Business Planning

Business owners may be eligible for tax-free gains on the sale of qualifying small business stock under IRC §1202.

By Eva Stark, JD, LL.M.

Selling a small or closely held business can be a stressful endeavor and tax considerations are typically far from top of mind. However, Internal Revenue Code Section 1202, a potentially overlooked tax provision, may allow certain taxpayers who sell stock in a "qualifying small business" to exclude from taxation a percentage—50%, 75%, or even 100%—of the gains realized on the sale of stock issued after August 10, 1993. Therefore, it could be beneficial in many circumstances to structure affairs in a manner that ensures that requirements for this potentially advantageous, non-elective tax provision are met. The following explores some of the general issues to be considered.

Qualifying Small Business

The definition of a "qualifying small business" or "QSB" may be very different from what would generally be thought of as a "small business." A QSB is a domestic C corporation (or possibly an LLC taxed as a C corporation) whose aggregate gross assets do not exceed $50 million. Aggregate gross assets are cash and the aggregate adjusted bases of other property held by the corporation.

Potential Tax Benefit

Business owners are usually aware that the federal income tax rate on long-term capital gain is generally 20% (0% or 15% for more moderate-income taxpayers), and that these long-term capital gains are subject to an additional 3.8% tax on net investment income. Where §1202 fully excludes gains on the sale of QSB stock, these taxes would be eliminated.

If §1202 gain is only partially excludible (see table below), the portion of §1202 gain that is not excludible but for the percentage limitations is treated as 28% rate gain (a characterization also used for gain on collectibles), plus net investment income tax. The table below illustrates how triggering §1202 may result in significant tax savings, especially for taxpayers in the highest capital gains tax bracket.

Stock is issued	% Gain that may be excludible under §1202	Maximum Federal Rate Without §1202	Federal Rate with §1202	Explanation of Calculation of Tax Rate with §1202
On or before August 10, 1993	Not applicable	23.8%	Not applicable	Not applicable
After August 10, 1993, and on or before February 17, 2009	50%	23.8%	15.9%	50% x (28%+3.8)
After February 17, 2009, and on or before September 27, 2010	75%	23.8%	7.95%	25% x (28%+3.8%)
After September 27, 2010	100%	23.8%	0%	0%
Figures ignore any state, local, or alternative minimum tax considerations.				

Active Business

To qualify for the §1202 exclusion, the C corporation whose stock is sold must be an active business. While guidance is lacking regarding the definition of an active business, the code states that this requirement is met for any holding period if during such period at least 80% (by value) of the assets of the corporation are used by such corporation in the active conduct of one or more qualified trades or businesses.

Qualified Trade or Business

The C corporation also must be engaged in a "qualified trade or business." While the definition of qualified trade or business is murky, the code does provide a long list of trades or businesses that DO NOT qualify:

- Any trade or business that performs services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade where the principal asset of the trade or business is the reputation or skill of its employees;
- Any banking, insurance, financing, leasing, investing, or similar business;
- Any farming business (including raising or harvesting trees);
- Any business involving production or extraction of products with respect to which a deduction under Section 613 or 613A is allowed (relating to depletion); or
- Any business operating a hotel, motel, restaurant, or similar business.

Disqualifying Redemptions

Certain redemptions of stock from the taxpayer or a related person, or significant corporate redemptions with respect to any shareholder, within relevant periods specified in §1202, may also disqualify stock from being QBS stock eligible for gain exclusion. A significant redemption is generally a redemption exceeding 5% of the aggregate value of the corporation's stock.

Non-corporate Shareholder

To take advantage of the §1202 exclusion upon the sale of QSB stock, the taxpayer must be a non-corporate shareholder, such as an individual, trust, or estate. Subject to additional requirements and limitations, certain pass-through entity shareholders, including S corporations and partnerships, may pass through the benefits of the §1202 gain exclusion to their respective owners who are otherwise eligible.

Original Issue Stock

Generally, the taxpayer must have acquired the stock at original issuance in exchange for money, property (not including stock), or compensation for services to the corporation. In some circumstances, where stock that meets the original issue requirement is transferred, the transferee will be treated as having acquired the stock in the same manner as the transferor, and this requirement will continue to be satisfied. Examples of these types of transfers include transfers by gift, transfers at death, certain types of transfers from a partnership to a partner, or certain conversions of stock in the corporation.

Five-Year Holding Period

The §1202 exclusion can apply to the sale or exchange of QSB stock held for more than five years. In some cases, a taxpayer may add or "tack" the holding period of the transferor from whom the taxpayer acquired the stock. Examples of circumstances where holding periods may tack include situations where stock is gifted, inherited, converted from other stock in the corporation, part of a tax-free exchange under Section 1045, and other circumstances.

Greater of $10 Million or 10x Basis Limitation

The amount of gain per C corporation shareholder that may be eligible for exclusion is limited. If a taxpayer has eligible gain, the amount of gain which may be taken into account may not exceed the greater of (i) $10 million or (ii) 10 times the aggregate adjusted bases of QSB stock issued by the corporation and disposed by the taxpayer during the taxable year (with adjusted basis determined without regard to any addition to basis after the date on which such stock was originally issued).

Calculating the amount of this limitation is a complex endeavor subject to many special—and often unexpected—rules. For example, where a taxpayer contributes property to a corporation in exchange for stock, the basis of such property for purposes of the 10 times basis limitation will generally be no less than the fair market value of the property exchanged for the stock when the stock was acquired. With advanced techniques, a shareholder may be able to capture greater tax savings than this limitation may seemingly impose at first look.

Conclusion

The recent reduction of the corporate tax rate from 35% to 21% made it relatively more attractive for businesses to operate as C corporations. As a result, the availability and use of IRC Section 1202 may become more prevalent in the future. It should be noted that the requirements of §1202 are nuanced and not as clear cut as the above discussion, or any other general educational discussion on the topic, may suggest.

Taxpayers should discuss with their tax and other professional advisors whether they might or might not benefit from triggering this often-overlooked tax provision, to help ensure their business affairs are structured with maximum tax benefits in mind.

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