Tax Strategies for Mergers & Acquisitions

An Important Tax Benefit for Selling Shareholders: Taking Advantage of the Section 1202 Qualified Small Business Stock Exemption

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This article provides an overview of the Qualified Small Business Stock (QSBS) tax exemption—a provision that could yield significant tax savings for owners of small businesses that sell their stock—and some guidelines for determining whether it may apply to your situation.

Section 1202 Capital Gains Exclusion

For investors in small businesses that meet certain criteria, Section 1202 of the IRC provides a significant tax benefit—the complete exclusion of capital gains from federal tax.

Small businesses make up a significant portion of the US economy, accounting for an estimated 99% of the 5.6 million employer firms in the US[1] and 44% of its gross domestic product (GDP)[2]. Unfortunately, few owners of these businesses are aware of a provision in the Internal Revenue Code (IRC) that could have a meaningful impact on their after-tax proceeds from a sale of the business. For shareholders of C-corporations that meet certain criteria, Section 1202 of the IRC provides a significant tax benefit—**the complete exclusion of capital gains from federal tax**.

The exclusion is only applicable for shareholders (must be a person, other than a corporation) that realize gains from the sale of qualified small business stock. Small business stock is qualified if it meets certain requirements related to, among other things: (i) the date of issuance of the stock; (ii) the gross assets of the issuer; (iii) the type of business conducted by the issuer; and (iv) whether the issuer repurchases stock from the investor or other investors within certain time periods.

Qualified small business stock generally cannot be transferred to another person and still receive the exclusion. However, transfers by gift, death, or from a pass-through entity are eligible for the exclusion.

[1] SBE Council (https://sbecouncil.org/about-us/facts-and-data/)

[2] The US Small Business Administration (https://advocacy.sba.gov/2019/01/30/small-businesses-generate-44-percent-of-u-s-economic-activity/)

Benefit Limitations

Beyond the restrictions on qualification for the exclusion, there are certain limitations on the amount that can be excluded for any investor. Notwithstanding these limitations, the benefit from the exclusion can be significant. If the investor holds the stock for more than five years, the investor may exclude from gross income a portion or all of the gain from the sale or exchange of the qualified stock—the amount depends on when the stock was acquired. Stock acquired before February 18, 2009 is eligible for 50% exclusion. Stock acquired between February 18, 2009 and September 28, 2010 is eligible for 75% exclusion. Stock acquired after September 28, 2010 is eligible for 100% exclusion.

Note that an investor cannot benefit from both the exclusion under Section 1202 and any reduced effective capital gain tax rates that may otherwise be available. Accordingly, the taxable portion of a gain from selling a qualified small business stock—the amount not eligible for exclusion—is subject to a maximum rate of 28% on capital gains.

Additionally, the amount that can be excluded (regardless of acquisition date) is capped at the greater of (a) $10 million per taxpayer ($5 million if married and filing a separate return), or (b) ten times the aggregate adjusted basis of the qualified small business tock issued to the taxpayer.

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Exclusion Limitations Based on Date of Acquisition of Stock

Summary

The tax benefit from the capital gains exclusion provided by Section 1202 can be substantial and could dramatically impact business decisions, including whether it is the right time to consider selling your existing business. There are numerous requirements that must be satisfied and certain limitations may apply. We recommend you consult with qualified tax, legal and investment banking professionals to assist you when considering whether, when and how to sell your business and potentially utilize the benefits of Section 1202.

Do You Qualify?

There are many criteria to consider in determining if your stock is qualified, but at a minimum it must meet the following requirements:

- Your business is a C-Corporation in the United States;
- Aggregate gross assets at or below $50 million before and immediately following the time stock was issued;
- Generally speaking, at least 80% (by value) of the corporation's assets is used for the active conduct of one or more qualified businesses;
- Stock was issued after August 10, 1993 in exchange for money or other property (not including stocks) or as compensation for a service rendered;
- The issuing corporation does not purchase stock from the taxpayer or significantly redeem its stock (greater than 5% of the total stock value of the company) within certain time periods; and
- The issuing corporation must be engaged in a trade or business other than banking, insurance, farming, oil and gas extraction, operating a hotel or motel, or trades where the principal asset of such trade or business is the reputation or skill of its employees (such as health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services).

If you have questions about the qualifications or wish to discuss QSBS implications related to your business, please contact one of the following professionals:

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