Hratch Karakachian :No. Okay. It launched it this time, but it's recording.

Igor Zey: I'll mute myself. Okay.

Chia-Li Chien: Okay, Igor. Thank you.

Hratch Karakachian: Good afternoon everyone and welcome to, uh, the, um, financial planning faculty study group presentation. And this afternoon, um, we're having a discussion on the benefits of the section 1202, the internal revenue code, the so-called qualified small business stock. Does anyone, is anyone familiar with the section or has worked in this area before?

-Chia-Li Chien: I would suggest that you go through it because I think this is a, this particular topic is, um, somewhat, um, Mmm, not very usual for people to work with. So if you don't mind to go through it, that might be helpful.

-Hratch Karakachian: Sure. Let's spend just the minute a second on the agenda. So, Mmm. I've laid out the presentation. Uh, I prepared a presentation. I have about 13 slides here, but I want it to be interactive. So if anybody has any questions, Mmm. Comments, et cetera, feel free to interrupt me at any point in time. So the agenda here, I have the purpose. I have some general summary points, historical background of how the section 1202 benefit came about. The requirements that would allow taxpayers to get this benefit than it is. It is a huge benefit to taxpayers and there's two sets of requirements or there's a requirement of issuance that we'll get into and there's also a requirement during the whole pier holding period. The impact on 1202 of the new tax act. There's some sister provisions that would be helpful when applied in conjunction with the 1202 and a half. I have a couple of examples as well. So what is the purpose of section 1202 the purpose is to spur investment investments in smaller, smaller and startup type businesses. Congress in the early nineties thought that small businesses needed a boost in capital and they came up with the section 1202 benefit to encourage that investment and participation from a big picture standpoint. And I'm going to get into a lot of tax legal detail here because it's very rule oriented. But let me give you the big picture so you can Keep that in the back of your mind. And if you're working on any project or if anything, Oh, comes up in this area. Um, you can use this as your, I guess one line or one sentence summary. This is the benefit that's provided under section 1202. If you buy a stock and it don't mess the corporation, and if you hold it for five years and then sell it at a gain, the gain is not taxable. Okay, let me repeat that. You have, uh, an investment in a corporation that has appreciated in value and you sell it for a gain. The gain is not taxable. So what are some of the highlights that allow a taxpayer to get this benefit? First, the position is to be sold that again, the next, which is by far the most important, has to be qualified small business stock. And I'll get into the requirements of this in the slide. Two slides after this one. The stock has to be held for a minimum of five years, and the exclusion amount currently is at a hundred percent so the entire gain is excluded. But it earlier when the provision came about, only 50% of the gain was excluded. And I'll get into the periods of time where the exclusion was up to 50% only and then it went up to 75% for a short period of time. And then since 2010 it's at 100% the stock, the investment has to be a domestic C corporation. So it can't be a foreign entity, it cannot be a partnership and it cannot be an S corporation. And that's one of the reasons why one of the few reasons why this provision has not been popular And used by most taxpayers. Another requirement is that the operations of the entity of the corporation has to be a qualified active business. And there's two provisions, two requirements underneath this qualified active business requirement that I'll get into in a few slides and there's some gross asset pests after the is made. This qualified active business has to satisfy these two gross asset tests. There is a cap on the exclusion amount, so it's not millions and millions of dollars and this is the cap and it's in the statute and this cap is per taxpayer per investment. So for example, for an individual makes investments in two separate enterprises, two different enterprises, two different corporations. This cap applies to each one separately. It's not combined, but it is cumulative as the one specific investment and that taxpayer who made that investment in that entity. So this is the cap, it's 10 million cumulative over the life of that investment in the, in that enterprise, in that corporation, the greater of 10 million or 10 times the adjusted basis of the investment. And here I have a maximum of 50 million, which in very limited circumstances, I guess it is conceivable that somebody could get to that level, but for the most part the lion's share of the investments. And the limitation is going to be at that 10 million. Any questions so far? Am I going to fast?

Chia-Li Chien: No, you're doing fine. So that, the key word that I learned from this line is that it has to be a game. If there's a loss, then this doesn't work. Right. So that's your number one rule there.

Hratch Karakachian: Correct.

Chia-Li Chien: Okay. Thank you.

Hratch Karakachian: The opportunities zones are separate. They're under a different code section, it’s called section 1400, and, but they do work hand in hand with this provision. So a combination of opportunity zones and section 1202 will prove charge this the benefit under IRC section 1202 and I will get into that in the, um, in my second to last, right before the example. Go ahead Chia.

Chia-Li Chien: So would you, would you, would you say that because of the opportunities, only investment became somewhat of a popular then section 1202 has also become gaining some traction because over over the last several decades, there's really very few companies actually took advantage of this. And you know, the, the, the, uh, the, the war on the street is because of the opportunities own investment kind of, uh, bring this, uh, this kind of a section back to life.

