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Client Alert

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Favorable Legislation Relating to Qualified Small Business Stock

"The 2010 SBJCA amends [Internal Revenue Code] Section 1202 to provide for a temporary exclusion of 100 percent of gain realized on the disposition of QSBS acquired on or after September 28, 2010 and prior to January 1, 2011. . . . This change results in a potentially significant federal income tax benefit to non-corporate investors . . ."

On September 27, 2010, President Obama signed the Small Business Jobs and Credit Act of 2010 into law (the 2010 SBJCA). This legislation includes various tax provisions relating to small business growth, including a provision amending Section 1202 of the Internal Revenue Code of 1986, as amended (the Code), to permit the temporary exclusion of 100 percent of any gain realized on the sale of certain "qualified small business stock" (QSBS) as defined in that Code section. Under prior law, stockholders were generally permitted to exclude from recognition only 50 percent of the capital gain on the sale of QSBS, or 75 percent of the capital gain on such stock acquired after February 17, 2009 and before January 1, 2011. Under the 2010 SBJCA, that exclusion is increased to 100 percent, but only for QSBS acquired between September 28, 2010 and December 31, 2010. This *Client Alert* summarizes the existing tax rules relating to QSBS and the changes to these rules made by the 2010 SBJCA.

Defining Qualified Small Business Stock

"Qualified Small Business"

QSBS may generally only be issued by a "qualified small business," within the meaning of Code Section 1202, which generally requires that the issuer:

- Be a domestic (US) C corporation;
- Have aggregate gross assets which, at all times on or after August 10, 1993, through and immediately following the issuance of the QSBS, do not exceed $50 million; and
- Agree to submit such reports to the IRS and shareholders as the IRS may require to carry out the purposes of Section 1202.

In calculating whether a corporation meets the aggregate gross asset test, subject to certain exceptions, cash is included at face value and other assets are valued at their adjusted tax bases. To date, the IRS has yet to issue any reporting requirements applicable to qualified small businesses or QSBS.

"Qualified Small Business Stock"

Section 1202 also requires that securities meet the following conditions in order to qualify as QSBS:

- The stock must be "originally issued" to the taxpayer by a corporation that is a qualified small business on the date of issuance;
- During substantially all of the taxpayer's holding period, at least 80 percent (by value) of the

corporation's assets must be used in the active conduct of one or more qualified trades or businesses;
- The corporation must be an "eligible corporation" during substantially all of the taxpayer's holding period;
- The corporation may not (directly or indirectly) redeem more than a *de minimis* number of shares held by a taxpayer to which the QSBS is issued, or certain related parties, within a four-year period beginning two years prior to the issuance of the QSBS; and
- There may be no "significant redemptions" of the issuing corporation's stock from any party during the two-year period beginning one year prior to the QSBS's issuance.

Stock can be originally issued within the meaning of this requirement by the qualified small business directly or through an underwriter. It can be acquired in exchange for money or other property, but not other stock, or as compensation for services other than underwriting. Special rules apply to stock received by a partner from a partnership, as well as to stock received in a reorganization pursuant to Code Section 368(a)(1)(F) or solely through the conversion of other stock in the same corporation.

A qualified trade or business specifically includes start-up activities and certain research and experimentation activities. The term is otherwise defined as any trade or business other than certain specifically excluded activities (for example, professional activities such as law or medicine, banking and finance, farming, mining, and the operation of hotels and restaurants). For purposes of determining whether the 80 percent requirement is satisfied, a corporation is treated as owning its proportionate share of the assets of any subsidiary in which it holds more than 50 percent of the combined voting power or value. Cash or other assets held to meet the reasonable working capital needs of a qualified trade or business, or which are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business, count toward the 80 percent requirement, subject to certain limitations. Other than these cash assets, no more than 10 percent of the value of a corporation's assets less its liabilities may consist of securities of corporations other than controlled subsidiaries, and no more than 10 percent of the value of a corporation's total assets may consist of real estate not used in the active conduct of a qualified trade or business.

Certain entities that enjoy special tax privileges under other Code sections are excluded from the definition of an "eligible corporation." For example, domestic international sales corporations, regulated investment companies, real estate investment trusts and cooperatives may not issue QSBS.

Tax Benefits and Limitations

If the requirements associated with the issuance of QSBS are satisfied, potentially significant tax benefits may apply. In addition to certain recognition deferral and rollover rights provided under Code Section 1045, prior to the enactment of the 2010 SBJCA, Section 1202 allowed non-corporate taxpayers to exclude from gross income either 50 percent or 75 percent, depending on the date of issuance, of the gain arising upon the sale of QSBS. In order to benefit from this exclusion:

- The QSBS must have been held for more than five years;
- Gains realized on certain "offsetting short positions" are limited;
- The amount of gain that can be excluded by any single taxpayer with respect to a particular issuer is generally limited to the greater of $10 million or ten times the adjusted basis of the QSBS; and
- A portion of any excluded QSBS gain is treated as an item of tax preference for alternative minimum tax (AMT) purposes.

The 2010 SBJCA amends Section 1202 to provide for a temporary exclusion of 100 percent of gain realized on the disposition of QSBS acquired on or after September 28, 2010 and prior to January 1, 2011. In addition, during this period, the excluded gain is not treated as a preference item for purposes of the AMT, although the other limitations described previously continue to apply. This change results in a potentially significant federal income tax benefit to non-corporate investors, essentially reducing to zero the federal tax rate for capital gain on QSBS to which the change applies.

Taxpayers interested in exploring the availability of or restrictions on the tax benefits provided by Code Section 1202, or that have questions about this *Client Alert*, may contact David Kahn in our Los Angeles or San Diego offices, Mimi Chao in our Los Angeles office, or the Latham attorney with whom they normally consult:

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