From Legislation to Implementation: Understanding Section 1202 Changes
Speakers: Morgan Klinzing, Jay Jumper, Eric Emrich
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Morgan Klinzing:

Hi everyone. I'm Morgan Klinzing, a tax partner at Troutman Pepper Locke, and today we're focusing on a topic that's been making waves in the financial and legal communities, which is the new tax act, the One Big Beautiful Bill or as we'll refer to it "O3BA" and its changes to Internal Revenue Code Section 1202, which is the provision that addresses qualified small business stock.

Jay Jumper:

Hello everybody. I'm Jay Jumper, private equity partner and co-chair of the Venture Capital practice here at Troutman Pepper Locke. The QSBS exclusion has long been a powerful tool for entrepreneurs and investors offering significant tax benefits. And on today's podcast, we want to highlight the recent taxpayer friendly enhancements to Section 1202 and the potential impact they may have on investment strategies and business decisions going forward. We're joined today by Eric Emrich, president and CFO at Independence Capital Partners.

Eric Emrich:

Thanks Jay. As Cylinder structures investments all the time, it's very interesting to see how these changes at 1202 could affect both current and future investments in small businesses.

Morgan Klinzing:

In today's episode, we're going to break down the key modifications that the new tax bill O3BA made to the qualified small business stock exclusion. We'll discuss their potential implications and provide insight on how to navigate these changes. Notably, the new tax bill was signed by President Trump into law on July 4th of this year. Thus, the changes that we're going to be discussing generally only apply to qualified small business stock issued after July 4th, 2025. So to get us started, Eric, can you give us a little bit of background on QSBS and what it is?

Eric Emrich:

Most of what is in Section 1202 has not changed. The sections been in the code since 1993, obviously enacted to encourage small business investment. Generally, the eligible shareholder being non-corporate shareholders, individuals, the estates and trusts, the original issuance of stock reconsideration or services. What is an eligible corporation, a domestic C corp., including an LLC / the "LC corp." The proceeds of the issuance can't be used for redeeming corporate shareholders and the qualified trader businesses stay the same. So those are all the same, but the three we're going to talk about that have changed are the holding period required to get some where all of your gains excluded, the limit on how much gains can be excluded and the size of a corporation that can issue qualified small business stock. Jay, we'll walk through the first one.

Jay Jumper:

Yeah, and with Eric's background, let's start with the shorter holding periods and what we call the new tiered approach to the exclusions of gain recognized on the sale of qualified small business stock. The changes shift away from the historic provisions where there was a five-year or greater holding period where a hundred percent of the gain was excluded and the new 1202 enhancements will take a tiered approach. Those tiered approaches are as follows, there'll be a 50% gain exclusion for stock that is held for at least three years. The 75% exclusion for stock that is held for four or more years and a hundred percent exclusion for stock that's held five or more years. And I'm going to ask Morgan to expand a little bit on exactly how those exclusions of capital gains work and effective tax rates to drill down a little bit further.

Morgan Klinzing:

Absolutely. One thing I think that surprises a shareholder on the sale when they're trying to take advantage of 1202 is that any gain that is not excluded under Section 1202 is then taxed at a 28% rate under current law, not a typical 20% rate that you would have for long-term capital gains. So that can often surprise folks from an effective tax rate perspective, when we're thinking about a three-year holding period and a 50% exclusion from capital gain, that means the remainder of your gain, the remaining 50% that is taxable, is going to be taxed at a 28% rate, and that gives you an effective tax rate of 14% for federal income tax. If you had a four-year holding period with a 75% exclusion, the resulting effective tax rate is 7%. Just keep in mind that these effective tax rates that we're discussing does not take into account the net investment income tax of 3.8%, which you may also be subject to the alternative minimum tax or state and local taxes. State and local taxes may or may not follow the federal rules with respect to the exclusion under Section 1202. Thus, those are rules that you always have to check if you're going to have a sale of qualified small business stock to understand that impact.

Eric Emrich:

Another thing that's changed is the increased exclusion cap prior to the change. The maximum gain that could be excluded is the greater of $10 million or 10 times your tax basis in stock. The $10 million cap is now increased to $15 million and that will be indexed to inflation after 2026.

Morgan Klinzing:

One question that we've been getting from clients on this is whether the exclusion percentage that Jay talked about, again, that 50% at three years or 75% at four years, whether that applies to gain on the sale of the qualified small business stock or to the cap on gain for that shareholder. Again, that 15 million that Eric just told us about that amount. For example, if we have a shareholder and they sell stock for $30 million of gain that they've held for three years, let's assume that stock is issued after July 4th, 2025. The question becomes is their benefit under Section 1202 capped at $15 million, which is 50% of the gain that they've recognized, or $7.5 million, which is 50% of the $15 million cap? We think the better answer here is the former so that the shareholder could then use the full $15 billion exclusion on the sale of stock for $30 million of capital gains. Again, provided that the shareholder has held the stock for at least three years and met all the other requirements under Section 1202.