Hratch Karakachian: Yes. Yes. There's some other provisions also, but that is one of them that, that brought it, that made 1202 front and center. So let's look at the historical background And discuss why he wasn't very popular. So this came about in 1993 During the Clinton administration, Originally the exclusion was 50%. So if you had gain, you could only exclude 50% of the game. And that was effective beginning on August 10th of 93 all the way up to, um, early 2009. And they included a provision in the code which said that if you include 50% of the game, Exclude 50% of the gain, the remaining 50% that is included will be taxed at 28%. So for example, if you had a hundred thousand dollar game, You could include exclude 50,000, but the other 50 would be taxed at 28%. Making the effective rate on the entire a hundred thousand at 14% Remember at the time, capital gains were being taxed at 28% in 1998 the capital gains rate was reduced to 20% However, The 1202 excluded, um, exclusion and the tax rate on the non excluded portion remained at 28%. So what happened was you were getting a 14% benefit, But the entire game would be taxed at 20% so your savings was only 6% Instead of 14% Originally. And in 2003 Was the final blow, which really made this a 1202 almost obsolete is when capital gains rates went down to 15%.

Igor Zey: Could I ask a question?

Hratch Karakachian: Go ahead.

Igor Zey: The 1202 applies only, this is Igor Zey, 1202 only applies applies only to the federal. Uh, uh, what about the state, cause it's, let's say California is that also

Hratch Karakachian: California had a provision, had a similar provision, but that expired in 2015. So for California purposes, there's no benefit at this point in time. So you'll have whatever.

Igor Zey: Okay, so you have a full exclusion, but you still pay the California capital gain?

Hratch Karakachian: Correct. Now, one thing that might be that might work, Igor, is, um, the purchase was made before 2015. Um, California may allow for that benefit, I'm not sure, but I know for all purchases after 2015, there's no California benefit because 1202 for California purposes has expired.

Igor Zey: Okay. And this does not have to be a public corporation, right? Publicly traded. It can be a private corporation as long as it's correct

Hratch Karakachian: The, there's no bar of it being a public entity. But as you will see in the next slide, the, uh, the benefit is focused on smaller, smaller type entities based on the capitalization of the entity. So hold your thought for just a couple of minutes and we'll get into it on the next slide. There's one more. There's one more thing to keep in mind is that oftentimes this also can be used as a deferral purposes. So I think, I think it's coming up in your other slides. Sometimes it's not just to exclude the game. Sometimes it said, you do know that there was a game. Did you exchange it for something else? You can further further defer that. So there, there's something about referrals strategy here as well. Yeah, I'm going to get into it on a, on the second the second from the last slide under other favorable provisions, the other sister provisions to this. So because of of the, the adjustment in the, in the capital gains rate in 2003 and the fact that very few people were using this, um, 1202 provisions in 2009 Congress bumped up the exclusion. Well we lost the Igor Congress bumped up the exclusion to 75% of the gain and that was for a very short period of time as you see from today, from early February of 2009 until about September of 2010 in 2010 I said, okay, we need to really enhanced the and spur investment in small and startup businesses. They bumped up the exclusion of the 100% and one point that I want to make here is the date of acquisition of the shares depending on when they were acquired after 1993 the period of time determines the exclusion amount. So for example, if an, if you have an investor who acquire chairs in 2019 98 for example, they would get the 50% benefit. Even if they sold their shares today for somebody who bought their shares and in late 2009 they would get the 75% exclusion. So if they get the 100% exclusion, the shares have to be have been purchased after September 28th of 2010 in 2015 and this was temporary. It was every year. Congress was extending it like the, some of the other provisions that some of the other expiring provisions that we have, Congress was extending it. And in 2015 it was made permanent retroactive to one one of 2004 the reason why this was not popular is one is the reduction in capital gains rate making the benefits smaller and smaller every year. The other is the requirement that the investment be a C corporation and C corporations have this problem with double taxation. So we have the income tax that's paid at the entity level by the corporation and the shareholders when dividends are paid out to the shareholders, shareholders pay income taxes on that dividend. So there's double taxation feature is the second reason why section 1202 was not popular, were small and startup companies. We're focusing and choosing an S corporation as their entity of choice to avoid the double taxation. And also as LLCs, limited liability companies became more and more popular, more and more in favor. Bye accountants and lawyers because of their flexibility, because of their legal and tax flexibility. Most of the startup entities where or being formed as escorts and or LLCs. And as a result of this, Mmm. I'm used, shall we say, of section 1202, there has been very little guidance from the IRS and very court cases to provide a background in analysis. So there are some, some big areas where the rules are not very clear and their subject, their interpretation and we don't know how the IRS might rule or my uh, the site is an entity or if a taxpayer get besides that take advantage of a 1202 benefit. Yes?

