Tax Notes

An Inside Look at the Benefits of IRC Section 1202 – Qualified Small Business Stock (QSBS)

By Alan S. Kufeld, CPA, Partner and Benjamin A. Beskovic, CPA, Partner

It is critical to analyze the decision of entity structure early in the lifecycle of a business. The Tax Cuts and Jobs Act (TCJA) reduced the top corporate income tax rate to a flat 21 percent from a maximum tax rate of 35 percent. As one might imagine, this rate change has resulted in an increased interest in establishing or converting existing entities to C corporations by their owners. Apart from the tax rate differential, there are significant tax differences upon the sale of the company that are worth looking into as well. IRC Section 1202 — which has been around for a number of years and was made permanent in 2015 by the Protecting Americans from Tax Hikes Act (PATH Act) — is worth revisiting.

In general, Section 1202 excludes 100% (subject to certain limits) of the gain from the sale of "qualified small business stock" (QSBS) as long as the requirements of this section (set forth below) have been met. The capital gains that are exempt from tax under Section 1202 are also exempt from the 3.8% tax on net investment income under IRC Section 1411. Moreover, certain states follow federal gain exclusion, but some states, like New Jersey, only allow exclusion for Section 1202 gains realized from the sale of a NJ qualified small business, while other states may have decoupled from the federal gain exclusion.

The combination of reduced corporate tax rates, as well as the possibility for meeting the requirements of Section 1202 — unique to C corporations — can create significant tax benefits. Individuals and private equity funds may wish to consider the benefits of this Section when evaluating prospective acquisitions.

Meeting the Requirements

In general, in order to qualify as QSBS the following must be met:

1. The stock was originally issued after August 10, 1993 by a domestic C corporation acquired from the corporation at original issue in exchange for money, property (other than stock), as compensation for services or in a tax-free transaction such as a gift, inheritance, or partnership distribution. Neither an S corporation nor a tax partnership can issue QSBS;

2. The exclusion is available for non-corporate shareholders that acquired the stock after August 10, 1993 and have owned the QSBS for more than five (5) years;

3. The aggregate gross assets of the corporation may not exceed $50 million at any time from August 10, 1993 to immediately after the issuance of the stock; and

4. The issuer corporation must meet an active business requirement whereby 80% or more of its assets are used in one or more businesses, other than those specifically excluded. Ineligible businesses include certain personal service activities (health, engineering, law, accounting, consulting, etc.), banking and other financial services businesses and hotels and restaurants.

For QSBS acquired before September 27, 2010, the exclusion is either 75 percent or 50 percent. *All* eligible gain from the sale of QSBS acquired on or after September 28, 2010 is 100% excluded.

Eligible Gain

The gain exclusion is limited to the greater of $10 million or 10 times the aggregate adjusted basis of the QSBS investment. The gain exclusion limits apply on a shareholder-by-shareholder basis.

Example

Consider a taxpayer, individual X, purchases $2 million of ABC corporation stock, a capital asset in the hands of individual X. If ABC stock is not QSBS and X sells it in 2018 for $8 million, then X realizes a gain of $6 million. In this case, X could potentially owe federal taxes of $1.428 million ($6 million gain x 23.8% capital gains tax rate). However, if ABC stock were to qualify as QSBS in X's hands, then the entire Section 1202 gain on the sale of the shares would be excluded from federal income tax.

Considerations

If you are contemplating pursuing the benefits of IRC Section 1202, please seek professional tax advice to ensure the qualifications are properly met. State and local income taxes should be considered, as well as the possibility of prospective legislative changes; specifically, a potential increase in the corporate tax rate.

QSBS eligibility is quite rigorous; therefore, it is important to maintain good records. As a best practice, documentation of the purchase price and date acquired, as well as detailed records or a memorandum indicating the eligibility requirements have been met, are critical.

Contact Us

If you have any questions, please reach out to any member of your client service team at PKF O'Connor Davies or contact either of the following tax partners:

Alan S. Kufeld, CPA
Partner
akufeld@pkfod.com | 646.449.6319

Benjamin Beskovic, CPA
Partner
bbeskovic@pkfod.com| 646.449.6379

www.pkfod.com

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