# Planning for the Potential Reduction in Section 1202's Gain Exclusion

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On September 13, 2021, legislation emerged from the House Ways and Means Committee that included an unexpected amendment to Section 1202, reducing its gain exclusion percentage to 50% from 100% for trusts and estates, and individuals with adjusted gross income (AGI) of $400,000 or more.[i]

On October 28, 2021, a beaten up and slimmed down Build Back Better Act (the "Biden Act") was repackaged and reintroduced, with President Biden releasing a White House briefing statement addressing what remained of the original $3.5 trillion spending (and funding) proposal after "negotiating in good faith with Senators Manchin and Sinema." In concert, the House Rules Committee released the text of the proposed tax legislation [Subtitle G — Responsibly Funding Our Priorities]. The Biden Act retained the amendment to Section 1202, but significantly reduced the reach of the remaining revenue-raising tax legislation.

This article updates our September 16th analysis of the potential impact of the amendment to Section 1202, focusing on business owners who already hold QSBS and those who are considering selecting the C corporation as their entity choice.

### Assessing the anticipated reduction in Section 1202's percentage gain exclusion

Congress noted in 1993 that Section 1202's gain exclusion was intended to "encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing." When the percentage gain exclusion was increased to 100% in 2010, Congress noted that the "increased exclusion and the elimination of the minimum tax preference for small business stock will encourage and reward investment in qualified small business stock."

On September 13, 2021, President Biden reversed this course by introducing the "Build Back Better Act," which included an amendment to Section 1202(a) eliminating the 75% and 100% gain


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exclusions for trusts and estates, and individuals with AGI of $400,000 or more. Stockholders would still be eligible to qualify for the 50% gain exclusion. The amendment to Section 1202 would be effective for sales and exchanges of QSBS occurring on or after September 13, 2021, subject to a binding contract exception for contracts in effect prior to September 13, 2021.

The proposed reduction of Section 1202's benefits is one of several revenue-raising amendments to the tax code included in the Biden Act. Other relevant proposed changes to the tax code and modifications from the original bill introduced on September 13th include: (i) the extension of the Obama 3.8% passive investment income surtax to active business income for business owners whose AGI exceeds $500,000 (for a married couple); (ii) the addition of a 5% surtax on an individual's income exceeding $10 million, along with an additional 3% surtax on income exceeding $25 million; and (iii) the addition of a 5% surtax on a trust's income exceeding $200,000, along with an additional 3% surtax on income exceeding $500,000. Significant modifications to the Biden Act from the version originally introduced on September 13th include no change to the 21% corporate tax rate, the 20% capital gains rate and the 37% individual tax rate.[ii]

### Potential impact of the Biden Act for holders of QSBS[iii]

For sales prior to September 14th, a stockholder selling non-QSBS and realizing a $10 million gain would owe $2,380,000 in Federal income tax (20% capital gain plus 3.8% investment income surtax). If that same stockholder sold QSBS, he would owe no Federal income tax.

For sales after September 13th, a stockholder selling non-QSBS and realizing a $10 million gain would still owe $2,380,000 Federal income tax. If that same stockholder sold QSBS, he would now owe $1,688,000 in Federal income tax.[iv]

As the example above illustrates, the reduction in Section 1202's benefits is significant for taxpayers whose AGI exceeds the $400,000 threshold — a reduction of $1,688,000 in tax savings on $10 million in gain realized on the sale of QSBS. For sales after September 13th, the spread in the aggregate tax rate between the


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sale of QSBS and non-QSBS is 6.92% (down from 23.8%), resulting in a $692,000 tax savings when a stockholder has a $10 million gain from selling QSBS. If the stockholder's modified adjusted gross income (MAGI; this includes the gain realized from the sale of QSBS) exceeds $10 million, he will be subject to a new 5% surtax, and if his modified AGI exceeds $25 million, he will be subject to an additional 3% surtax (i.e., a combined 8% aggregate surtax) on his MAGI in excess of those thresholds. For high-income stockholders subject to these surtaxes, the aggregate tax rate spread between the sale of QSBS and non-QSBS will widen to a very meaningful 8.92% or 10.92%.[v]

Based on the potential tax savings outlined above, we believe that if a corporation has issued QSBS, it will continue to remain mindful of Section 1202's eligibility requirements and take reasonable steps to maintain QSBS status. On the other hand, one potential impact of the reduced rate spread between QSBS and non-QSBS might be that the business owners will be more likely to take advantage of the currently favorable M&A climate or an attractive offer, regardless of whether their stockholders have satisfied Section 1202's five-year holding period requirement.

