Section 1202

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A. Sec. 1202(a) provides that gross income does not include 50% (75% or 100%) of any gain from the sale or exchange of qualified small business stock held for more than 5 years.

B. Investors must purchase stock in a regular C corporation with assets of $50 million or less directly from the company and sell more than five years later. If the stock is purchased after 8-10-1993 and before 2-18-2009, the exclusion is 50%. If the stock is purchased after 2-17-2009 and before 9-28-2010, the exclusion is 75%. If the stock is purchased after 9-27-2010, the exclusion is 100%.

    1. The 100% exclusion was made permanent in 2010.

C. The 50% and 75% exclusion requires that 7% of the excluded gain is a tax adjustment for the alternative minimum tax. Gain from the sale of Sec. 1202 stock acquired after September 27, 2010, is not subject to the AMT adjustment [Sec. 1202(a)(4)(c)].

D. The maximum amount of the exclusion from income is the greater of:

    1. $10 million reduced by the aggregate amount of eligible gain taken into account under Sec. 1202 for prior tax years attributable to stock in the corporation (cumulative limit), [Sec. 1202(b)(1)(A)] or

    2. 10 times the shareholder's basis in the stock that the taxpayer sold during the tax year (annual limit) [Sec. 1202(b)(1)(B)].

E. Tax Rate

    1. Any gain from the sale of Sec. 1202 stock that is not excludable under Sec. 1202 because the stock was acquired during a period where the applicable exclusion percentage was only 50% or 75% is subject to tax at a rate of 28% [Sec. 1(h)(7)]. Gain recognized upon the sale of Sec. 1202 stock because of the application of the cumulative or annual limit is not subject to the 28% rate.

F. Sec. 1202 Requirements

    1. The stock must be issued when the corporation is a C corporation, and the corporation must be a C corporation for "substantially all" of the shareholder's holding period [Sec. 1202(c)(2)(A)].

    2. The stock must have been acquired at original issuance in exchange for cash,

property, or the performance of services [Sec. 1202(c)(1)(B)].

3. From the date of the corporation's formation up to the moment immediately after the shareholder acquires the stock, the total assets -- the sum of the cash plus the adjusted tax basis of all other assets -- must be less than $50 million.

    a. In cases where the corporation receives assets as a contribution from a shareholder in exchange for stock, however, the contributed assets are counted towards the $50 million test at their fair market value, rather than their adjusted tax basis [Sec. 1202(d)(2)(B)]. In turn, solely for purposes of Section 1202, the shareholder's basis in the stock is equal to the fair market value of the contributed assets (as opposed to the adjusted basis of the assets, which is the normal rule under Section 358). This ensures that a shareholder can't convert pre-contribution appreciation into gain eligible to be excluded under Section 1202 upon the disposition of the stock.

4. The stock generally loses its Section 1202 status when it is transferred unless the transfer is tax free and by gift, by death, from a partnership to a partner, or a stock-for-stock transfer.

5. The corporation cannot be a specified service business, including any business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage, architecture, engineering, or any other trade or business where the principal asset of the business is the skill or reputation of the owner or employees.

6. 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 or Owners – The Treasury Department and the IRS believe that the “reputation or skill” clause as used in Sec. 199A was intended to describe a narrow set of trades or businesses, not otherwise covered by the enumerated specified services, in which income is received based directly on the skill and/or reputation of employees or owners.

7. Additionally, the Treasury Department and the IRS believe that “reputation or skill” must be interpreted in a manner that is both objective and administrable. Thus, Prop. Reg. 1.199A-5(b)(2)(xiv) limits the meaning of the “reputation or skill” clause to fact patterns in which the individual or relevant passthrough entity is engaged in the trade or business of:

    a. Receiving income for endorsing products or services, including an individual's distributive share of income or distributions from a relevant passthrough entity for which the individual provides endorsement services;

    b. Licensing or receiving income for the use of an individual's image, likeness,

name, signature, voice, trademark, or any other symbols associated with the individual's identity, including an individual's distributive share of income or distributions from a relevant passthrough entity to which an individual contributes the rights to use the individual's image; or

c. Receiving appearance fees or income (including fees or income to reality performers performing as themselves on television, social media, or other forums, radio, television, and other media hosts, and video game players).

8. A corporation that engaged in providing medical information to healthcare providers through its laboratory reports was a qualified trade or business for purposes of the qualified small business stock rules under Sec. 1202. Although valuable, the information did not provide healthcare professionals with any diagnosis or treatment recommendations for treating their patients as defined in the Sec. 1202(e)(3) exclusion [PLR 201717010].

