to meet the original issuance requirement. The holding period for the stock received in exchange includes the taxpayer's holding period for the convertible stock. These are just a couple examples of stock features that might complicate eligibility and holding period considerations.

### When can a tax attorney help?

A tax attorney can help you navigate the intricate rules of Section 1202 and structure your business to qualify under it. This includes structuring advice upon formation, when seeking investors, when looking into an investment that may qualify as QSBS, and upon planning for the disposal of stock. Furthermore, Section 1202 qualification and timing considerations may be an important part of the tax representation and warranties in a stock purchase and sale agreement. A tax attorney can review purchase agreements to ensure your interests are protected if purchasing stock in a company that may qualify as a qualified trade or business.

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