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TAX AND WEALTH ADVISOR ALERT–SECTION 1202 STOCK: AN ATTRACTIVE TAX BENEFIT FOR INVESTORS IN SMALL BUSINESSES

Investors in small closely held businesses looking for ways to reduce their tax liability might want to consider taking advantage of Section 1202 stock, also known as Qualified Small Business Stock. Section 1202 of the Internal Revenue Code offers a tax break for individuals who invest in certain qualified small businesses.

So, what exactly is Section 1202 stock? In simple terms, it refers to shares of stock issued by qualified small businesses that meet specific criteria outlined in the tax code. The main advantage for investors holding these stocks lies in the potential exclusion of a portion of their capital gains from taxation upon the future sale of these stocks.

Under Section 1202, eligible investors can potentially exclude up to 100% of their capital gains from the sale of qualified small business stock held for more than five years. However, it is important to note that the tax benefits provided by Section 1202 are subject to certain limitations and restrictions. For instance, the exclusion of capital gains is limited to the greater of $10 million ($5 million for married taxpayers filing separately) or ten times the investor's basis in the stock. Also, the exclusion only applies to investments made after August 10, 1993. Despite these limitations, Section 1202 stock can result in substantial tax savings and provide a significant incentive for individuals looking to invest in startups or small businesses.

To qualify for these tax benefits, the small business must meet certain requirements. First, the company should be a domestic C corporation. Additionally, the business must have total gross assets of $50 million or less at the time the stock is issued.

Another crucial condition is that the company must be engaged in an active trade or business. The Section 1202 exclusion does not apply to any business primarily providing professional services such as health, law, engineering, architecture, accounting, actuarial science, performing arts, athletics, banking, insurance, financing, leasing, and investing fields, any business operating a hotel, motel, or restaurant, or any business that is primarily holding assets for investment. However, there are exceptions for certain technology-focused businesses that meet specific criteria.

Notwithstanding these limitations, Section 1202 stock remains an attractive tax benefit for investors in small businesses. Investors should plan carefully to determine whether their investment qualifies for the Section 1202 exclusion, and to understand the specific requirements and limitations of this tax benefit. As with any tax-related matter, it is crucial to consult with a qualified tax attorney before making investment decisions. A tax attorney can help navigate the complexities of Section 1202 and ensure compliance with all applicable regulations.

Overall, Section 1202 stock can offer a significant tax break for small business owners and investors. By taking advantage of this provision, investors can potentially reduce their tax liability and support the growth of small businesses.