Chia-Li Chien: So question is that, um, I think that the, the maybe you'll get into in the interpretation in a little bit, um, if I recall correctly, that if you follow all the rules, that's a, if you, if you invest in a, in a small corporation in 2010, you have the gain increased to a hundred percent. However, that small cooperation, it was not initially set up as a C Corp. So that's a, they initially set up as LLC and then somehow somewhere elected to become a C Corp in the life of the corporation. I think there was a problem there. It has to be initially founded as a C corporation to go into it. I think that was, that was one of the interpretation that the IRS is still not quite clear on that. I don't know the answer but I'm just just kind of let you know. I think there, there is some some interpretation issue there.

Hratch Karakachian: Yes, that's correct. So here are the requirements at the time of issuance of the shares are at the time of purchase. So the corporation has to be C Corp since inception or since August of 1993 so it was an escorp at some point and then converted into a C Corp that wouldn't work. That has to be a C Corp at all times. The other requirement is this qualified small business requirement where the assets within the entity within the corporation has have to be less than or equal to 50 million right after the issuance of the shares. So if I'm, we have a couple of investors, let's say an investor and an operator form an entity and each one of them put in a million dollars. We have $2 million. There's not a problem because we're not even close to 50 million. But if at some point in the future of the company, the operations take off and they need more seed capital and they go out in the marketplace and do some and sell additional shares, if at any point in time the gross assets go above 50 million, Mmm. Then the company, the shares can never be section 1202 shares because it can never qualify as a small business. However, the original investors, in my example, those two individuals that formed the entity and put in the million each, those individuals would be protected if years down the line, five or 10 or 15 years later, uh, there was a need for additional capital and the gross assets go above 50 million future subscribers. Future purchases could not get section 1202 benefit, but the original investors, the original contributors would be, would, would get section, We'll be able to get section 1202 benefit.

Chia-Li Chien: Okay. So I guess, um, the, the keyword that, the key issue here is the gross assets less or equal to $50 million at all times, right? Yeah. So if it's, um, forget about the, assuming that everything's original issuance, but if at all time, any given time that gross assets over 50 million, that would disqualify the entire, um, section. Is that correct or whatever only that's right.

Hratch Karakachian: And for future subscribers,

Chia-Li Chien: Right. Yeah, and, and the assets here is defined as cash and adjusted basis of the assets. So, so that, that means that, um, it is very likely that say if I go form a company, I contribute a real assets into it that could consider it to be an asset. Or, um, I could also, uh, contribute intellectual properties into the company as an asset and typically into intellectual properties potentially are a lot smaller. Um, from assets perspective. Am I interpreting that correctly?

Hratch Karakachian: Yes. Um, so let me give you an example. Let's say somebody forms a corporation and contributes two items to it, a hundred thousand dollars in cash. And a patent that has a fair market value of 900,000, well, effectively this individual contributes a million dollars into a corporation, but his cost basis has, is his adjusted basis in that he is very low. If it's a self created pad that could be close to zero for this test, for the gross asset test, we take the cash of a hundred thousand and the adjusted basis of that patent, which for all intents and purposes a zero. So even though in terms of value, the corporation has about a million dollars in it for purposes of gross assets, this asked this test, it only has about a hundred thousand dollars in it.

Chia-Li Chien: Correct. So, so effectively that if it's something like intellectual properties, it's probably more favorable, um, in considering this type of, um, take advantage of this. But the other questions that I have is in terms of assets, right? What if I contribute? So real assets is interest. We realize it's pretty straightforward. But what if I contribute a company? A company is an assets as well, right? What if I contribute a entire corporation as an asset?

Hratch Karakachian: Mmm. That works. But there's additional requirements during the holding period. Right? Right. And um, that you, that those rules have to qualify. So in your example, you're saying, okay, what if I contribute some shares of stock of another enterprise or some LLC interests for purposes of this test? You would look at the cost basis, but that asset in your hands for purposes of this test. But if you look at the last bullet point, special basis rules, that is a different rule that will come into play. But for purpose of the gross asset test, if you contribute, shares a stock that has appreciated in value with a low cost basis, the cost basis would be calculated in determining this less than or equal to $50 million asset.

Chia-Li Chien: So let me walk you through an example. My, my, um, bring up some discussion here. So let's say that I have a company that I know the cost spaces is less than $50 million. Okay? So the company was formed long time ago, not a C corporation. And I later learned about this there's wonderful things going on and I know the company is going to be appreciated. Um, um, a lot more than what I currently have. So then I create a C corporation right around 2015, right, whatever the deadline, 2010, right. Made a C cooperation and then use the idea of um, let's say a merchant acquisition. So the C corporation is a different business but somewhat relative relevant business. And then I contribute this particular company that stays an LLC into this C corporation, which adjusted basis of the assets is still qualify. Oh, but then that effectively where logically you're effectively wouldn't have turned that um, C corporation that were turned into assets of that this particular C corporation, is that still qualify?

