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Federal Tax ADVISORY ■

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Qualified Small Business Stock (Section 1202)

The qualified small business stock (QSBS) gain exclusion under Section 1202 can provide significant tax benefits by allowing an individual to exclude up to 100% of taxable gain from the sale of QSBS. While venture capital practitioners are more likely to have come across this tax rule, excluding gain under Section 1202 is a potentially extremely beneficial rule that should be known by anyone deciding how a small business should be classified for tax purposes, investing in a small business, or acquiring a small business. The ideal small company to be a candidate for QSBS is one whose shareholders expect to recognize most of the value upon an exit event and don't mind having corporate-level tax liability until the exit (e.g., because the company is in a loss position or does not make shareholder distributions).

High-Level Requirements

To qualify as QSBS, the stock must be C corporation stock. The holder must have acquired the stock from the C corporation in exchange for money, other Section 1202 stock, other property (excluding non-Section 1202 stock), or services provided to the corporation. The corporation must meet certain active business requirements (based on asset use) during substantially all the taxpayer's stock holding period, and the aggregate gross assets of the corporation (and certain subsidiaries) must not have exceeded $50 million at any time before or immediately after the taxpayer's receipt of the stock. Stock held in corporations conducting certain industry-specific trades or businesses (e.g., health, law, engineering, architecture, or accounting) and consulting (or other personal services) trades or businesses will not qualify as QSBS. The $50 million test is not really a limiter once the QSBS has been issued, because it does not matter how valuable the corporation grows by the time of the exit.

Gain Exclusion

The gain exclusion applies to the sale of QSBS held directly by an individual (or held indirectly through a partnership or S corporation) for more than five years. The amount of gain that may be excluded is the greater of $10 million or 10 times the aggregate "adjusted stock basis" of QSBS sold during the taxable year. The exclusion amount varies depending on when the stock is acquired, but QSBS acquired after September 27, 2010 is eligible for a 100% gain exclusion.

When to Consider

Founders, early-stage investors, and startup businesses should consider setting up their operations in a C corporation in order to take advantage of QSBS. If the business is not originally set up as a C corporation, businesses may be able to convert to a C corporation structure and issue QSBS at the time of conversion. Investors should consider whether it is possible to receive QSBS in the context of an investment in an existing business. Also, Section 1202 will often need to be considered for existing shareholders and/or purchasers in the context of merger and acquisition transactions.

Certain Circumstances Warranting Special Attention

Stock redemptions may result in the failure of stock issued within two years before or two years after the redemption to qualify as QSBS. Unlike direct issuances of QSBS to a partnership (including a limited liability corporation (LLC) taxed as a partnership), transfers of stock from an individual stockholder to a partnership (including an LLC taxed as a partnership) will result in the loss of QSBS treatment for the transferred stock. Also, special rules and requirements apply to QSBS issued by the corporation to a partnership (including an LLC taxed as a partnership) or an S corporation.

Rollover of Certain Gain

If QSBS held for more than six months is sold and the proceeds are reinvested in separate QSBS within 60 days following the sale, the gain resulting from the sale may be deferred.

Section 1202 may provide substantial tax benefits in connection with the sale of QSBS and should be considered in the context of a number of transactions and scenarios.

For more information, please contact Jack Cummings at +1 919 862 2302 or John Harden at +1 404 881 7990.

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