Why & How IRS IRC §1202 enables the Tax-Free sale of a Qualified US Business

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By Howard Francis, Author of several Books

1. **True or False?** Each qualified business owner does not pay any tax on their first $10 million of sales proceeds in a business sale? **True if you use** §1202 it does not matter if it is an asset or a stock sale.

2. **True or False?** Qualified Investors and business buyers do not pay any capital gains taxes until their return in a sale or investment exceeds 1,000% (10X) of their original investment? **Also True using §1202.**

In order for a Buyer or Investor to acquire **§1202 status** the original sale had to be a stock sale and 5 years must pass from the date of that stock purchase to become QSBS eligible.

Example: A private equity firm bought / invested in a company for $20 million, and over the next 6 years the value of their shares increase in that company to $220 million. Using QSBS they would pay NO taxes on a sale. Taxes would only begin to be calculated after the first $220 million of sales proceeds.

Let us now verify that the two True or False bullets above are valid using two of the most credible 3rd party sources available.One is an article published on the *American Bar Association* website written by two attorneys one of which is affiliated with Ernst & Young and the other *Bloomberg Tax.*

American Bar Association website article *"Section 1202: A Big Deal for Small Business"*

Published August 3rd, 2018

To verify quote below click here Scroll down to page 2, part B.

"***B. Limitations on Gain Exclusion***

The statute limits the per-issuer amount that can be excluded to "eligible gain," which is the greater of:

1) *$10 million reduced by any amount the taxpayer excluded from sales or exchanges of QSBS from the same issuer in prior years, or*

2) *10 times the aggregate adjusted basis of the QSBS issued by the corporation disposed of by the taxpayer during the taxable year, as measured on the original issue date."*

Bloomberg Tax article *"IRS IRC §1202 enables the Tax-Free sale of a qualified US Business"*

Published March 5th, 2018. 12 page PDF has 123 footnotes referencing the IRS's tax code.

To verify quote below click here go to page 1 paragraph 1 and 2.

- Bloomberg Tax has 1,400 employees and is a subsidiary of Bloomberg L.P and is one of the most respected sources of legal, tax, regulatory, and business information for financial professionals.

"Section 1202 was enacted in 1993 and generally provides non-corporate taxpayers with an exemption from federal income tax for eligible gains from the sale of qualified small business stock in subchapter C corporations held for more than five years. As described in more detail below:

1) *The 1202 exemption generally is limited to the greater of $10 million per taxpayer, or*

2) *10 times the taxpayer's original adjusted tax basis in the 1202 stock."*

The 6 Major Benefits QSBS Provides American Families

1. Have a 401k or mutual fund? There are companies in it which owe their success to venture capitalists.

America's venture capitalists and angel investors are the envy of the world for creating wealth by discovering new business ideas and technologies. They fund these embryonic businesses and build companies around these innovators. If they go public, your 401k and mutual funds benefits.

2. In contrast to entrepreneurial America, in Europe they have a less business friendly approach. In Europe most financing for business is provided by banks and then government. In America it is wisely private money. Who would you bet on to help grow a winning small business or start up? A seasoned, successful business owner with skin in the game and decades of relevant expertise, or a banker?

3. When someone aged 50 to 70 sells their business they generally retire. The influx of additional millions of dollars from a sale using QSBS often benefits their extended family and friends. This manifests itself in new mortgages for home buyers, education, vehicles, daycare. The extended family improves its quality of life since the business seller can pay for daycare, have more frequent and better family get togethers, offer better healthcare and dental etc. to family members.

4. Too often male business owners have not done the appropriate estate planning or the asset and creditor protection their family requires for generational security.

5. Most California families lack the asset & creditor protection required for a stress-free retirement.

    A) In California, according to *CA Civil Procedural Code. §704.730,* $75,000 of the equity in a home is exempt from creditors if you are married and if you are married and a senior it is $150,000.
    B) According to *CA Civil Procedural Code.* §704.100, only $9,700 of the cash values in a life insurance policy are protected from creditors if you are single and $19,400 if you are married
    C) Whereas, in Florida 100% of both the equity in a home (Fla. Const. Art. X, §4, Fla. Stat. Ann. §§222.01 & 222.02) and the cash values in a life insurance policy (Fla. Stat. Ann. § 222.14) are fully protected from creditors. Texas offers the same creditor protection.

6. Angel investors invest both their time and money into small business and get involved before venture capitalists. QSBS allows a greater number of successful business owners to become angel investors since more businesses are sold and the seller nets more money than they otherwise could as a result of paying less taxes. Increasing the number of angel investors is great for America's long term economic vitality, competitiveness and success.

Which 24 business activities DO NOT qualify for QSBS, (there is no work around)

- Listed below are 24 business activities which DO NOT Qualify for QSBS.
- Any combination of these 24 business activities may not exceed 20% of your total business activity in order for your business to become

The 24 business activities which are ineligible for QSBS are:

- health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services,
- or any other trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees.
- banking, insurance, leasing, financing, investing, or similar business;

- any farming business (including the business of raising or harvesting trees);

- any business involving the production or extraction of products of a character for which percentage depletion is allowable under section 613 or section 613A (i.e., oil or gas properties subject to depletion); or any business of operating a hotel, motel, restaurant, or similar business.

Additionally, the business must be an "eligible corporation," and such also <u>excludes:</u>

- a DISC (a domestic international sales **corporation**),

- a corporation that either has a §936 election in effect or one of its subsidiaries does,

- a regulated investment company, REIT, or REMIC, or
- a cooperative.
- In Alabama, California, Mississippi, Pennsylvania and Wisconsin do not follow federal QSBS guidelines and attorneys can make that irrelevant as well.

If it is free to find out what you don't know that can save you millions of dollars why wouldn't you?

THE END