The Powerful Tax-Planning Strategy You've Probably Never Heard Of

By Gary Altman

Often overlooked, the Section 1202 Qualified Small Business Stock gain exclusion is a powerful tool that business owners should consider when starting a new business. In essence, Section 1202 allows individuals to avoid paying taxes on up to 100% of the taxable gain recognized on the sale of a Qualified Small Business Stock (QSBS) that was issued by a C-Corporation. Specifically, the owner of eligible QSBS stock can claim an exemption of the greater of $10 million dollars or 10 times the aggregate adjusted basis of the stock at the time of issuance. The former is nothing to sniffle at, and the implications of the latter are truly staggering.

As with anything, however, it is important to read the fine print.

In order for stock to qualify as QSBS, the following corporate criteria must be met:

1) Any domestic C-Corporation qualifies, other than certain limited exceptions (IC-DISC, former DISC, RIC, REIT, or cooperative). An S Corporation is not eligible, but an LLC that has elected to be taxed as a C-Corporation is.

2) $50 Million Gross Assets Limitation - at the time the QSBS stock is issued, the corporation must not have more than $50 million of tax basis in its assets. After issuance, this assessment is not reevaluated, even if the corporation's assets subsequently exceed $50 million.

3) Qualifying Types of Businesses - Not all businesses qualify, even if they are C Corporations. A non-exhaustive list of disqualified businesses are those where the principal asset is the reputation or skill of one or more of its employees, farming, mining, drilling, hotel, motel, restaurant, or business dealing with real estate or real property.

Additionally, the following individual criteria must be met:

1) Eligible Shareholder - Eligible shareholders are all non-corporate shareholders, including individuals, trusts, and estates. Members of an LLC can also qualify as eligible shareholders as the LLC is a pass through tax entity. Shareholders must have received stock when it was originally issued by the C-Corporation, received it via a gift or inheritance.

2) Holding Period - Stock must be held for a minimum of five years to qualify for QSBS treatment. The holding period starts on the date the stock was issued to the original shareholder.

3) Original Issuance of Stock - The stock must have been acquired on original issuance after August 10, 1993. This means that the stock must have been issued by the C-Corporation, not purchased from another shareholder.

In sum, the Section 1202 QSBS gain exclusion allows for significant tax savings for individuals holding qualified QSBS stock. The key is discovering ways to have multiple shareholders of the original qualified QSBS stock, usually through separate irrevocable trusts for each member of the family of the original shareholder. The Altman and Associates team is experienced in implementing estate and business succession plans that incorporate Section 1202 planning, whether the goal is to pass on already-issued QSBS stock to the next generation, or to facilitate the issuance of new QSBS stock.

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