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Section 1202: **An Opportunity for Investors to Save Millions in Taxes**

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In baseball, the expression "a walk is as good as a hit" connotes smart logic. Employing that same logic to the world of tax, we believe Section 1202 is a home run.

With careful tax planning, Section 1202 of the Internal Revenue Code[1] (the "Code") can save sellers millions in taxes by **excluding up to $500 million in capital gains** from taxation upon the sale of Qualified Small Business Stock ("QSBS"). Despite such an extraordinary benefit available to individuals invested in private equity firms or founder-owned businesses, this Code section is commonly characterized as "underutilized." Why is this the case? Based on our advisory experience in connection with hundreds of transactions per year, we believe there are three reasons: a) Section 1202 requires precise planning and identification of opportune situations; b) there is a default preference (or convention) for pass-through entities in investment structures instead of taxable C corporations; and c) tax practitioners are generally consulted too late (or not at all) to provide meaningful advice.

This article's objective is to provide an overview of Section 1202 and its authors strongly encourage Houlihan Lokey clients to consider incorporating Section 1202 into their arsenal of tax-saving strategies. This article is a mere conversation-starter, and our clients should not hesitate to reach out to their respective Houlihan Lokey contacts to gauge if Section 1202 can be either implemented in structuring new investments or applied to existing investments.

Section 1202 May Provide More Savings in a Post-Election Landscape

Up to $500 million in gain can be excluded from capital gains taxes under Section 1202.[2] Assuming a current 20% capital gains rate, approximately $100 million in federal taxes can be saved with a stock sale that qualifies for Section 1202 treatment. If capital gains rates under a Biden Administration increase to 37%, approximately $185 million in taxes would be saved.[3]

With tax savings of this caliber under either scenario, can an investor or founder stomach a C corporation in their structure? Should they "reverse-engineer" investments to ensure Section 1202 treatment?

Some private equity firms and founders may logically view C corporations as inherently tax-inefficient and avoid them in their structures and businesses, due to taxation at the entity level and subsequent taxation imposed upon dividends received.[4] Why entertain a C corporation subject to a 21% statutory federal tax rate when a partnership or S corporation will pay no entity-level tax? The real answer varies by the facts and circumstances of each business, and the motivation to find the answer—and continue reading this article—is potential tax savings at exit. As demonstrated on the next page, there may be situations where the resultant taxation (while operating as a C corporation) is far less than the taxes saved under Section 1202 upon a business sale.

(1) All section references in this document are to the Internal Revenue Code of 1986, as amended, and regulations thereunder.

(2) The amount that may be taken into account for purposes of the exclusion is subject to a limitation equal to the greater of $10 million (less previously excluded gain attributable to the disposition of other shares issued by the company) or 10x the aggregate adjusted basis of the shares.

(3) $500 million x 37% = $185 million. Please visit our prior piece regarding Biden's proposed tax plan to increase tax rates in general at http://cdn.hl.com/pdf/2020/potential-impact-of-the-biden-tax-plan-july---2020.pdf.

(4) Partners and shareholders of S corporations are taxed at the individual level at graduated income tax rates. Qualified Dividends from a C corporation are taxed at a maximum rate of 20%.

Demystifying the 21% C Corporation Tax Rate

While C corporations face a statutory tax rate of 21%, very few C corporations effectively pay a full 21% on average per annum due to tax deductions such as Net Operating Losses ("NOLs") carried over, bonus depreciation deductions, and other common tax strategies employed by tax professionals. For example, startups frequently pay no tax in their early years due to losses generated. Alternatively, bonus depreciation enables companies to immediately expense the cost of fixed assets when placed in service (i.e., Year 1). Hence, tax modeling in tandem with tax planning is crucial in this sphere.

To illustrate, consider the following scenario simplified for this discussion.

In this scenario, let us assume a C corporation is formed by contributing $45 million of cash and grows to an enterprise value of $400 million in five years. Let us also assume the corporation posts losses that create large NOLs in Year 1 and Year 2 that can be carried over and reduce its tax liability in future years.

Here is how taxes paid would look during a five-year investment holding period with the aforementioned facts:[5]

In '000s	Year 1	Year 2	Year 3	Year 4	Year 5
Taxable Income (Pre-NOL Deduction)	(40,000)	(10,000)	10,000	40,000	65,000
NOL Carryover		(40,000)	(50,000)	(42,000)	(10,000)
NOL Deduction[6]			(8,000)	(32,000)	(10,000)
Earnings Before Taxes	0	0	2,000	8,000	55,000
Tax Paid	0	0	420	1,680	11,550
Effective Cash Tax Rate	0	0	4.2%	4.2%	17.77%

While the example is oversimplified, it clearly illustrates that NOLs created in Year 1 and Year 2 lower the Effective Cash Tax Rate well below 21% in Year 3 and Year 4 and still slightly below 21% in Year 5.

