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Excluding Gains From Small Biz Stock Sales

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Under the right circumstances, 100% of gain from the sale of qualified small business stock (QSBS) is not taxed either under regular federal income tax principles or for purposes of computing a taxpayer's Alternative Minimum Tax (AMT). To qualify for this 100% exclusion, the stock must be acquired between Sept. 28, 2010 and Dec. 31, 2011, and otherwise qualify as QSBS. The potential for exclusion provides an inviting opportunity for both businesses seeking investors and investors alike.

However, before getting too overjoyed by this opportunity, businesses and investors need to ask themselves two fundamental questions. First, what are the circumstances under which this 100% exclusion is available? And second, in light of both short-term and long-term considerations, is it worth the effort to qualify?

This article briefly addresses (i) who is eligible to qualify for the QSBS exclusion; (ii) what type of stock qualifies as QSBS; (iii) the general benefits and limitations of QSBS; and (iv) the questions taxpayers must ask themselves in determining if qualifying under the QSBS rules is worth the effort.

I. Eligible Taxpayers

As a general matter, only individuals qualify for this exclusion. In addition, individuals who hold QSBS indirectly through an interest in a flow-thru entity, *e.g.*, a partnership, limited liability company or S corporation, may also qualify for the exclusion if certain requirements are met.[1]

II. What is QSBS

In general, to qualify as QSBS, the following requirements must be satisfied:

- the stock must be that of a domestic C corporation,
- the stock must be acquired in an original issuance from the corporation in exchange for money, property or services,
- the gross assets of the corporation could not have exceeded $50 million at any time between Aug. 10, 1993, and immediately following the issuance (*i.e.*, the calculation takes into account amounts received from the issuance),
- at least 80% of the corporation's assets, determined by value, must be used in the active conduct of a trade or business which is not: (i) the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial sciences, performing arts, consulting, athletics, or financial or brokerage services; (ii) banking, insurance, finance, leasing or investing; (iii) a hotel or restaurant business; (iv) a farming or mineral extraction business; or (v) anything similar to the businesses or fields listed above, and
- the taxpayer must hold the stock for more than five years before selling it.[2]

1 The rules applicable to flow-thru entities are not addressed in this article.

2 An investor may qualify for the QSBS exclusion if, after six months, the investor sells his or her QSBS and, within 60 days, rolls over the investment into new QSBS which, when combined with the holding period of the original QSBS investment, is held by the investor for the required holding period. *See*, Code §1045.

III. A Brief Overview of QSBS

A. The Ability to Exclude from Taxable Income Gain from the Sale of QSBS

Special treatment available for taxpayers selling QSBS has existed since 1993[3] and, in many respects, is nothing new. The historical rules applicable to QSBS remain relevant to investors and businesses today, and will continue to be relevant in the future. Therefore, in order to best understand why excluding 100% of QSBS gain may not be as good as it sounds, you must first understand the history of QSBS.

Historically, taxpayers were permitted to exclude 50% of gain from the sale of QSBS. When first enacted, the maximum long-term capital gain rate for individuals was 28% — meaning that the effective tax rate on gain from the sale of QSBS was approximately 14%. As such, the benefit of investing in QSBS could be roughly calculated as the difference between (i) a 28% tax rate generally applicable to long-term capital investments; and (ii) a 14% effective tax rate applicable to QSBS. In this respect, the legislation strongly favored investing in QSBS.

However, in 1997, the cumulative effect of two changes in the tax law undermined the incentive to invest in QSBS. First, the maximum long-term capital gain rate was reduced from 28% to 20%. Second, that rate reduction did not apply to QSBS and, as a result, the effective tax rate on gain from the sale of QSBS remained at 14%.[4] As such, the benefit of investing in QSBS was reduced — and could be roughly calculated as the difference between (i) a 20% tax rate; and (ii) a 14% effective tax rate.

In 2003, the maximum long-term capital gain rate was reduced again — this time to 15%. And, once again, the rate reduction had no impact on QSBS.[5] As such, the benefit of investing in QSBS could be roughly calculated as the difference between (i) a 15% tax rate; and (ii) a 14% effective tax rate. For many investors, after taking into account the required five-year holding period and other applicable requirements, acquiring QSBS hardly seemed worth the effort.

In recent years, legislative efforts were taken to stimulate investments in QSBS. For example, gain from the sale of QSBS acquired after February 17, 2009 and before the end of 2010, was subject to a 75% exclusion (as opposed to a 50% exclusion). As a result, the maximum effective rate applicable to QSBS was 7%, as opposed to 14%;[6] and the benefit could be calculated as the difference between (i) a 15% tax rate; and (ii) a 7% effective tax rate.

In late September 2010, the amount of excludible QSBS gain was increased to 100%. However, these rules applied only for QSBS acquired between Sept. 28, 2010 and the end of 2010 — giving taxpayers only a few short months to react.[7] In addition, gain from the sale of QSBS acquired during that brief window would not be subject to the AMT.[8]

In late December 2010, the rule allowing taxpayers to exclude from taxable income, including the AMT, 100% of their gain from the sale of QSBS was extended to QSBS acquired through Dec. 31, 2011.[9] Thus taxpayers were given ample time to consider whether to invest in QSBS, or to qualify as a corporation with the ability to issue QSBS.

B. Limitations

It is important to recognize the limitations of investing in QSBS. For example, the amount of gain from the sale

3 *See*, the Revenue Reconciliation Act of 1993.

4 *See*, the Taxpayer Relief Act of 1997 and Code §1(h)(1) (addressing, among others, "Section 1202 gain").

