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PERSPECTIVE

An Investment Window for Qualified Small Business Stock

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In an effort to help spur an economic recovery, Uncle Sam is offering a tax incentive for investing in innovative small businesses - but only to those who act promptly, as the window for taking advantage of a key capital gains provision of recently-enacted legislation will close at the end of 2010.

On Sept. 27, President Barack Obama signed the Small Business Jobs and Credit Act of 2010 into law. The legislation includes various tax incentives relating to small business growth, including a provision to permit the temporary exclusion of up to 100 percent of any gain realized on the sale of certain "qualified small business stock" as defined in Section 1202 of the Internal Revenue Code. Under prior law, stockholders were generally permitted to exclude from recognition only 50 percent of the capital gain on the sale of qualified small business stock, or 75 percent of the capital gain on such stock acquired after Feb. 17, 2009 and before Jan. 1, 2011. Under the Act, that exclusion is now increased to 100 percent, but only for qualified small business stock acquired between Sept. 28, 2010 and Dec. 31, 2010.

Qualified small business stock may generally only be issued by a "qualified small business," within the meaning of Code Section 1202, which usually requires that the issuer: be a domestic (U.S.) C corporation; have aggregate gross assets that do not exceed \$50 million at all times on or after Aug. 10, 1993 through and immediately following the issuance of the qualified small business stock; and agree to submit such reports to the Internal Revenue Service and shareholders as the IRS may require to carry out the purposes of Section 1202.



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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 qualified small business stock.

To be considered qualified small business stock, Section 1202 requires that securities meet several conditions. The stock must be "originally issued" to the taxpayer by a corporation that is a qualified small business on the date of issuance, and 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. Also, the company must be an "eligible corporation" during substantially all of the taxpayer's holding period, and it may not (directly or indirectly) redeem more than a *de minimis* number of shares held by a taxpayer to which the qualified small business stock is issued, or certain related parties, within a four-year period beginning two years prior to the issuance of the qualified small business stock. Finally, 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 qualified small business stock'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 qualified small business stock.

If the requirements associated with the issuance of qualified small business stock 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 Act, 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 qualified small business stock. In order to benefit from this exclusion, the qualified small business stock must have been held for more than five years. Gains realized on certain "offsetting short positions" are limited, and 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 10 times the adjusted basis of the qualified small business stock. A portion of any excluded gain is treated as an item of tax preference for alternative minimum tax purposes.

The Act amends Section 1202 to provide for a temporary exclusion of 100 percent of gain realized on the disposition of qualified small business stock acquired on or after Sept. 28, 2010 and prior to Jan. 1, 2011. In addition, during this period, the excluded gain is not treated as a preference item for purposes of the alternative minimum tax, 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 qualified small business stock to which the change applies.

In signing the legislation, President Obama predicted the measure would drive "capital to as many as one million small firms across America." Such an outcome will depend in part on how aware investors are of the tax break opportunity, and how quickly they act to take advantage of it.