Hratch Karakachian: Not for the, if you like at the last bullet point special basis rules to prevent big conversion. Okay. They would qualify.

Chia-Li Chien:The question will be big. How big?

Hratch Karakachian: It'll qualify because for the shareholder there, there's a, um, there's a, there's an anti abuse you rule built in this, which is,

Chia-Li Chien: okay, good.

Hratch Karakachian: If you have low basis, I see, okay, good. If you have low basis, high value asset that is contributed into one hand Dicky for the 50 million tests you compute, you calculate the 50 million. And now the calculation is based on the adjusted basis, which has the low basis. However, for purposes of calculating the 1202 gain on sale, you calculated at the fair market value on the date the asset is contributed into the entity. So we have, we have kind of a two separate calculations that are happening in the entity and one outside of the entity to calculate the gain or loss upon sale.

Chia-Li Chien: Right. So, so even if, um, even if that, you know, for sure that that company is going to be appreciating a lot, but other than the moment of their transfer, it's still the fair market value is still not there yet. So, but anyway, so I, I understand the prevention of big conversion here.

Hratch Karakachian: Any future appreciation, future appreciation would qualify after the contribution. If the stock appreciates after the contribution that may qualify. They do, but not, but not the friendship that happened before it was contributed into the entity.

Chia-Li Chien:Okay. Thank you.

Hratch Karakachian: Sure, and then the, so we covered that special basis issue and then the issuance date is important because for the, uh, uh, the period of time determines the exclusion amount and that that's important to determine whether the exclusion of 50, 75 or a hundred percent. Now here's the more complicated analysis and computations because these happen within the entity. This analysis is done at the entity level, but then the entity itself, so the entity must be a C Corp for substantiate all of the holding period. And what is the holding period? It's that five year period or it's the period of time before the sale. And I'll get into the substantiate all analysis and just the moment here. So that's one item. One of the requirements. The entity must be a C Corp for substantially all of the holding period and the operations of the entity must be an active business for substantially all of the holding period. And in the previous example where we're contributing a corporation or a business enterprise into a corporation, that would work if that entities operations would qualify as an active business. And there's some, um, there's some expect, um, was a provision of what an active business has. There's, there's still requirements for an active business. The entity has to be an eligible corporation. This one is fairly easy eligible corporation. Our corporation is a corporation that is not a disk, a former guest, uh, Rick, a rate a remake or a co-op. Okay. So if it's none of these entities that the desk is a domestic, international sales corporation of rec as a, um, as a registered investment company or read as a real estate investment, trust the REMIC as a real estate mortgage investment conduit or cooperative. So if it's none of these entity types and those are special elections that entities have to make at the time of formation, um, it would work. So it must be eligible, I E not want to be special, uh, entities. And then the operations have to be a qualified trader, business qualified trader business. And there's a tie in here too. Now, 199 A Mmm specify trader businesses here. And although the, the list under 1202 is a little bit bigger and I'll go over some of the them here. So what are we looking at? What it does not qualify as a trader business for purposes of Volvo. Two is lawyers are accountants, doctors, chiropractors, engineers, architects, the individuals that require professional license and are providing professional services. Also banking and financial services don't qualify. Farming doesn't qualify oil and gas. It doesn't qualify operation of a hotel or motel does not qualify. There are two, um, areas that there is some guidance on by the IRS. One entity that was providing consulting services for drug Mmm. Medication doing research and development on medication. And the IRS said that that was okay. That was not a um, providing of medical or health service or at least those types of first services where okay. For purposes of 1202, another was they weren't qualified trader business. Um, another one was a large insurance brokerage with about 400 employees, 150 employees and 250 agents. And the IRS said that was okay as well. Now, one area that is not a qualified trade or business is when the primary, a reason of the operations of the business is the reputation and knowledge of an individual. And the IRS, in the case of this insurance broker, it said that even though the owners to the two or three individual owners had the reputation in the community, that was not, that was not a reason to disqualify them from section 1202 because they had a, they had an operation, a 400 uh, employees and independent contractors and the reputation of one or two or three individuals was not enough to counteract and prevent this entity for getting the 1202 benefit. So what does that leave us with? What type of businesses qualify manufacturing, retail and wholesale operations.

Chia-Li Chien: Tech probably. And is it, did you mention engineering?

Hratch Karakachian: Yes. Yes. Engineering.