5 Although, in certain circumstances, if the corporation was a qualified business under the Empowerment Zone Rules, then the amount of gain excludible was increased from 50% to 60%.

6 *See*, the American Recovery and Reinvestment Act of 2009.

7 *See*, the Small Business Jobs Act of 2010.

8 For QSBS acquired prior to that time, a portion of the gain was treated as a preference item and was therefore included in income for purposes of computing the AMT.

9 *See*, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010.

of QSBS eligible for exclusion is limited to the greater of (i) $10 million; or (ii) 10 times the taxpayer's investment in the corporation.

In addition, special rules exist which, if applicable, could deny the benefits of QSBS. For example, if a corporation redeems stock from a stockholder within the four-year period commencing two years prior to the issuance of the stock, the exclusion rules may no longer apply to that stockholder. Similarly, if the corporation redeems a significant portion of its outstanding stock within the two-year period commencing one year prior to the issuance of the stock, the exclusion rules may no longer apply to any stockholder.

Also, as one would suspect, there are special rules that deny the benefits of QSBS if the taxpayer (or a related party) takes an offsetting position before the end of the required five-year holding period.

IV. Is It Worth It?

Notwithstanding the limitations discussed above, the ability to exclude 100% of gain from the sale of a five-year, or longer, investment is incredibly enticing. Unfortunately, the analysis does not end there. There are many other factors to consider before deciding either to acquire QSBS, or to qualify as a corporation with the ability to issue QSBS.

A. Choice of Entity

Both investors and the businesses seeking to attract them need to consider whether it makes sense for the investment vehicle to be treated as a C corporation. As a general matter, limited liability companies, partnerships and S corporations are viewed as more tax-favorable investment vehicles due to the flow-thru tax regimes applicable to them.

In contrast, because investing in a C corporation gives rise to both a corporate-level tax and a shareholder-level tax, an investor's return on investment — other than from a sale of stock qualifying for the exclusion — will be significantly and adversely impacted by a decision to be treated as a C corporation.[10]

Businesses currently taxed as partnerships or S corporations should carefully consider the consequences of converting to a C corporation or terminating their S corporation status, respectively. Not only can such decisions have an immediate adverse tax impact on the business, but those decisions could have lingering tax consequences as well.[11]

Moreover, if, after the passage of time, it turns out that having the ability to issue QSBS was not the best way to attract investors, businesses will quickly discover that converting from a C corporation may be even more painful than converting to a C corporation.

B. Subsequent Changes in Tax Laws

Potential changes in tax laws further complicate the difficulty in deciding whether it is worth the effort to acquire, or have the ability to issue, QSBS.

1. Percentage of QSBS Gain Excludible for Subsequent Investors

If the new law excluding 100% of gain from the sale of QSBS is not extended beyond 2011, then the 50% gain exclusion rules will again be in effect for stock acquired after 2011, and a percentage of the excluded portion of the gain will be treated as a preference item for purposes of computing an investor's AMT. Although this change will not directly impact inves-

10 Assuming a corporate tax rate of 35% and a shareholder tax rate on qualified dividends of 15%, the effective tax rate on $100 of corporate profits that, after taxes, will be distributed to its shareholder, is approximately 44.8% (*i.e.*, $100 x 35% corporate tax rate leaves only $65 available for distribution as a qualified dividend, and $65 x 15% qualified dividend rate, leaves $55.2 after-tax proceeds for the investor). If the 15% qualified dividend rate sunsets at the end of 2012, then the tax rate on dividends may increase to ordinary income tax rates, resulting in an even larger effective tax rate.

11 For example, if an S corporation terminates its S corporation status then, in general, it may not re-elect S corporation status for the 60-month period following such termination.

tors who acquire QSBS during 2011, such change will impact these investors indirectly.

For example, if the corporation seeks additional capital in subsequent years, it may have difficulty because potential investors may decide not to invest due to the fact that the QSBS rules are no longer particularly attractive i.e., if all else remains unchanged, the benefit of investing in QSBS after 2011 could be roughly calculated as the difference between (i) a 15% tax rate; and (ii) a 14% effective tax rate.

As explained above, after taking into account the required holding period, this may not seem worth the effort.[12] Absent the ability to attract new investors, the corporation's overall success may suffer which will, in turn, adversely impact those who invest during 2011.[13]

2. Tax Treatment of Dividends

The analysis is further complicated if investors include anticipated dividend income as part of their projected return on investment. In such a case, investors need to know whether, over the course of the next five years, the current 15% tax rate available for "qualified dividends" will remain intact — and if not, whether it will be repealed in its entirety or simply modified.[14]

V. Conclusion

In light of the above, businesses and individuals should give serious thought to whether QSBS is worth pursuing given their particular situations. Taxpayers should consider not only the benefits of investing in QSBS, but how those benefits may be impacted by the potential changes in the tax law. This article is by no means a substitute for careful tax planning, and taxpayers are strongly encouraged to consult with a tax professional familiar with these rules and the taxpayer's particular situation.

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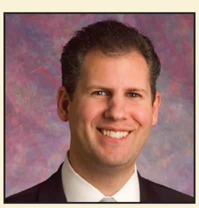
12 If long-term capital gain rates increase in the near future, then the comparative benefit of QSBS would have to be reconsidered.

13 Although this is a very real concern, it is worth noting that the current administration recently announced its proposal to make the 100% exclusion permanent.

14 Currently, the law taxing qualified dividends at the preferential 15% rate is due to sunset at the end of 2012; absent further legislation, dividends would thereafter be taxed at ordinary income tax rates.



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