Gain Exclusion for Section 1202 Stock

TAX SECTION

By John G. Hodnette

The decrease in the corporate tax rate by the 2017 Tax Act has made it more favorable for businesses to operate as C corporations. With more businesses opting to be C corporations, the gain exclusion of Section 1202 is more important. Section 1202 provides an exemption to eligible taxpayers of between 50% and 100% of the gain of the sale of Section 1202 stock.

Section 1202 applies only to qualified small business stock held for more than five years. Qualified small business stock is stock of a C corporation that was issued on or after August 10, 1993, if (a) as of the date of issuance, the corporation was a qualified small business, and (b) the stock was acquired by the taxpayer at its original issue (subject to narrow exceptions). A qualified small business is a U.S. corporation that is a C corporation and the aggregate gross assets of which at all times after August 10, 1993, and before and immediately after issuance did not exceed $50 million. Additionally, the corporation must meet an active business requirement. At least 80% by value of the assets of the corporation must be used in the active conduct of one or more qualified trades or businesses. A qualified trade or business is any trade or business other than the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, or financial services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, banking, insurance, financing, leasing, investing, or similar business, any farming business (including raising or harvesting trees), any business involving the production or extraction of products to which a deduction is allowable under Section 613 or 613A, or operating a hotel, motel, restaurant, or similar business.

Section 1202 stock provides a 50%, 75%, or 100% gain exclusion, subject to limitations. The amount of the exclusion depends on when the stock was issued. Any gain not excluded by Section 1202 is subject to a maximum capital gain rate of 28% rather than the more typical 20% rate. Thus, a taxpayer who sells 1202 stock is unable to take advantage of both the 1202 exclusion and the favorable long-term capital gains rate. An additional benefit of Section 1202 is gain is also excluded from the 3.8% tax on net investment income tax

Section 1202 gain exclusion is limited each year to the greater of (a) $10 million reduced by the aggregate amount of eligible gain taken into account in prior years, or (b) ten times the aggregate adjusted bases of qualified small business stock issued by the corporation and disposed of by the taxpayer during the year. It is a common misconception that the maximum aggregate exclusion available for 1202 stock is $10 million. In fact, the annual limitation will allow a shareholder potentially to exclude more than $10 million of total gain.

If sellers hold Section 1202 stock (or generally any C corporation stock), it is important for the transaction to be structured as a stock sale rather than an asset sale. The sellers may have to offer a discount to the buyer for it to agree to a stock purchase, but it is usually possible to negotiate a relatively small deduction that is outweighed by the tax savings.

January 15, 2021