Chia-Li Chien: I would assume this tax law is encouraging innovation. It could be innovating, you know, consulting part of, um, Mmm drops creations and you know, potentially just, just, just to encourage more innovation in the country.

Hratch Karakachian: Right. I agree. I think that was the goal. And then it's, it's evolved overlap over the last 20, 25 years since the tech field is as mushroom than is exploding a lot of the software development, manufacturing of electronic equipment, all of that would qualify for purposes of 1202. The other, there's some other very tricky rules here that could create problems for entities. Mmm. More than 80% of the gross assets have to be used in the qualifying trader business more than 80% of the assets. So the patent, for example, in our previous example, the patent that was contributed into the entity, it has to be used in the operations, whether it's generating royalties for the company or it's being used in other, um, factors that would qualify if it's used in the trader business rather than, um, as an investment, big being held by the business as an investment. So what type of other activities would qualify startup activities, research and development, internal research and pre formation expenses qualifying. The goal here is Congress, when they put this rule together, they wanted these startup businesses too. We want to qualify for 1202 to start spending money. As soon as possible. Now in this case, and this would probably be the case if the entity has been around for Mmm for quite some time, if there's internal creative good. Well, um, in the previous at issuance internal created Goodwill because we were looking at the adjusted basis, I probably would not factor in, but here for purposes of the 80%, any internal creative Goodwill most likely would have to be computed and included in the 80% test. And that requires, as you probably know, some type of evaluation. Working capital, um, reasonably needed by the, the operations for one operating cycle. In other words, Mmm. The of time that that accompany goes from, it's from, from the start until completion, whether it's manufacturing an item as an example from getting the raw materials, the work in process inventory selling it, collect, um, billing and collection, that cycle for one cycle, reasonably necessary working capital is allowed and included in the 80% test, but only for the first two years of formation. After that, working capital is limited to 50% of the gross assets and then more than 10% cannot be held in investment real estate. But if the real estate, if it's a research lab, for example, if the real estate is owned by the corporation as being used in as a research lab, that would be okay and that would be included in the 80% but if it's an asset being held purely for investment purposes and it's not being used in the operation, it wouldn't be included. Same with investment securities that are being held for investment purposes. Then further substantiate all, remember this substantially all has to apply to both the first and the second bullet point. The entity has to be a C Corp or substantially all of the holding period. Oh for the shareholder. And then the operations must be active for substantiate all of the holding period as well. So what does substantiate all mean? Substantiate all, in my opinion means something less than 100% but how much less is the key question? Is it okay? 90% 95% 85% 80% there was a case, well there's a under another code section where there was an analysis done by the court and the court said 86 over 86% 86% are higher, was substantially all, and if we use that case and analogize to the substantia, all right, in under the section 1202 rules, if 86% of that period of time the entity is a C Corp that it would qualify if more than 86% of the time the entity was conducting a , um, it was an active business or in other words was, was operating a qualified trader business, then it would be okay. I would venture to guess that if we even, we went down a little bit lower to 80%, that would be defensible as well, but not below that. So something that 60 or 65 or 70% or 75% would be challenged, would be easily challenged

Chia-Li Chien: and that that percentage is measuring the gross assets.

Hratch Karakachian: No, that is measuring the substantiate,

Chia-Li Chien: meaning the holding period, Hratch Karakachian: meaning the entity has to be a C Corp C corporation. For 86% of the time, Of that holding period. And so, and also that's one. And then the other one is 86% of the time or more. The entity operated a qualified trader business during this period of time.

Chia-Li Chien: So, um, can I walk through an example? Make sure that, I totally understand. So that's a, um, this company I buy the workplace clothes from, they basically make Mmm. They make the space specialized for women clothes and the materials is basically your yoga pants material and they make that into stylish office, you know, dress or pants and stuff like that. So that's assuming that they put, um, they put $10 million into the company, which is their gross assets such as, such as, as soon as cash. Um, 50% of that, well, less than 50% of that can be used as working capital. Right. For the two years period of time where they, they designed the clothes and then they potentially outsource manufacturing. All of it. And then they, they sell them. So, so the working capital will be, that's say 50% of that, that money. But the, they could also at the same time contribute a building, um, into the C corporation knowing that they will be operating from that particular real estate. And this real estate that they, the way they contribute is, is that they actually borrow money to buy that piece of real estate. And so, so the down payment, effectively the down payment of that real estate has to be less than 10% of the gross assets. Am I, am I logically thinking that correctly?

Hratch Karakachian: Because the building has going to be used in the operations. You don't have to worry about that 10%.

