

# What is Section 1202?

## Understanding the Small Business Stock Gains Exclusion

Created in 1993 by the United States Congress, the exclusion was designed to encourage investment in domestic small businesses. **Section 1202** is a provision in the U.S. tax code that allows investors who took a risk on investing in a small business to be exempt, or “excluded”, from paying taxes on any capital gains realized on that stock.

### So, how does the exclusion work?

Regular investors (not companies) are exempt from paying taxes on somewhere between 50% and 100% of capital gains realized from the sale or exchange of “qualified small business” stock. Stock must have been purchased after August 10, 1993; if the stock was acquired after late 2010, it must have been held for 5 years for the exclusion to kick in.

The exclusion can be used whether the taxpayer pays regular taxes or is subject to the AMT (alternative minimum tax). There is a limit on eligible gains of the greater number of \$10 million USD or 10x the taxpayer’s cost basis in the stock of the qualified small business from which they would be receiving the exclusion.

### What Qualifies for Exclusion?

“Qualified small business stock” must be issued by a small business that meets the following criteria:

- ✓ Gross assets were under \$50 million around the time stock was issued;
- ✓ Categorized for tax purposes as a domestic C-corporation;
- ✓ At least 80% of its assets must have been used in active trade or business;
- ✓ An active trade or business can include: legal, financial, engineering, architecture, or actual services, artistic or athletic performance or lessons, running a hotel, restaurant, etc.

Only a regular US taxpayer who acquired the stock when it was originally issued by a qualified small business is eligible (corporations who bought in are not).

#### FOR EXAMPLE:

A taxpayer owns a small business along with a few partners. In 2012, the partners decide to issue stock. This taxpayer is issued stock valued at \$5,000,000. In 2019, the taxpayer decides to sell the stock, which is now valued at \$6,000,000. The capital gains tax rate for this taxpayer’s tax bracket in 2019 is 20%.

Without the exclusion, the taxpayer would pay a tax of 20% of the \$1,000,000 gain upon the sale, or \$200,000. If the taxpayer qualifies for the exclusion, they save the \$200,000. Remember, there is a limit to the potential gains, but that limit is not reached here.

Because the taxpayer is also an owner of this small business, they will benefit from: (1) an accelerated depreciation deduction allowed for businesses invested in tangible property, and (2) the current corporate tax rate of 21% which is lower than the previous rate of 35%. Combining the Section 1202 exclusion allows this taxpayer to shield the gains on the sale of his stock from taxable income, with the lower corporate tax rate and depreciation deduction, shaving a significant amount off their tax bill.

*The information provided above is to be used as a summary document. There may be additional rules and limitations, variable by circumstance.*



350 N. Orleans, #9000n, Chicago, IL 60654  
Phone: (847) 234-9000 | Fax: (847) 234-9008  
info@pasquesipartners.com  
www.PasquesiPartners.com



**FOUNDER TAX**

Sign up for FREE tax tips, due date alerts, and tax planning checklists at [FounderTax.com](https://www.FounderTax.com).