The Jaffe Update
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COVID-19 TAX UPDATE
LOW VALUES OFFER OPPORTUNITY UNDER CODE SECTION 1202

The economic decline from the COVID-19 pandemic may provide a planning opportunity for any business entity treated for tax purposes as a partnership or sole proprietorship—convert to a C corporation, in order to benefit from Section 1202 of the Internal Revenue Code of 1986, as amended (the "Code"), upon a future exit.

What is Code Section 1202?

- Under Code Section 1202, a shareholder who holds "qualified small business stock" ("QSBS") for at least 5 years generally can exclude 100% of the gain from a sale or other disposition of the stock.
  - Note that the amount of excluded gain is generally limited to the greater of $10 million and 10 times the shareholder's tax basis in the stock.
- Only stock in a C corporation can be QSBS; equity interests in flow-through entities do not qualify.

Why is now the right time to consider a C corporation conversion?

- In order to qualify as QSBS, stock cannot be issued by a corporation that has more than $50 million of gross assets. Companies that were previously over this threshold may now find that their assets are worth less than $50 million.
- Code Section 1202 does not exclude gain that is attributable to appreciation that a member had in his LLC interests at the time of the LLC's conversion to a corporation. If the value of a flow-through business is depressed at the time of conversion, the amount of gain excluded under Code Section 1202 will be increased.

What are the characteristics of businesses that should consider this strategy?

- An exit event is not expected for at least 5 years.
- Current distributions of operating cash flow are not expected prior to exit (otherwise, such distributions would be subject to two layers of taxation).
- The proceeds expected from an exit event are significant relative to current value.
- The business is actively conducted and is not in certain excluded fields.

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