Season 1 – Episode 11 - Section 1202: The Hidden Gem of Tax Code - A Deep Dive Into Qualified Small Business Stock

Date: July 22, 2023

Host: Daniel J. Rohr, CPA/PFS, EA, M.S. Tax

Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we'll be diving into qualified small business stock, also known as Section Twelve Two Stock. Established by the Revenue Reconciliation Act of 1993, section Twelve Two of the Internal Revenue Code encourages investment in small businesses by providing an attractive tax incentive.

It allows investors in qualified small business stock QSBS to exclude a large portion, if not all, of their capital gains from taxation when they sell their shares. Under certain conditions, the tax benefits are very enticing. If you hold the QSBS for at least five years, you can exclude 100% of your capital gain up to the greater of $10 million, or ten times your basis in the stock from federal taxation. If the stock was purchased after September 27, 2010, 100% tax free gain. There isn't really anything else like this in the US. Tax Code. So let's imagine for a moment that you've invested in a small tech startup by purchasing $100,000 worth of QSBS. If you fast forward five years and the company's done incredibly well, and your stock is now worth 10 million if you decide to sell. Thanks to Section Twelve Two, none of your $9.9 million gain would be subject to federal tax.

Not a single cent. To claim the gain exclusion under Section Twelve Two, both the issuing corporation level and stockholder level eligibility requirements must be satisfied. The issuing corporation level requirements are as follows it must be an active domestic C corporation. So this means that it must be incorporated in the United States as a C corporation and engaged in active business operations rather than being a holding company. And to be considered and engaged in active business operations, 80% of the corporation's assets must be used in the active conduct of one or more qualified trades or businesses. In addition, the total gross assets of the corporation, both before and after the issuance of stock, must not exceed $50 million. This asset limit is determined based on the fair market value of the corporation's assets. Unfortunately, there are certain types of businesses that are not eligible, including those involved in professional services like law, health consulting, finance, mining, natural resource extraction, farming and hospitality businesses like hotels and restaurants.

Now, regarding the stockholder level requirements, an eligible stockholder or shareholder is any type of stockholder, including individuals trusts pass through entities like partnerships, limited partnerships, LLCs and even other C corporations can qualify for claiming section twelve two S gain exclusion. The stock must be acquired at original issuance directly from the company in exchange for cash, property, or services. It cannot be purchased from another shareholder. The investor or corporation must also not have made certain significant redemptions in the period two years before or after the QSBS stock acquisition. And lastly, the stock must be held for more than five years to qualify for the exclusion, and the holding period is calculated from the date of acquisition to the date of sale. Now, let's address a question we get quite often can an operating LLC partnership incorporate into a C Corp and still get the benefits of twelve two stock?

And the short answer is yes. But your timing is critical, and the conversion needs to be handled properly. If your LLC is converted into a C Corp, the stock received at the time of the conversion can potentially qualify as QSBS, and the original contribution to the LLC does not count towards the five-year holding period. The clock starts ticking from the date of conversion, so you would need to hold the stock for at least five years after the conversion to benefit from the QSBS exclusion. It's important to note that most states conform to section twelve two stock gain exclusion, either fully or partially. There are a few states, however, that do not allow for twelve two stock treatment. Those states are California, Alabama, Mississippi, New Jersey, and Pennsylvania. Section twelve two presents an excellent opportunity for investors and small businesses, but as with all tax matters, the specifics can get complex.

It's crucial to understand the rules and ensure that your company meets all the requirements and navigate the process with the help of a knowledgeable tax professional.

That's all for this episode of Tax Blueprints of Rohr CPAs podcast. You can find us online at Rohrcpas.com/podcast and don't forget to subscribe on Apple podcasts or Spotify. If you enjoy the show, please consider rating or reviewing us wherever you listen. I'm your host, Daniel Rohr. Thanks for listening.