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Section 1202 provides a tax break for qualified small business stock (QSBS) by allowing shareholders to avoid paying up to 100% of the tax on the capital gain on the sale of QSBS. This capital gain would otherwise be subject to a 23.8% tax, so the potential tax savings are significant. For a more in-depth discussion of the benefits and requirements of Section 1202, see *The Qualified Small Business Stock Gain Exclusion (Section 1202) – Benefits, Requirements, and Trends*.

In order to qualify, the issuer of the qualifying stock must be a domestic C corporation. As such, shareholders of S corporations do not qualify unless the S corporation is converted to a C corporation. The remainder of this article will discuss several important aspects to consider when discussing whether to convert to a C corporation in order to qualify for the Section 1202 tax benefit.

Converting from an S corporation to a C corporation

There are two basic requirements to convert from an S corporation to a C corporation:

- **File a statement with the IRS to revoke the S corporation election.** In order to register as an S corporation, a business must file an election (Form 2553) with the IRS. To convert, the S corporation must file a revocation statement with the IRS office in which it previously filed its election. The revocation statement must include (1) a statement revoking its prior election, (2) personal information of shareholders, (3) the number of shares owned by the shareholders, and (4) a signature of a person authorized to sign tax returns for the corporation.
- **Get the signed consent of a majority of the shareholders.** Revocation requires the consent and signature of shareholders who collectively own more than 50% of the corporation. This must be submitted with the statement.

The S-Corp may specify a future effective revocation date in the revocation letter. Absent a specified date, if the revocation statement is filed by the 15th day of the third month of the corporation's current tax year, the revocation becomes retroactively

effective as of the current tax year. However, if the revocation statement is filed after the 15th day of the third month of the corporation's current tax year, the revocation date is the first date of the next tax year.

Timing Considerations

There are two key timing factors that will impact how soon you may be eligible for the tax benefit after conversion: when the qualifying stock was issued and how long the qualifying stock must be held.

- Qualifying stock under Section 1202 includes only stock issued as new shares *after* the S corporation has been converted to a C corporation. This means any stock issued while still an S corporation will not qualify. If you do decide to convert, you should do it quickly to ensure that any new stock issued is eligible.
- Once acquired, the qualified stock must be held for at least five years to be eligible for 100% gain exclusion. However, you are still eligible for a 75% gain exclusion for stock held for four years and 50% for stock held for three years.¹ Again, the sooner you acquire qualified stock, the sooner you will be eligible under Section 1202 because the holding period will begin to run.

Potential tax consequences of conversion

Converting from an S to C corporation will result in tax consequences. It is important to consult with your tax advisor to determine whether the potential Section 1202 tax savings outweigh those consequences. Below are four potential tax consequences to consider.

- **Taxation of distributions to shareholders.** Distributions to shareholders of an S corporation are generally not taxed. However, distributions to shareholders of a C corporation are generally taxed at a rate of 23.8%.
- **Double taxation.** The taxing structure of C corporations means that dividends distributed to shareholders and capital gains on stock not eligible for gain exclusion are subject to double taxation. Both a 21% corporate tax on the corporation's income and a 23.8% federal tax at the individual level apply.
- **Potential for higher total tax as a C corporation.** If the Section 1202 tax savings do not apply (meaning the 23.8% tax applies to the gain) and the earnings are distributed to shareholders, the double taxation will most likely result in a 10% increase to the annual total taxes that would have been paid if the entity had remained an S corporation.
- **Lower tax on retained earnings at the corporate level.** A potential benefit of conversion to a C corporation is that lower corporate tax rates apply to retained

earnings, so corporations that plan to reinvest profits will be taxed at a lower rate than the applicable S corporation tax rate for profits that pass through to the owners.

Non-tax consequences of conversion

The following are a few non-tax issues to consider before converting. Like the tax consequences, these potential issues should be discussed with your attorney and tax advisor.

- Converting to a C corporation does not automatically qualify you for the Section 1202 QSBS gain exclusion. For example, Section 1202 also requires that the C corporation be engaged in a qualified trade or business and be within asset thresholds.
- C corporations are generally more flexible (e.g., more capital-raising options, no limit on the number and type of shareholders, permitted to issue multiple classes of stock).
- The non-tax goals of a corporation are also relevant in determining whether an S or C corporation is more appropriate. Specifically, whether there are any future plans to sell the entity will be relevant.

Be sure before converting, but don't ignore Section 1202's potential benefits

After an S corporation revokes its election, the corporation will generally not be eligible to convert back to an S corporation for five years. Further, if the corporation converts back after the five-year period, it may also be subject to penalty taxes. Because of this restriction and possible penalties, converting without fully consulting your attorney and tax advisor regarding all potential consequences (including those that may not have been raised here) is strongly advised against.

Notwithstanding the potential consequences and warnings addressed here, the tax benefits of being a qualifying C corporation under Section 1202 are certainly substantial enough that any potentially qualifying S corporation should at least consider such a conversion.