### Updated factors to consider when engaging in choice of entity planning

The benefits of Section 1202 are only available if the issuer of QSBS is and remains a C corporation. After the 100% gain exclusion for QSBS was introduced in 2010, planning to take advantage of Section 1202's benefits has represented a significant factor in the choice of entity planning, which has also generally involved comparing the relative benefits of pass-thru entities (i.e., LLCs taxed as partnerships and S corporations) and C corporations.[vi] The substantial reduction in Section 1202's benefits will undoubtedly move the dial away from the C corporation. But what we also know today is that the extremely attractive 21% corporate tax rate will not be increasing as part of the Biden Act, and that business owners operating through a pass-thru entity will be exposed to an additional 3.8% business income surtax, and potentially the 5% surtax on MAGI exceeding $10 million and the 3% surtax on MAGI exceeding $25 million. These factors favor selecting the C


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corporation as the entity choice. On the other side of the equation, the abandonment of the proposed increases in the capital gains and individual tax rates, along with the other traditionally understood benefits of operating through a pass-thru entity, will continue to favor pass-thru entity as a competitive alternative to the C corporation. This brief look at the potential impact of the Biden Act changes suggests that when engaging today in a choice of entity planning, it will be important to take a fresh look at the reshuffled mix of tax and business factors.

In spite of the reduction in Section 1202's benefits, it is important to note that there will continue to be strong business candidates for operating through the C corporation among closely-held businesses. Many start-ups intending to obtain capital through the venture community will automatically default to selecting C corporation. If a business can issue QSBS, avoid double taxation and the accumulated earning tax by reinvesting revenues in growth and additional activities, and eventually engineer a successful exit through a stock sale or IPO, that business will remain an attractive candidate for the C corporation. Based on perhaps a way to early prediction, we believe it is possible that despite the changes to Section 1202, the Biden Act's mix of tax law changes that made the cut and those that were left behind could incrementally tip the scale towards selecting the C corporation as the entity of choice. Of course without a doubt, many main street businesses will continue to identify business and tax reasons for operating through LLCs and S corporations. Finally, in the category of anything can happen, we note that future tax legislation could reverse the Biden Act's changes to Section 1202 or increase the capital gains rate, either of which would potentially increase the value of holding QSBS and selecting the C corporation.

### More resources

In spite of the potential for significant tax savings, many experienced tax advisors are not familiar with Sections 1202 and 1045 planning. Venture capitalists, founders and investors who want to learn more about Sections 1202 and 1045 and related planning opportunities are directed to several articles on the Frost Brown


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Todd website:

- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202

Contact Scott Dolson if you want to discuss QSBS issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[i] References to "Section" are to sections of the Internal Revenue Code. Under current law, QSBS issued from August 11, 1993 to February 17, 2009 qualifies for a 50% gain exclusion, QSBS issued from February 18, 2009 to September 27, 2010 qualifies for a 75% gain exclusion, and after September 27, 2010 qualifies for a 100% gain exclusion. A stockholder's AGI includes gain realized from the sale of QSBS and non-QSBS.

[ii] The references to rates are to the highest applicable rates.

[iii] This discussion assumes that the relevant tax code amendments included in the Biden Act will be enacted into law.

[iv] For simplicity sake, the example assumes that the $10 million in gain realized on the stock sale is the stockholder's only income. The calculation of taxes applying to the sale of QSBS after September 13th assumes that the 3.8% investment income tax will apply against the 50% of QSBS gain not excluded by Section 1202. Further, Section 1(h)(4) provides that the 50% portion of QSBS sales gain not excluded is taxed at a 28% rate. Finally, the example assumes that the taxpayer selling QSBS beginning on September 14th will be subject to the 28% alternative minimum tax (AMT), with Section 57(a)(7) providing that 7% of the excluded gain (i.e., the $5,000,000 excluded portion) is an AMT preference item. Because it is assumed that the taxpayer's adjusted gross income (AGI) is only $10 million,


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the example excludes the impact of the proposed 5% surtax on income exceeding $10 million and the additional 3% surtax on income exceeding $25 million.

[v] The percentage spread cited assume that the high income taxpayer would be subject to the 5% and 3% surtax on 100% of the capital gains from the sale of non-QSBS and 50% of the gain on the sale of QSBS. It is possible that a taxpayer's aggregate MAGI, adjusted for the Section 1202 gain exclusion, would take the stockholder below the thresholds for either the 5% or 3% surtax. This discussion does not take into account the possibility of an additional tax savings at the state level.

[vi] Sometimes S corporations are also considered, although the limitations on classes of stock and limitations on shareholder eligibility severely restrict the universe of businesses that could effectively operate through an S corporation.

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