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## 1202 Stock

### Qualified Small Business Stock; A Golden Opportunity for Investors & Entrepreneurs

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Since the August 10, 1993, investors in **Qualified Small Business Stock (QSBS)** could exclude half the gain on the sale of this stock if it was held for more than 5 years.....up to \$10 million or 10 times cost basis (whichever is greater)! **QSB's** (described later in this article) are certain businesses formed after August, 1993 having less than \$50 million in total assets. Over the years, portions of the excluded gain were subject to Alternative Minimum Tax (AMT), thus few sellers of this stock received the potentially huge tax savings which one should expect if he (she) was excluding \$10 million or more from income. Over the years we have assisted founders and "Angel" or "family and friend" investors plan for these gains which usually occur when a company is sold or goes public. That darn AMT always gets in the way!

**This is huge!** For a 460 day period commencing September 28, 2010 and ending December 31, 2011, those who invest in QSBS and hold that stock for five years get to exclude 100% of the gain up to \$10 million, or 10x investment and the AMT does not apply! This was included in the last two stimulus packages.

I recall when Alice Cooper and David Bowie packaged their copyrights in companies they took public. They made a fortune! If I thought my garage band had commercial potential, I'd incorporate before year end to take advantage of this tax windfall!!

Seriously, this is a phenomenal opportunity! Inventors, R & D companies and others with a new idea or product should consider setting up a new qualifying corporation before the end of the year. Likewise, Angel investors and others, willing to invest in high risk investments like start ups and small businesses should seriously consider closing a deal by 12-31-11! It also appears that employees of qualified small business corporations could exercise stock options and take delivery of the stock certificates by year end. It doesn't have to be a new company, just one formed after August 10, 1993 which is issuing stock directly to the investor after September 27 and before January 1, 2012. Individuals and, under certain circumstances, LLC's, Partnerships and S Corporations are eligible shareholders.

My mind has been grinding on this ever since I saw it for creative ways to utilize this opportunity. One that came to mind is a business which will eventually be sold as a business unit verses an asset sale. If you have a qualifying small business that is going to pass to the next generation or, perhaps be sold to employees or competitors, and that business is presently an LLC, partnership or sole proprietorship, consider incorporating that business before 12-31-11. Issue stock and that stock will be eligible for the 100% exclusion, the stock issued upon the "incorporation" would be eligible based on the holding period from the time the 1202 stock is issued for the exclusion; however the basis is computed under complex rules and a different holding period. Consult with your tax advisor.

These are extremely complex transactions. If you want to take advantage of this opportunity and have identified a deal, and completed your due diligence review, talk to your tax professional soon. You will need significant time to complete the deal.

Here are a few details:

First, this is a shareholder, not a corporate level limitation. That means if there are 100 shareholders, each can take advantage of the up to \$10 million or 10x investment (whichever is higher) exemption.

The following example illustrates the benefit of this 460 day tax window over the old (and future) law as it was in December, 2009:

	Old Rules 2009	"95 Day Window" Rules	
	(acquired before 12/17/09)	(acquired 9/28/10- 12/31/11)	Difference
Net QSBS Gain	\$ 4,000,000	\$ 4,000,000	
Exclusion	(2,000,000)	(4,000,000)	
Other Income	<u>411,717</u>	<u>411,717</u>	
Adjusted Gross Income	\$ 2,411,717	\$ 411,717	
Deductions:	<u>394,355</u>	<u>429,095</u>	
Taxable Income	<u>\$ 2,012,496</u>	<u>\$ (22,244)</u>	
Federal Tax	\$ 685,354	\$ 73,166 *	
State Tax	<u>256,321</u>	<u>25,965</u>	
Total Tax:	<u>\$ 941,675</u>	<u>\$ 99,131</u>	<u>\$ 842,544</u>
Percent of Gain			<u>21.06%</u>

\* This is AMT; with proper planning could be reduced

Please let me know if you were able to take advantage of opportunity. I would get a great deal of satisfaction knowing that by providing this information I was able to help someone outside the beltway take advantage of this great tax break!

Here are the rules regarding QSB's. These are somewhat oversimplified. I strongly urge you to get professional help if you are going to pursue this opportunity!

## Requirements

### Qualified Small Business (QSB) stock under section 1202(c):

1. The stock was originally issued after August 10, 1993.
2. The corporation issuing the stock meets the C corporation requirements.
3. The stock satisfies the original issuance requirement.
4. The corporation issuing the stock satisfies the QSB requirement.
5. The corporation issuing the stock satisfies the **active business** requirement.

### Qualified Small Business (QSB) requirement:

Only a domestic C corporation is eligible, if such a corporation meets a pair of gross asset tests:

1. The aggregate gross assets of the corporation must not exceed \$50,000,000 at any time on or after August 10, 1993 and before the sale of the stock.
2. Immediately after the issuance, the aggregate gross assets of the corporation must continue to be no more than \$50,000,000.

The corporation **cannot** be a:

1. Domestic international sales corporation or former DISC
2. Regulated investment company (RIC)
3. Real estate investment trust (REIT)
4. Real estate mortgage investment conduit (REMIC)
5. Cooperative
6. Corporation electing the Puerto Rico and possessions tax credit or having a direct or indirect subsidiary so electing
7. Professional service business
8. Financial service business
9. Farm business
10. Natural resource producer
11. Banking, insurance, financing, leasing, investing, or similar business
12. Hotel, motel, restaurant business
13. Possibly others, check section 1202 re: your business and contact your tax advisors.

This is probably that *once in a lifetime opportunity* for those few people who can take advantage of it. If you own or are starting or investing in a qualifying small business which will gain value over the next five or more years and provide the opportunity to sell the stock at a significant profit, this one's for you!