Chia-Li Chien: I see. Okay. So, so because it's going to be using in there, so it doesn't have to be, um, following that 10% rule. So then I could acquire that real estate. Um, you know, I, the very beginning is probably a guy could acquire that maybe second year, uh, once that business is going well, yes. And, and, and because it's the investment of the securities. So I don't have enough cash, so I'm going to use my existing securities as part of the investment to make up the gross assets. I'm giving the fact that the business need to borrow money for working capital. Those could be leveraged as a collateral, um, inside the corporation to qualify potential borrowing of, of a working capital. Um, so all of those examples could be part of, um, either initial or, um, part of the, the, the establishment of the corporation as well.

Hratch Karakachian: Yes. Let me clarify a couple of points. The working capital can not be too high of an amount.

Chia-Li Chien: Correct.

Hratch Karakachian: Number one. Number two is if it's a corporation, um, the recommendation would be because we have a corporation here, the recommendation is not to put any real estate in a corporation, but rather have the investors and the shareholders got it by the real estate outside of the entity. And another Mmm, well most likely a partnership or limited liability company and then lease it to the corporation and the corporation would use that property and its operating business. The rental expense being paid out every month by the corporation would use up some of this cash and help with using the cash. And so that there's not a lot of cash sitting on the balance sheet of the entity. Yeah, yeah. That's the big risk. That's the big risk is, is having too much cash lined around and not being used.

Chia-Li Chien: Right. So, so this, this particular company I'm talking about, they're quite smart in terms of how they set it up is that they, um, every single product that they, they introduced, they use the concept of um, uh, like a GoFundMe type of concept. So they will put their design right on their website and then they will ask people to provide feedback. So for example, a typical yoga pants doesn't have pockets, so for a lot of women, then you can put your cell phone. So because of the recommendation of their customer, consumers, so they put the design up on their website and they don't go on sale right away. What they will do is, and if, um, if we have number of you as a consumer sign up, we pre purchase the product, then we will go make it and then we will ship you a product for six in six months. So, so that is very smart. So they are not necessarily, uh, borrowing a lot of capital for the working capital cause he's already pre-purchased. Um, and, and so, so a lot of, a lot of those companies are quite smart In terms of how to structure their business to their advantage, um, for, for operation purposes.

Hratch Karakachian: Yeah. It seems like it's a, it's a, uh, a and improved more sophisticated way of using the Justin time inventory system.

Chia-Li Chien: Correct. Yeah. Yeah. It's crazy. You know, we women have to buy clothes and then I actually waited for six months for a scorch and scoring. It's a combination of skirt and pants and they're all made of yoga pants and I was extremely comfortable and stylish in the office, but that's how they get around with not using too much of a working capital. So I thought I was a very smart design.

Hratch Karakachian: Yea, However, though, at that point, if I'm, they have cash lying around that they're not using, uh, but, uh, after two years that working capital will only go against 50% of the gross assets. So if they have too much cash then, then that might be a problem. The, um, so the reason why 1202 is, is, has become a lot more popular now is because under the new tax act, the corporate tax rate went from a high of 35% to a flat tax of 21%. So even though corporations still have the double tax problem, it's, it's a lot tempered then it was before the 2018. And this is one of the reasons why 1202 is kind of getting more traction and has become more interesting four uh, operators and for investors. The other option, the other component too, is that, uh, corporations can retain their earnings and not pay the dividends. Bye. Bye. Doing that. They Mmm. Can avoid or delay some of that double tax problem. Mmm. The other two, um, things to note in a 1202 context is if the client or the individuals approach an accountant or an attorney ahead of time, there could be some, uh, diligence and some pre formation planning who set things up. Now these rules, the requirements are issuing is at the time the stock is issued. However, the requirements for the holding period has to be done regularly during the operation of the company. And one commentator was recommending doing this analysis, this 80%, 50% 10% analysis on an annual basis. It could be done on a semiannual basis or if somebody is really aggressive, it could be done on a quarterly basis so that the company can adjust quickly if they're getting close two breaking some of these thresholds.

Chia-Li Chien: So do you, do you mean that they need to conduct some sort of formal appraisals? So then these um, uh, numbers has been checked on a regular basis?

Hratch Karakachian: Yes. Even if it's not formal, then, uh, for sure in an analysis, uh, uh, so that the, see where they fall within within the state 80% and the 50% and the 10% and making sure that their working capital is not hot as are too high.

Chia-Li Chien: So really in reality is that if someone wants to take really take advantage of this from those from the start of the formation, um, other than working with the attorney of practically pre formation planning, you also need to have a good CPA firm, you know, giving you guidance on the valuation along the way. So then you keep track of what your, uh, making sure that you stay below that threshold.

Hratch Karakachian: Absolutely. Because that's going to be critical since, um, these rules have to be met for subsection all of the holding period. Otherwise, the, the talk fails this 1202 provisions and the shareholders, the seller and not get the benefit.

Chia-Li Chien: So really for for people to take advantage of this now only you have to have proper planning, continuing to monitor. You have to really, really be proactive on it.

