

Tax Law Extension Good News for Non-corporate Investors

Congress once again temporarily extends the 100 percent capital gains exclusion on “qualified small business stock.”

On December 19, 2014, President Obama signed the Tax Increase Prevention Act of 2014 (the 2014 TIPA) into law. The 2014 TIPA renews and extends the 100 percent capital gain exclusion relating to gain realized on “qualified small business stock” (QSBS).

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 percent 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 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 SBJA, that exclusion was increased to 100 percent, but only for QSBS acquired between September 28, 2010 and December 31, 2010. This date was extended to December 31, 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Relief Act) and was further extended to December 31, 2013 under the American Taxpayer Relief Act of 2012 (the 2012 Taxpayer Relief Act). This most recent legislation, the 2014 TIPA, renews and extends this 100 percent exclusion period through December 31, 2014. Furthermore, the extension applies retroactively, such that the exclusion now applies to QSBS acquired after September 27, 2010 and prior to January 1, 2015. This *Client Alert* summarizes the existing tax rules relating to QSBS and the changes to these rules made by the 2010 SBJA, the 2010 Tax Relief Act, the 2012 Taxpayer Relief Act and the 2014 TIPA.

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
- 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 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.
- 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. 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 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 SBJA, 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 US\$10 million or 10 times the adjusted basis of the QSBS.
- A portion of any excluded QSBS gain is treated as an item of tax preference for alternative minimum tax (AMT) purposes.

The 2010 SBJA amended 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. The 2010 Tax Relief Act further amended Section 1202 to extend this exclusion period until January 1, 2012. The 2012 Taxpayer Relief Act further extended the exclusion to December 31, 2013. The 2014 TIPA extends the exclusion through December 31, 2014, such that the 100 percent exclusion now applies to QSBS acquired after September 27, 2010 and prior to January 1, 2015. In addition, for dispositions of QSBS that are eligible for this 100 percent capital gain exclusion, the excluded gain is not treated as a preference item for purposes of the AMT, although the other limitations described previously continue to apply.

Conclusion

The temporary retroactive extension of the 100 percent capital gain exclusion under the 2014 TIPA 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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