Jay Jumper:

And rounding out and finishing up the three major changes. And I think you'll see that we've referred to them as taxpayer friendly enhancements. The final one has to deal with the threshold for a company itself to qualify as a small business under Section 1202. There's two changes to that requirement. First, the threshold itself has been raised from $50 million to $75 million. Again for the issuer itself to qualify as a small business under 1202. It's interesting to note that that $50 million threshold that had been in place has been the same and stagnant since 1993. So in addition to raising the threshold, the changes in O3BA also will now index the threshold to inflation. So they increase this year with the passing of the new changes at $75 million will be indexed to inflation going forward, which is again something we'll need to monitor and see how that plays out as the threshold moves because historically it had been set at a stagnant rate that did not move.

Morgan Klinzing:

And it's important to note that that threshold amount for qualifying as a small business generally is going to be based on the company's tax basis and its assets and not the equity value of the overall business. So we can have a corporation that's raising capital and its valuation is set forth in the LOI or other documentation is significantly in excess of $75 million. However, the corporation may still be eligible to issue QSBS, the qualified small business stock so long as the corporation's tax basis in its assets is less than $75 million. There were several other changes in the recent tax act O3BA that can also lower tax basis for a company which can again expand the availability of this exclusion for companies. Those changes include the full expensing for business property that bonus depreciation of a hundred percent and expensing of research an d experimental expenditures.

So with this test based on tax basis, again, it really does expand the timeline for which a corporation may be eligible to qualify for qualified small business stock and to be able to issue that for investors. One point that often does come up that can kick you out of Section 1202 is if there's been a significant capital raise in the past. So while again this test is based on tax basis when we're looking at $75 million, if the company itself has had a fundraise of over $75 million of cash, if that cash all comes in at the same time, you're going to hit that threshold and be outside. Once you have breached the threshold, the $75 million threshold, the company is no longer eligible to issue qualified small business stock. So something to really keep an eye on as you're fundraising and as you're determining how cash is going to be brought into the company and the timeline for spending that cash before your next fundraise. If you're interested in maintaining 1202 benefits. Now note we've highlighted the three changes from O3BA as Eric prefaced in the beginning. These are not all of the 1202 requirements and many of the rules under Section 1202 remain unchanged. That said, Eric, what are your thoughts on how these three changes to Section 1202 can impact venture capital and private equity investors going forward?

Eric Emrich:

Clearly the changes are very investor capital formation friendly. It's clear there will be an increased flow of funds. How it manifests itself is another thing, but I think it'll expand the investor base looking to invest in early stage companies. You've always had angel and venture capitalists invest in 1202 stock where they could even some of our private equity funds have been able to invest in those. I think there's more of an opportunity for larger private equity funds and even family offices to take advantage of this provision. The question is, will it encourage people to make earlier stage investments than they traditionally have? I think that remains to be seen. So again, I think one thing is safe to say this will be beneficial. More issuers will qualify this alone will increase deals using 1202. How much deal and fundraising activity increases though remains to be determined.

Jay Jumper:

I think it would be helpful to follow up on some of the points that both Morgan and Eric raised on the venture capital startup ecosystem and almost take us back to the beginning. I think it's impossible to talk about 1202 and the benefits that 1202 has to offer without talking about the impact on choice of entity considerations. And one of the areas that we all focus on is an initial startup business, having to choose the type of entity it be both from a governance standpoint but as well as from a tax standpoint. And there's several factors to assess when a business venture is selecting its initial choice of entity liability protection, capital structure, governance, nature of the business venture itself, how the parties want to treat gain and loss. Do they prefer taxable versus flow through status and all the way down the road to exit transaction considerations.

And while many of those are outside of the scope of what we're going to talk about on today's podcasts, the enhancements to 1202 may make investing in small businesses even more attractive by expanding the number of small businesses that are eligible to qualify. Think about the increase in the threshold we talked about earlier and the number of small businesses that will qualify, and then the benefits and enhanced tax benefits that holders of qualified small business will receive with the tiered approach to gain exclusions and also increased in the thresholds and caps on gain exclusions. So that is definitely a factor that we will be putting into the blender when we're thinking about entity formation and types of entities. Not only something we've always looked at tax implications of entity formation, but to Eric's point, additional investment opportunities for qualified corporations that want to make 1202 eligible to its investors is definitely something that'll play a larger, more enhanced role in our analysis of early stage formations.

Morgan Klinzing:

And again, when you're thinking about that choice of energy analysis when you're taking Section 1202 into account, it's key to remember that 1202 only excludes gain on the sale of stock. It doesn't impact annual corporate income tax, right? So to the extent the company is making money on an annual basis, there will still be taxes that it will need to pay. In addition, 1202 only applies on a sale of stock received at original issuance. So to the extent an investor has acquired stock from a founder or from another investor on a secondary transaction and not as a result of putting cash into the company for newly issued shares, those shares do not qualify for the benefits under Section 1202. One thing we do see on the choice of entity side is that companies that anticipate generating large losses in the early years often consider maintaining their pass through status for those early years and then converting to a C corp later in their life.