Hratch Karakachian: Absolutely. The, uh, the other, um, way to do it. He is in your example, the um, the yoga pants, uh, manufacturing company for example, if they did not think about this at some point early on they could do retroactive analysis. For example, if a company is around for a few years, so long as it's a C Corp, a domestic C corporation and analysis can be done. Um, if the company is not, uh, is not big, uh, or it's within a is if it's less than 50 million and analysis can be done retroactively to see if they fall within these 80% of the gross asset as rules. Here's some sister provisions. The um, the rolling over that you were thinking about earlier in the presentation is under section 1045. So 1202 allows the exclusion of the game. 10 45 allows a roll over of the game and here, um, the holding period is only six months, only six months.

Chia-Li Chien: So for six months of holding, once you, sold a property is all the company you have six months to get into to exchange into something else. Is that correct?

Hratch Karakachian: That's a, that's under, that's the opportunities on rule actually. Well 1245 works more like a section 1031. Okay. The holding period is the holding period of the shares. So if an investor or if an original purchaser who bought the shares from a corporation holds a share for six months, they can roll over that gain and they have to, they can sell it, but they have 60 days to acquire a new QSBS

Chia-Li Chien: Correct, so I think that, uh, what in the past, what my clients have done was that, um, for using 1045 to a roll over to another QSBS, some investment company has the equivalent, the equivalent, um, QSB is type of security that they can actually purchase as it, as a 10 45. So they are, they are an investment available specifically designed to roll over again like that.

Hratch Karakachian: Yes. The key, the entity that's that they're rolling over into must be a QSB S correct. These rules, these requirements at issuance and for the holding period has to. There's also another Mmm. Beneficial provision section 1244. It's very minor. And for that reason, it's not used very, it's rarely used. The benefit is the following. If a, and it's a little bit different, it's not a QSBS but it's the acronym is an SSPs, a small business stock. And here, if a small business focus sold for a loss, this section allows the conversion of that capital loss to ordinary loss, but only up to 50,000 or a hundred thousand for married filing joint taxpayers. So up to 50 or a hundred thousand of a capital loss could be converted to ordinary loss. This is the amount of so small, then a lot of preplanning to fit into 1244 is most likely not beneficial or efficient. Right? And then there's section 1400, the opportunities zones and uh, the opportunities zones have a longer cool period of time where the gain could be rolled over. It's 180 days. There's a 15% initial gain exclusion, but to get the entire 15%, the investment has to be made by the end of this year, by the end of December. Otherwise that, that 10% goes away. So the only 5% could be excluded. They have to be holding the the asset, the yeah, enterprise for snap for seven years to get the benefit and after the rolled over gain is, is included in 2025 and a future appreciation is excluded. But if 1400 can be combined with 1202 in other words, if the entity is a C corporation, that's that the rate gain is being rolled over into then it's possible to get the 1202 benefit and the opportunity zone benefits together. However opportunity's own does not has to be a corporation. It could be a business, it could be a partnership or limited liability company. It could be a sole proprietorship and it costs could also be a corporation. But in order to get the 1202 benefit, the opportunity zone fund has to be formed as a C corporation.

Chia-Li Chien: Well I think that maybe in the future that we can talk about opportunity zone funds. There is, there is a lot of interest. So far the opportunity zone hasn't been performing as well as expected. So, but maybe at some point we can talk about the section 1400 Z.

Hratch Karakachian: Yeah. The, the um, the main concern that I have with opportunities zones is Mmm. How well the the, the investment or the business, that's the challenge.

Chia-Li Chien: Yeah. So most of the opportunities, and I won't take too much time here, but I think that most of the opportunities are predominantly real estate base. So that may potentially not qualify for the 1202, but if it's not, then you know, if you have manufacturing business like the one that I talked about happened to be operating in that operating, um, opportunities zone, then that will be pretty good combination.

