

Overview of Section 1202

The overall purpose of Section 1202, or the qualified small business stock (QSBS) gain exclusion, is to encourage investment in qualified small businesses (QSB). When properly taken advantage of, Section 1202 creates significant tax benefits for investors and founders. Additionally, recent amendments to Section 1202 have eased the requirements and increased the potential available benefits.

Potential Tax Benefits

Generally, the capital gain on the sale of QSBS is subject to a 23.8% tax. However, Section 1202 allows shareholders to exclude up to 100% of the tax on the gain.

The maximum available tax benefit is determined by the date the qualified stock was issued. The allowed gain exclusion for stock issued after July 4, 2025 is the *greater* of either (1) \$15 million (indexed for inflation) or (2) 10 times the aggregate adjusted basis of the stock. This is an increase to the previous cap. For stock issued on or before July 4, 2025, the gain exclusion is capped at the greater of (1) \$10 million (not indexed for inflation) or (2) 10 times the aggregate adjusted basis of the stock.

Section 1202 Requirements

The biggest challenge of the Section 1202 tax benefit is figuring out and complying with the requirements necessary to qualify. Below is a discussion of four of the basic requirements to help you in determining whether you qualify¹:

- **Be an eligible business.** An eligible business includes almost any domestic C corporation (but not an S corporation) or an LLC that has elected to be taxed as a C corporation.
- **Engage in a qualified trade or business.** A “qualified” trade or business includes any trade or business except those explicitly listed in Section 1202(e)(3).

Trades and businesses that do not qualify include:

- **Personal services** in which the “trade or business is the reputation or skill of 1 or more of its employees,” such as health, law, engineering, architecture, etc.²;
 - **Financial services**, including banking, leasing, or investing;
 - **Farming businesses**;
 - **Hospitality services**; and
 - **Mining**.
- **Be within the asset threshold.** In order to be recognized as a QSB under Section 1202, a business must not exceed the applicable aggregate gross assets limitation. For stock issued after July 4, 2025, the applicable aggregate gross assets limit is \$75 million. For stock issued on or before July 4, 2025, the applicable aggregate gross assets limit is \$50 million. A business’ aggregate gross assets are evaluated at the time of each stock’s issuance. This means that the business cannot have had more than the applicable limit (\$75 million or \$50 million) of tax basis in its assets at the time the specific stock was issued. An increase in the business’s assets outside of the threshold after the qualified stock has been issued will not disqualify the stock.
 - **Hold the stock for the required period.** The required holding period depends on when the qualified stock was issued.
 - For stock issued after July 4, 2025, Section 1202 provides for partial gain exclusion when the QSBS is held for at least three years and complete gain exclusion at five years:
 - 100% gain exclusion for stock held at least five years;
 - 75% gain exclusion for stock held at least four years; and
 - 50% gain exclusion for stock held at least three years.
 - For stock issued between September 27, 2010 and July 4, 2025, the gain exclusion is only allowed for QSBS held at least five years.
 - For stock issued prior to September 27, 2010, lower gain exclusions apply.

Set it up Right & Early

A lot of businesses unintentionally disqualify themselves from being able to access Section 1202. To avoid making the same mistake, remember to:

- **Set up your C corporation early and properly.** Failing to properly register as a C corporation will disqualify you. While converting to a C corporation at a later date is possible, the delay will disqualify any stock already issued by the business and delay your ability to access the benefit for any newly issued stock for at least three

years (the minimum required holding period for partial exclusion) after the date of conversion.

- **Plan out when to issue stock to ensure it is qualified stocks under Section 1202.** Avoid issuing stock if you are not within the asset threshold at the time.
- **Hold the qualifying stock for at least three to five years, depending on the acquisition date.**
- **Reach out to your tax advisor to ensure you meet all the requirements.**

Section 1202 is one of the most valuable tax benefits available to shareholders, but only if you are proactive in making sure you qualify.