Again, they do need to convert to a C corp assuming they want their C Corp stock to be eligible for 1202 benefits before their value hits the $75 million threshold for these purposes. When you're converting from a pass through to a corporation and we're testing $75 million again as previously, we typically test based on tax basis. But there's a special rule when you're converting that we're going to test based on the fair market value at the time of the conversion. So a startup may want to consider forming as an LLC taxed as a partnership, allowing losses to flow through in those early years and then converting to a C corp later on in its life before its value has exceeded $75 million. This also can be a planning tool to get a larger exemption under Section 1202. Again, the exclusion of gain from income tax is the greater of under the new rules $15 million or 10 times your basis in the stock. So if you are converting at a time when the assets have a value of $75 million from a 1202 perspective, you have a $75 million effectively tax basis in that stock and your exclusion is capped at $750 million. So that can be a really important planning tool when you're considering when to convert to a C corporation and how to maximize these benefits when you're considering an ultimate sale transaction.

Eric Emrich:

But to be clear, the building gain at the time of conversion is not eligible for the exclusion.

Morgan Klinzing:

That's right. So if you convert at the time where it's $75 million, if you have zero basis in those assets, first $75 million will be subject to tax, then you get to exclude your $750 million. So hopefully you're really hitting it out the ballpark on that one.

Eric Emrich:

From a partnership and s corporation perspective, there are look through roles. So you can be investor in a partnership or an S-corp and take advantage of that entity making investments into qualified small business stock. Those roles have been retained. Clearly you must be a partner at the time. The investment in the QSBS is made, but an area that still is somewhat open is what happens when income allocations switch from committed capital to carried interest. Do the carried interest participants get the exclusion on their allocation? I believe most practitioners still take the view that the carried interest allocations can qualify for 1202 exclusion.

Morgan Klinzing:

And it's interesting too to key in the new three-year holding period requirement for that initial tier of exclusion at 50% with the holding period for long-term capital gain for carried interest under Section 1061 in order for a carry partner to recognize long-term capital gain. Congress has already said that they want that carry partner to have a longer holding period again, to get those beneficial tax rates under 1202, which isn't limited solely to carry partners, but often is utilized by founders and other service providers to the company. Congress is also looking to that three-year holding as an appropriate timeframe for holding the asset by a service provider before giving them exposure to a beneficial tax regime. So we have these three changes to Section 1202 under O3BA that says there are a variety of open points under Section 1202. And of course we would always love to have guidance from the IRS. We would love to have clarity on the carried interest point and regulations. Also looking forward, we're hoping to get guidance from the IRS on holding period, particularly for shareholders that may hold blocks of stock with different holding periods that may be prior to July 4th and blocks of stock they may be holding after July 4th that are subject to these new rules.

Jay Jumper:

I think one area we're all clear we do not need guidance on. Just to remind everyone, the changes to 1202 relate solely to qualified small business stock issued after July 4th, 2025. These are not retroactive rules to stock issued prior to that date. And I think that's clear on its face. And as we near the end, I think Morgan and Eric could talk a little bit about the planning opportunities that arise as a result of these changes as well as some helpful reminders on the reporting requirements, which haven't necessarily changed under the rules, but I think are worth highlighting again,

Morgan Klinzing:

With respect to planning opportunities. Once we have shareholders that have blocks of stock, again pre July 4th, 2025 and post July 4th, I think there's going to be opportunities to think through which block of stock the shareholder wants to sell first, taking into account holding period at that time, right, three years plus in the future, how much gain they anticipate recognizing overall with respect to the stock in order to maximize the exclusion that they expect to obtain under Section 1202.

Eric Emrich:

From the reporting requirements. I think most private equity funds like us have obviously relied on the company we're investing in and the documents at issuance to clearly rep that the company qualifies for that benefit. You need to keep track of that company that it's continuously been eligible all those years. You certainly have to keep track of your own partners. Obviously partners that transfer in after acquisition and things like that will not be eligible for the exclusion, but there's a fair amount of reporting on the K ones that you need to provide your investors to make sure that they're handling this correctly on their side. It's great to have a benefit, but if you don't communicate that clearly and they can't take it, it's not helpful.

Morgan Klinzing:

Absolutely. Well, thank you Eric. As we wrap up today's discussion on the recent changes to Section 1202, we hope that you've gained some valuable insights and to how these updates might affect your business and investment strategies,

Jay Jumper:

And it was my pleasure to chat with Morgan and Eric today and share our insights on these changes to 1202. Please reach out to the Troutman Pepper Locke team for any specific questions we expect to continue to monitor the topics we talked about in the podcast today and provide future relevant updates if they're useful. Thanks to everyone for listening.