Hratch Karakachian: Yes. Yes. The, and the other thing too is real estate. That's one. The other one that is excluded from 1202 or the, the uh, operating a hotel or a motel, correct. Another investment then, uh, opportunities on that. A lot of firms are looking at, correct. We're over our hour, but let just spend just a minute on an example. Um, here's an example that would give you an idea of how this, this 1202 works. Assuming all of the other provisions are satisfied. So if we have, um, Luther purchases 10,000 shares and Cal directly from the company and pays a hundred thousand dollars for it, and in 2019 he sells it for 24 million, what is the gain and how much of the gain is excluded? So the gain is going to be, as you see in the first item there, 23.9 million and yeah, for section 1202 purposes since you've wired it, if he acquired it before 2009, the exclusion is only 50% so we have the ceiling, it's 10 million or 10 times the basis. So what's his basis? A hundred thousand so it's the higher of 10 million or 1 million. And here's the calculation. So our gain is 23.1 million. We can exclude 50% the limitation is 10 million or 1 million. He can exclude 10 million and get a 50% exclusion. Of the 10 men, 10 million. So again, under 1202 he can exclude 5 million. So his entire gain is 23.9 the 1202 exclusion is five. Remember the balance, 10 million minus 5 million, the other 5 million has to be taxed at 28% and then the remainder, the 13.9 million is taxed at 20% at the capital gains rates, uh, in 2019. So he was able to get some type of a benefit here. And of course, let's not forget about the AMT adjustment where this makes, and I'll jump over to the 100% example. This is where it makes the most sense since the rules were changed, um, if we can exclude 100% of the gain, the entire 10 million is excluded. Nothing is taxed at 20%. So 10 million is excluded. He only pays tax on 13.9 million at 20% of course, the taxes would apply to this if the state in which Luther lives does not have a corresponding provision that gives them the 1202 benefit and there's no AMT adjustment,

Chia-Li Chien: But can they can, so 10 million excluded, the 13.9 million could roll over. Is it possible, can you roll over the game? So the 10 million is excluded so I don't have to pay taxes on 10 could I then roll over the 13.9 however much I could? I don't know if that's possible or not.

Hratch Karakachian: Yes, it is possible, but the way that it would be, it would have to be set up is the following, the sale has to be split into two components. Got it. Right. One would be the sold at ten million ten million. Right. And the other one is sold at 13.9 and then that gain would be rolled over.

Chia-Li Chien: And that's how basically it's probably basically an installment sale for two transactions

Hratch Karakachian: or splitting it up into two transactions, transactions, transactions. They would work, correct.

Chia-Li Chien: Yeah. Or in this case, we're talking about just one taxpayer acquired 10,000 share unless it's two taxpayers. And that's a different story.

Hratch Karakachian: Correct. Yeah. And there's, and if, if this individual showed half the shares in 2019 and the other half in 2020, for example, in 2020, he won't be able to, he will be able to exclude, um, 1 million only because used up this 10 million in 2009. Got it.

Chia-Li Chien: So I, I would assume based on this particular scenario that you have, should have encouraged a lot of Android investors. Because most of, most of these are, uh, most Angela investors are looking for, uh, you know, prototype potential innovative, innovative type of products or services. And so the, this would have been a very, very good encouragement. If the company was preplanned properly, um, and has a good ideas of the innovation, has a good potential going forward, then Angelo investor probably will be a lot more um, uh, favorable in terms of investing such as, uh, part of the qualified companies that you had mentioned. Um, didn't include this. Such a company such as gaming company. So a lot of the smaller gaming company, they can design a software, um, they can effectively, they don't have to be a big player software. They could be a subcontractor or a big player of doing nothing more, but then doing the artistic designs or programming and stuff like that, that could have been a very beneficial type of investing.

Hratch Karakachian: The other benefit to that is helpful in your, I mean, the fact that you just described is that a partnership or LLC can buy, can invest and get these shares. That's correct. It's not limited. It's not restricted the individuals only.

Chia-Li Chien: Correct. Yeah, right. There could be another entity.

Hratch Karakachian: Yeah. Yes. Yeah. And that escort for example, even though he wouldn't qualify as 1200 to an escorp itself, you're a partnership or an LLC can buy. Here's a stock that's not right.

Chia-Li Chien: That's right.   All right. This has been really, really informative.

Hratch Karakachian: Yeah, I'm glad you enjoyed it.

Chia-Li Chien: Yeah, it's uh, it's, it's lots of, I believe that this type of presentation can be presented again if you are interested, um, to, um, the Hub 10 has Angela investors group. Um, and this, this could be a concept introduced to the hub one Oh one as, as all these high tech startup company are forming and thinking about how they should structure their, their company and having the, having that concept in there could be a very good selling factor when they're out there pitching, investing investors opportunities.

Hratch Karakachian: Okay. Yeah, that's an excellent idea.

Chia-Li Chien: Yeah. Yeah. Well, thank you so much. I know that we've gone 10 minutes over and this, this is, this is a great session and, um, well we'll, we'll do an email exchange as far as when is the next one going to be and then what would be a next appropriate topic. Um, if there are any particular topic that you want to talk about, we can, we can discuss that as well. But I liked that, uh, opportunities, zone topic. I think it's, it's a questions that a lot of people ask and it doesn't tend, it doesn't seem to have a lot of, um, uh, guidance yet. Yeah. So hopefully we are coming down to the, The end of the fall. Um, you, depending on your timeline, cause I know you're going to be busy.

Hratch Karakachian: Yeah. Let me, the tax season, let me finish the, um, let me turn the recording.