Let us assume this C corporation qualifies for Section 1202 treatment and is sold after a five-year holding period. The basis in the C corporation would be $45 million and the resulting gain would be $355 million.[7] Assuming a capital gains rate of 20%, the tax liability would be approximately $71 million under a typical sale of C corporation stock. However, under Section 1202, the calculation would reflect the following exclusion:

Sale Price	Tax Basis	Capital Gain	S. 1202 Exclusion	Federal Tax Due
$400 Million	$45 Million	$355 Million	($355 Million)	NONE

(5) In general, NOLs generated can be used to offset 80% of adjusted taxable income ("ATI") as defined under the Code. For simplicity, this example disregards the Coronavirus Aid, Relief, and Economic Security ("CARES") Act, which removes the ATI limitation for certain years.

(6) See footnote 5.

(7) $400 million sale price - $45 million basis = $355 million capital gain. Please note that none of the examples in this writing contemplate if the 3.8% Net Investment Income Tax ("NIIT") is applicable.

As indicated above, through the operation of Section 1202, no federal tax would be due. In short, the sellers endured approximately $13.65 million of cumulative taxes during the holding period but saved $71 million in taxes upon exit. The net tax benefit is approximately $57 million in federal taxes.(8)

Would sellers and investors endure paying $13.65 million of taxes during Years 1–5 to save $70 million in taxes at exit?(9) We believe the question should at least be posited at the onset of tax structuring and compared to using a pass-through entity (e.g., partnership or S corporation) through precise tax modeling.

Can a C Corporation That Qualifies for Section 1202 Save More Taxes Than a Pass-Through Entity?

In certain circumstances, a C corporation that qualifies for Section 1202 may save more taxes in the long run than a pass-through entity (e.g., S corporation or LLC). Let us assume a simplified scenario where $10 million of intangible assets are contributed to a business and the founders have a choice of entity: a partnership or a C corporation that qualifies for Section 1202 treatment.

C Corporation Scenario

Year	Net Income	Entity-Level Federal Tax	Earnings Available for Dividend	Dividend Tax(10)	Total Taxes Paid
1	$1 Million	$210,000	$790,000	$158,000	$368,000
2	$1 Million	$210,000	$790,000	$158,000	$368,000
3	$1 Million	$210,000	$790,000	$158,000	$368,000
4	$1 Million	$210,000	$790,000	$158,000	$368,000
5	$1 Million	$210,000	$790,000	$158,000	$368,000

Let us assume at Year 5 the C corporation is sold for $100 million. With a basis of $10 million, the capital gain would be $90 million and the federal tax due would be $18 million.(11) If Section 1202 was to apply, the capital gains would be excluded and thus $18 million in taxes would be saved. In essence, the founders together paid approximately $1.84 million in taxes during Years 1–5 to save $18 million in taxes for a joint net savings of $16.1 million. This example illustrates that a C corporation scenario is largely dependent on the facts and circumstances.

This example works nicely under these facts, but how does a Section 1202 C corporation compare to a pass-through entity?

(8) Certain states follow federal Section 1202 treatment, while other states decouple from the federal rules and have their own rules. A separate state analysis would be required in a sale.

(9) In this example, dividends (if any) during Years 1–5 would be subject to taxation at the shareholder level. In general, dividends are optional unless two somewhat uncommon and archaic Code sections are applicable.

(10) Dividends are not required, but for simplicity, we have assumed 100% of available earnings are distributed as a qualified dividend which is taxed at a 20% federal tax rate. This is a conservative approach that likely inflates the taxes paid by shareholders.

(11) $100 million - $10 million = $90 million gain. $90 million of gain taxed at a 20% capital gains tax rate = $18 million in tax due. The entity and founders jointly paid $368,000 in taxes total for five years for a cumulative tax paid of $1.84 million. The example does not incorporate potential application of the NIIT.

