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Client Alert
News Flash

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Congress Permanently Extends Capital Gains Exclusion for Qualified Small Business Stock

Tax law change is good news for non-corporate investors.

On December 18, 2015, President Obama signed the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act) into law. The PATH Act retroactively renews and permanently extends the 100% capital gain exclusion relating to gain realized on certain dispositions of “qualified small business stock” (QSBS) acquired after September 27, 2010.

The Small Business Jobs Act of 2010 (the 2010 SBJA) included a provision amending Section 1202 of the Internal Revenue Code of 1986, as amended (the Code), to permit the temporary exclusion of 100% of any capital gain realized on the sale of certain QSBS as defined in that Code section. Under the law in effect before the 2010 SBJA, stockholders were generally permitted to exclude from recognition only 50% of the capital gain on the sale of QSBS (or 75% of the capital gain on such stock acquired after February 17, 2009). Under the 2010 SBJA, that exclusion was increased to 100%, but only for QSBS acquired between September 28, 2010 and December 31, 2010. The end date for this 100% exclusion was subsequently extended through December 31, 2014. The PATH Act now renews and permanently extends the 100% exclusion for all QSBS acquired after September 27, 2010. This *Client Alert* summarizes the existing tax rules relating to QSBS and the changes to these rules made by the PATH Act.

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 US $50 million, and
- Agree to submit such reports to the IRS and stockholders 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 U.S. corporation that is a qualified small business on the date of issuance.
- During substantially all of the taxpayer’s holding period, at least 80% (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.
- 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’ issuance.

Stock can be originally issued within the meaning of this requirement by the qualified small business directly or through an underwriter. The stock 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 certain reorganizations.

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% 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% 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% requirement, subject to certain limitations. Other than these cash assets, no more than 10% 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% 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 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, Section 1202 now allows non-corporate taxpayers to exclude from gross income either 100%, 50% or 75%, depending on the date the QSBS was issued, of the gain arising on 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 any single taxpayer can exclude with respect to a particular issuer is generally limited to the greater of US$10 million or 10 times the taxpayer’s adjusted basis of the QSBS.

Subject to these requirements, the PATH Act provides for the exclusion of 100% of any gain realized on the disposition of QSBS acquired after September 27, 2010. For QSBS acquired before February 18, 2009, the exclusion is limited to 50% and for QSBS acquired between February 18, 2009 and September 27, 2010, the exclusion amount is limited to 75%.

In addition, for dispositions of QSBS that are eligible for this 100% capital gain exclusion, no portion of the excluded gain is treated as a preference item for purposes of the alternative minimum tax (AMT). For dispositions of QSBS that are eligible for the 50% or 75% exclusion (*i.e.*, issued prior to September 28, 2010), a portion of any excluded gain will continue to be treated as a preference item.

Conclusion

The permanent, retroactive extension of the 100% capital gain exclusion under the PATH Act results in a potentially significant federal income tax benefit to non-corporate investors, in some cases reducing the federal tax rate for capital gain on QSBS to zero.

Taxpayers interested in exploring the availability of or restrictions on the tax benefits provided by Code Section 1202 described in this *Client Alert* should contact one of the authors listed below or the Latham lawyer with whom they normally consult:

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