G. Conversion of S Corporation to a C Corporation

1. The first requirement of a C corporation has huge implications when a shareholder intends to convert an S corporation into a C corporation by revoking or terminating the S election. Because the existing outstanding stock of the corporation was not issued while a C corporation, the stock will never be eligible for the benefit of Section 1202 upon sale. As a result, after revocation or termination of the S election, the now-C corporation would have to issue NEW shares of stock to the shareholders, who in turn would have to hold that stock for five years -- while meeting all of the other requirements for Sec. 1202 stock -- before the stock could be sold tax-free. This means that not only will none of the pre-conversion appreciation ever be eligible to be excluded under Section 1202, neither will any of the post-conversion appreciation on the shares that were issued while an S corporation. Only the post-conversion appreciation on the newly issued shares will enjoy the benefits of Section 1202.

2. Example: X Co. was formed in 2016 upon the issuance of 80 shares of stock to A in exchange for $10,000 in cash. A, the sole shareholder, made an S election for X Co. effective upon formation. A revokes X Co,'s S election effective January 1, 2020, when the value of the 80 shares is $800,000 and A's basis in the shares is zero. X Co. then issues 20 additional shares to A after the revocation in exchange for $200,000. In 2026, A sells all 120 shares for $5 million, at a time when A's basis in the stock remains a total of $200,000. The $4 million of gain attributable to the first 80 shares issued in 2016 is not eligible to be excluded under Section 1202, because the stock was issued when X Co. was an S corporation and can thus never be Sec. 1202 stock. The remaining $800,000 of gain ($1 million of allocable proceeds less $200,000 basis) attributable to the 20 shares issued while a C corporation, however, may be excluded in full in 2026 [Tony Nitti, Forbes].

3. Section 1202(g) provides that a pass-through entity may also hold Sec. 1202 stock, provided all of the requirements are met. In addition, for the owners of the pass-through entity to exclude their share of the pass-through entity's gain upon the pass-through entity's disposition of the Sec. 1202 stock, two additional requirements must be met:

    a. The owners of the pass-through entity must hold an interest in the entity from the time the entity acquires the Sec. 1202 stock through the date of disposition, and

    b. Each owner may only exclude the gain up to their share of the gain on the date the pass-through entity acquired the stock. Thus, if an owner's share of the pass-through entity increases during the entity's holding period of the Sec. 1202 stock, the amount of the exclusion is limited to the owner's share of the business on the date of acquisition of the Sec. 1202 stock.

4. Example. In the previous example, instead of simply revoking X Co.'s S status effective January 1, 2020, on that date, X Co. contributed its assets to a newly formed C corporation, Y Co., in exchange for 80 shares of Y Co. stock. At that time, the assets are worth $800,000, X Co. takes a basis in the Y Co. stock of $800,000 for purposes of Section 1202. The Y Co. stock was acquired by X Co. at original issuance, and the value of Y Co.'s assets are well less than $50 million, so all initial requirements are met for eventually qualifying the 80 shares of Y Co. stock held by X Co. as Sec. 1202 stock.

    In 2026, X Co. sells the 80 shares of Y Co. stock for its value of $5 million, when the basis of the shares remain $800,000 for Section 1202 purposes. Thus, X Co. recognizes $4.2 million of gain, which is all passed through to A, and under Section 1202(g), A is entitled to exclude the full amount of the gain.

H. Tax Planning

1. With the TCJA reducing the corporate tax rate to 21% and Sec. 1202 offering a 100% exclusion upon the sale of Sec. 1202 stock, should businesses be established as C corporations?

2. Owners of sole proprietorships, partnerships, and S corporations are subject to only a single level of tax as high as 37%. The 20% QBI deduction reduces the top rate of passthrough income to 29.6% (37% - (20% x 37%)). The imposition of double taxation of C corporation income amounts to an effective tax rate as high as 39.8% (21% + (1 - .21%) x 23.8%).

3. If a business can be structured to qualify for the benefit of Sec. 1202, paying higher taxes in early years can be overcome by excluding the gain under Sec. 1202.

a. Example. Bill, in the 37% tax bracket, is planning to form a new business in which he will invest $50,000. Bill expects the business will earn $100,000 net income in each of the next five years, which will be withdrawn as a distribution. Bill expects the business will be worth $1.5 million after five years.

If the business is formed as a passthrough entity, Bill will qualify for the full QBI deduction. If the business is formed as a corporation, the corporation would meet the definition of Sec. 1202 stock.

b. Taxation as Passthrough vs. C Corporation

	Passthrough	C Corporation
Tax on Year 1-5 income of $500,000	$148,000	$105,000
Tax on year 1-5 distributions ($500,000 in the case of a passthrough business; $395,000 in the case of a C corporation)	N/A	$ 94,010
Total tax on income/distributions	$148,000	$199,010
Tax on gain from sale of business of $1,450,000 ($1.5 million value less $50,000 stock basis)	$ -0-	$345,100
Total tax over life cycle of business	$493,100	$199,010

1) Retaining Earnings

a) Retaining some or all of the earnings of a corporation will make the C corporation even more beneficial assuming the selling price is increased for the retained earnings.

4. Sec. 199A and Sec. 1202

a. If a high income owner of a service business does not qualify for the Sec. 199A deduction, the entity formed as a corporation will not qualify for the Sec. 1202 exclusion.