The Partnership Scenario

Year	Net Income	Entity-Level Tax	Combined Partner-Level Federal Tax[12]	Amount Distributed	Total Taxes Paid
1	$1 Million	0	$370,000	$500,000	$370,000
2	$1 Million	0	$370,000	$500,000	$370,000
3	$1 Million	0	$370,000	$500,000	$370,000
4	$1 Million	0	$370,000	$500,000	$370,000
5	$1 Million	0	$370,000	$500,000	$370,000

Let us assume two partners form a partnership and it is their only investment. In this simple scenario, the partnership is generating $1 million of net income per annum and the two partners must recognize this income on their individual tax returns ($500,000 each) to pay a total combined tax of $370,000 per year (i.e., each partner pays $185,000 tax individually). During the five years of operation, the partners pay a combined $1.85 million at the individual level.[13] Let us assume the partnership is also sold for $100 million and the partners have a tax basis of $12.5 million[14] at the time of sale. The resulting capital gain would be $87.5 million and the resulting federal capital gains tax would be $17.5 million.[15]

While both scenarios are oversimplified (e.g., high-valuation growth, consistent net income, etc.), the founders are clearly better off with a C corporation that qualifies for Section 1202. The table below quickly summarizes the two scenarios:

	Sec. 1202 C Corp. Scenario	Partnership Scenairo
Taxes Paid During Operations (Years 1–5)	$1.84 Million	$1.85 Million
Capital Gains Upon Sale	$90 Million	$87.5 Million
Capital Gains Excluded Under Sec. 1202	$90 Million	N/A
Federal Tax Liability Upon Sale	$0	$17.5 Million

Precise Situational Planning—How Does Section 1202 Work (in Simple Terms)?

In general and subject to limitations discussed below, under Section 1202, a **noncorporate** taxpayer may exclude (from gross income) 100% of the gain realized on the sale or exchange of QSBS acquired after September 27, 2010, and held for more

(12) Assumes the partners are each allocated 50% of taxable income and are subject to a 37% federal individual income tax rate. We also assume the partners in this example have no other investments besides the one in this example.

(13) Each partner pays roughly $925,000 tax during this time on their individual returns.

(14) Partnership tax basis rules are extraordinarily complex, as they are constantly adjusted upward for allocated income and downward for distributions.

(15) Assumes each partner is responsible for half of this total federal tax liability.

than five years.[16] Although the term "small business" is used under Section 1202, we emphasize that the company must be deemed a small business **at the time stock is issued**, but can grow to any magnitude and the capital gains exclusion would still potentially apply.

To be eligible for a 100% exclusion, a seller must satisfy a number of requirements:

- **ORIGINAL ISSUE:** The taxpayer received the stock at **original issue** in exchange for money or property other than stock or as compensation for services to the corporation (other than as underwriter of the stock).
    - » What Does This Mean? For example, the stock in question could not have been purchased from another party; it has to be stock originally issued to the taxpayer. Please note that the stock of corporations purchased through bankruptcy are oftentimes considered original issue stock.
- **DATE:** The stock was issued after September 27, 2010, and must be held for at least five years.[17]
- **QUANTITATIVE TEST:** The issuer was a "qualified small business" when the stock was issued.
    - » What Does This Mean? This is crucial to Section 1202, but it is a "snapshot" analysis. The C corporation needs to be a "small business" only at the time of stock issuance and can grow to any size (although the tax exemption is capped at $500 million in gain). A "qualified small business" is a business with aggregate gross assets not exceeding $50 million in tax basis at the time or immediately after the stock is issued. Further, the C corporation must use at least 80% of its assets (other than personal services) in an active trade or business when the stock is issued.
- **QUALITATIVE TEST:** The issuer must be engaged in a "qualified trade or business."
    - » What Does This Mean? Corporations must be engaged in a line of business that is not one of the prohibited businesses listed in Section 1202 (a reverse definition). Some of the prohibited business lines include, but are not limited to, law, engineering, architecture, performing arts, financial services, brokerage services, and hotel lodging. Even if an industry is listed as prohibited, the analysis here can be intricate for certain businesses and industries. For example, while healthcare is ostensibly prohibited on the surface of Section 1202, the actual prohibition is very much nuanced in this industry and numerous types of healthcare businesses are eligible.[18]
- **ACTIVE BUSINESS REQUIREMENT:** The corporation meets an active business requirement "during substantially all of the taxpayer's holding period" for the stock.
    - » What Does This Mean? While the C corporation should not be passive or a mere holding company, the active trade or business of a subsidiary can be imputed to it for Section 1202 purposes.

