VIDEO: Section 1202 - Qualified Small Business Stock, A Recipe of 100% Gain Exclusion

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IRC Section 1202 allows investors and employees of small companies to exclude up to 100% of their gain when they sell their shares. In other words, an investor or employee may be able to avoid all tax on the sale of her stock under the appropriate circumstances.

But to get the exclusion from gain, you've got to follow a rather complicated recipe.

If this tax dish turns out correctly, an investor who has held QSBS for more than five years should be able to exclude 100% of the gain on up to $10 million worth of stock.

1. Starting Ingredients

IRC Section 1202(c) provides the starting ingredients. To get the exclusion, a "noncorporate taxpayer" must purchase or receive shares of a C corporation (not an S corporation or LLC) at original issuance in exchange for money or compensation for services.

What does this mean in practice? The section 1202 exclusion generally only applies to C corporation stock issued directly to an individual (or a partnership). If you buy the shares from a prior owner of the stock, you probably can't get the QSBS exclusion.

In addition, where a corporation is redeeming shares from its shareholders, the QSBS exclusion can be lost. Subject to certain de minimis exclusions, if the company redeems shares of a shareholder, and then issues new stock to that shareholder within two years of the redemption, those new shares can't qualify as QSBS. Additionally, if the company redeems more than 5% of its aggregate outstanding shares (by value), any shares issued within one year of that cap cannot be QSBS.

Finally, stock acquired through the exercise of options or warrants, or the conversion of convertible debt can be QSBS, but only at the time of exercise or conversion.

2. Qualified Small Business

The basic ingredient is C corporation stock received at original issuance. In order for that stock to be QSBS, it must be stock in a "qualified small business." This is where you really need to follow the recipe. There are two general requirements to ensure that the issuing corporation is a qualified small business.

A. Gross Assets Test

The first test is relatively straightforward. At the time the stock is issued, IRC Section 1202(d) says that the corporation must have aggregate gross assets of $50 million or less. Note that if the value of the company subsequently exceeds $50 million, the exclusion won't be lost. It's just that at the time the stock is issued, the company can't be worth more than $50 million.

B. Active Business Test

In addition to the $50 million valuation cap, the gain exclusion is only available if the qualified small business dedicates at least 80% of its assets to a "qualified trade or business." What is a qualified trade or business? With its usual clarity, the Internal Revenue Code defines qualified trade or businesses by exclusion.

IRC Section 1202(e)(3) states that a qualified trade or business is anything other than the performance of services in the fields of health, law, engineering, architecture, accounting, and similar trades or businesses where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

Interestingly, IRC Section 1202(e)(3) also excludes restaurants from the definition of a qualified trade or business.

One final point about the active business test. A new company doesn't necessarily need to comply with the qualified trade or business rules. IRC Section 1202(e)(6) provides that if a corporation uses assets in certain start-up or research activities, or its assets are held to meet reasonable working capital needs (and are reasonably expected to be used within two years), those assets are used in a "qualified trade or business."

This working capital exclusion is helpful if you've formed a new qualified small business, but are not yet conducting an actual business.

3. Additional garnishes

You've got the basic recipe for the QSBS exclusion. A non-corporate owner of C corporation stock can exclude up to 100% of the gain from the sale of that stock after a five year holding period provided that, at the time the shareholder is issued shares, the gross assets of the corporation are less than $50 million and the corporation engages in one of the qualified trades or businesses.

However, there are some subtle garnishes that help make the QSBS exclusion even more appetizing.

Tax-free transfers

First, while the exclusion generally only applies to stock received at original issuance, most tax-free exchanges will not taint the QSBS benefit. For example, where QSBS is transferred by gift or at death, the transferee steps into the shoes of the transferor and is treated as having received the shares at original

issuance. The transferee also gets to tack their holding period to the transferor's.

In the tax-free reorganization context, the QSBS benefit can also be preserved. If you own shares of QSBS and exchange those shares for stock in a non-QSBS company in a tax-free reorganization, IRC Section 1202(h) makes clear that when you sell the non-QSBS company stock, you can still exclude gain as though you were selling the original QSBS you owned.

4. Cook and Results

Under IRC Section 1202(a)(1), that cooking time is five years. However, once you've held the QSBS for five years, IRC Section 1202(b) allows you to exclude up to the greater of (1) $10 million of gain or (2) 10 times your basis in the QSBS sold.

Note that the amount of gain that can be excluded has changed as IRC Section 1202 has evolved. IRC Section 1202 originally provided that a taxpayer could exclude 50% of up to $10 million gain. However, Congress later increased the exemption to 75% for QSBS purchased between February 18, 2009 and September 28, 2010. Finally, Congress increased the exemption to 100% with the Creating Small Business Jobs Act of 2010. Provided you purchased your qualified small business on or after September 28, 2010 and have held such stock for more than five years, you should be able to avoid tax on all gain for up to $10 million worth of stock or 10 times your basis in your stock. Hard to think of something tastier than that.

One final point: Previously the 100% exclusion was subject to sunset provisions and needed to be renewed each year by Congress. On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015. This Act makes permanent the 100% exclusion going forward.

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