

CORPORATE TAX MATTERS

IRC Section 1202: A Calculated Approach To Increase Tax Benefits

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Section 1202 of the Internal Revenue Code (Section 1202) provides substantial benefits to non-corporate shareholders of certain C corporations. Whether a client is looking to form a business, or a client is seeking to invest in an already formed and established business, the client should be aware of the benefits and risks associated with forming or acquiring different types of entities.

Clients should understand that every entity, whether it be a C corporation, S corporation, limited liability company, partnership, etc., has certain benefits and risks associated with them. Some benefits and risks are obvious, such as centralized management, limited liability and basic tax consequences—however, certain tax benefits are not as well known or understood.

One of the lesser known provisions of the Internal Revenue Code is Section 1202, which provides selling shareholders of a C corporation with a substantial tax savings if certain conditions are met. Potential tax benefits provided by Section 1202 are one the most overlooked and underutilized in the Internal Revenue Code, provided that



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certain requirements are met, including that the corporation is a “qualified small business” and the shares qualify as Qualified Small Business Stock (QSBS). The income tax benefits of Section 1202 became even more pronounced after the 2017 legislation that reduced the corporate tax rate from 35% to 21%.

Requirements for QSBS Under Section 1202

Section 1202 was enacted in 1993 to encourage investment in small businesses. Section 1202 provides certain shareholders of a qualified small business whose shares qualify as QSBS with substantial tax benefits. However, in order to have such shares qualify as QSBS under Section 1202, business owners and shareholders must ensure that the corporation qualifies as a qualified small business

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and the certain holding period requirements are met by the selling shareholder. Further, if qualified, there are no filing or election requirements to claim the benefits under Section 1202.

In order to benefit from Section 1202 and for shares to be deemed QSBS, the following requirements must be met:

- the issuing corporation must be a domestic C corporation (an S corporation does not qualify as a qualified small business under Section 1202);
- the shares of the corporation must have been acquired directly from the corporation in exchange for money, other property or as compensation for services provided to the corporation (shares may not be purchased from a prior shareholder);

A QSBS holder can also defer tax obligations on the sale of QSBS if the QSBS is owned for more than six months and the sale proceeds are reinvested into another QSBS within 60 days.

- the aggregate gross assets of the corporation may not exceed \$50 million either before the shares are issued or immediately after the shares are issued;
- the corporation must be an eligible business, which includes any domestic C corporation, except for businesses involving personal services, skill or reputation, such as financial services, engineering, consulting, banking, farming, natural resource extraction, hospitality industries, insurance, operating a hotel, motel or restaurant, a domestic international sales corporation, investment companies, real estate investment trusts or real estate mortgage investment conduits, or a cooperative;
- the corporation must be an active business at all times that the shares are held, meaning such corporation uses at least 80% of its assets in the active conduct of its business during substantially all of the shareholder's holding period of the shares; and

- the shares must be held by the shareholder for at least five years prior to being sold.

The foregoing requirements may be subject to further exceptions and regulations, which are not covered herein.

QSBS Tax Benefits

Currently, Section 1202 exempts from tax 100% of the eligible gain from the sale of QSBS issued after Sept. 27, 2010. For QSBS acquired after Aug. 10, 1993, and before Feb. 18, 2009, 50% of the eligible gain realized is exempt from tax, and for QSBS acquired after Feb. 17, 2009, and before Sept. 28, 2010, 75% of the eligible gain is exempt from tax.

Under Section 1202 the amount of "eligible gain" that can be excluded from tax is limited to the greater of (i) \$10 million dollars or (ii) up to 10 times the shareholder's basis (investment) in the company. With proper tax planning, these exclusion amounts may be increased.

The following examples illustrate the potential tax gains associated with selling QSBS.

Example 1: A shareholder acquires shares in a C corporation on Sept. 30, 2018, for \$1 million dollars and sells the shares in the C corporation on Oct. 1, 2023, for \$10 million dollars, resulting in a gain of \$9 million dollars before the application of Section 1202. Assuming the shares qualify and are deemed QSBS, then the shareholder would be entitled to a 100% tax exemption up to \$10 million dollars or 10 times the shareholder's investment in the company (i.e., up to \$10 million dollars). In either instance, the shareholder would be entitled to full exemption from federal income tax on the \$9 million gain under Section 1202.

Example 2: A shareholder acquires shares in a C corporation on Sept. 30, 2018, for \$1 million dollars and sells the shares in the C corporation on Oct. 1, 2023, for \$10 million dollars, resulting in a gain of \$9 million. If the C corporation is not a qualified small business and the shares are not QSBS, then the shareholder would be subject to the current long-term capital gains tax rate of 20% plus the 3.8% excise tax on net investment income and its \$9 million dollar gain and would owe federal income tax of \$2,142,000.

The aforementioned examples depict how powerful of a tool Section 1202 can be for shareholders who own QSBS. The tax benefits of owning QSBS can make a substantial difference to a shareholder's bottom line when selling shares in a corporation.

Further Exemption Qualifications and Strategies

The tax benefits of Section 1202 mentioned above may be multiplied if QSBS is divided among other individuals such as a spouse, children or other family members through a gift. In addition, the benefits may also be multiplied by a gift to a non-grantor trust; if the QSBS shareholder is an S corporation or partnership which has multiple members, since the benefits of Section 1202 flow through to each individual shareholder or partner; if the QSBS is reinvested into another QSBS; or if the QSBS is bequeathed to multiple beneficiaries upon the death of the holder of the QSBS.

A QSBS holder can also defer tax obligations on the sale of QSBS if the QSBS is owned for more than six months and the sale proceeds are reinvested into another QSBS within 60 days.

Prospective Approach To Section 1202

Based upon the foregoing, there are stringent requirements when it comes to what businesses qualify under Section 1202 and how shares qualify as QSBS. Clients should consult with their attorneys before forming or acquiring stock in an entity to determine whether the entity qualifies under Section 1202 as a qualified small business and whether its shares qualify as QSBS.

In order to take full advantage of this extremely beneficial tax opportunity, a client should prepare in advance and look prospectively at what type of business entity it is acquiring or forming and the benefits and risks of each.