(16) QSBS acquired prior to this date is eligible for favorable tax treatment, but not a complete exclusion. The focus of this writing is the 100% exclusion, but the reader should note the gain exclusion is 50% for QSBS issued before February 18, 2009, and 75% for QSBS issued between February 18, 2009, and September 27, 2010.

(17) Please note the gain exclusion is 50% for QSBS issued before February 18, 2009, and 75% for QSBS issued between February 18, 2009, and September 27, 2010.

(18) For example, in PLR 201436001, a pharmaceutical research and clinical testing company was deemed eligible, and in PLR 201717010, a healthcare technology company providing laboratory reports was deemed an eligible QTB because the company did not offer "diagnosis or treatment recommendation," but only issued reports.

- The C corporation stock may also be held by a pass-through entity, which is common in private equity structures.[19]
- The corporation is a domestic C corporation when the stock is sold and during substantially all of the taxpayer's holding period for the stock.

Section 1202 Sounds Great on Paper. What Are Some Other Practical Applications?

While the following scenarios can be entertained in a cursory manner in a hypothetical Section 1202 context, any actual transaction would require a detailed analysis and engagement of tax advisors who are well versed in Section 1202 to conclude if any scenario is eligible for Section 1202 treatment.

- **EARLY PLANNING FOR FOUNDERS:** A company is formed by its founders in 2020 and in an eligible line of business for Section 1202 purposes. The company anticipates heavy losses in its early years and does not anticipate to have taxable income for its first three years of operations. With those assumptions, the company strategically forms a C corporation and stock is issued in exchange for $35 million of cash. The founders decide to sell their business in Year 6 for $200 million and the capital gains tax liability is $0 by operation of Section 1202.
- **MARKETING STRATEGY:** The founders of a company (set up as a partnership) with multiple service lines engage an investment bank to sell their company and the anticipated enterprise value is approximately $500 million. The investment bank reviews the line of business by consulting with its internal tax advisors who note that one of the smaller service lines of the business is dedicated to manufacturing (a trade, or business that is eligible for Section 1202 treatment).[20] The investment bank markets the company by softly highlighting that there is a **potential** Section 1202 QSBS opportunity within the company. The company is sold through an asset sale. The buyer of the company independently consults with its tax advisors who restructure the company post-close for a future Section 1202 exit.
- **EXIT STRATEGY:** The founders of a C corporation are contemplating a sale of their business, but they are not sure if they are holding stock eligible for Section 1202 treatment. The founders consult with their investment bankers who request their internal tax team to perform a Section 1202 analysis. The tax team concludes that the company is indeed eligible for Section 1202 treatment.[21] When the company is put up for sale, the founders have additional negotiation leverage with a buyer once they assert that a stock sale would permit a tax-free exit while an asset sale (which would be taxable to the founders) requires a purchase price premium from the buyers.
- **PORTFOLIO RESTRUCTURING:** A private equity firm is aware that one of its early funds (e.g., Fund 1) has a portfolio company that is a Section 1202 eligible C corporation and winding down the fund as all limited partners have exited. The private equity firm believes that this particular portfolio company would be a perfect fit in its new fund (e.g., Fund 8) because it holds a similar portfolio company. Because there is no common ownership between Fund 1 and Fund 8, a tax-free reorganization is not feasible. Instead, the Fund 8 holding partnership purchases the portfolio company from Fund 1 in an arms-length stock sale. The gains are excluded under Section 1202, and the partners of Fund 1 are not subject to tax.

(19) Section 1202(g) permits originally issued QSBS to be held by a pass-through entity, but a transfer to a pass-through subsequent to original issue could cause the QSBS to no longer qualify as QSBS.

(20) Section 1202(e)(3). Please note that the founders themselves are not eligible for the exclusion upon exit.

(21) The authors find this to be a common scenario.

- **BANKRUPTCY:** A private equity firm purchases a corporation through a bankruptcy process. As part of the bankruptcy process, the corporation issues original issue stock and meets all other Section 1202 requirements.

Closing Thoughts and Next Steps

The authors note that Section 1202 has limited guidance from the IRS and the above is merely meant as an introduction of Section 1202 and **should not be relied upon as tax advice.** In addition, the examples provided within this article are merely illustrative and should not be applied to an actual transaction without consulting a tax advisor beforehand. Notwithstanding these caveats, we believe that Section 1202 merits discussion and consideration within investment structures, as it is frequently overlooked. We at Houlihan Lokey are available to review our clients' current investments and prospective investments to gauge if there is a Section 1202 opportunity available.

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