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TAX-FREE CAPITAL GAINS ON QUALIFYING SMALL BUSINESS STOCK

In late 2010 and then again in 2011, Congress amended key provisions of the Internal Revenue Code designed to spur investment in qualifying small businesses.¹ These amendments work to exclude up to \$10 million of otherwise taxable gain from the sale of Qualifying Small Business Stock (“QSBS”).

In particular, Congress amended existing Section 1202 of the Internal Revenue Code, which previously permitted a taxpayer to exclude 50% of its gain from the sale of QSBS but applied a higher-than-normal tax rate of 28% to the remaining gain. The higher-than-normal rate produced an effective tax rate of 14% on gains from the sale of QSBS – a mere 1% less than current long-term capital gains rate. Consequently, Section 1202 provided no real benefit to most taxpayers.

With the amendments, a taxpayer may now exclude 100% of the gain on QSBS up to \$10 million. The \$10 million exclusion must be reduced, however, by gains excluded in prior years and may not exceed 10 times the aggregate adjusted basis of QSBS disposed of during the current tax year. Even with these limitations, the tax-savings afforded by the amendments are significant. For example, \$10 million of gain on QSBS under the old Section 1202 would result in \$1.4 million in taxes. For QSBS acquired between September 27, 2010, and January 1, 2012, the tax on the gain is \$0.

Given these tax advantages, taxpayers with capital to invest (whether in new or existing businesses) and taxpayers who made prior investments in qualifying small businesses should consider carefully the requirements of revised Section 1202.

Eligibility

A taxpayer must generally satisfy the following requirements, among others, to qualify for the capital gains exclusion provided by Section 1202:

- Must acquire QSBS after September 27, 2010, and before January 1, 2012.²

¹ These amendments were included in the Small Business Jobs Act of 2010 and the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2011.

² A 75% exclusion applies to gains on stock acquired during 2009 and for most of 2010

- Must acquire QSBS upon original issuance by the qualifying small business.
- Must acquire QSBS for cash, property other than stock, or compensation for services.
- Must hold QSBS for more than five years (subject to certain exceptions).
- Must be an individual, partnership, LLC, S corporation, or other noncorporate taxpayer.

Additionally, the QSBS must be issued by a domestic C corporation that:

- Holds aggregate gross assets (i.e., cash plus adjusted tax basis of other assets) less than or equal to \$50 million both before and immediately after the investment by the taxpayer.
- Uses 80% of its assets (by value) in a qualifying active trade or business for substantially all of the taxpayer's holding period.

The active trade or business requirement denies Section 1202 treatment to certain business, including stock issued by most personal service business such as engineering, architectural, accounting, or law firms and stock issued by banks, hotels, financial service firms, and other corporations. Yet, the active trade or business requirement does not deny Section 1202 treatment to corporations engaged in certain start-up activities.

Planning Opportunities

The amendments to Section 1202 are clearly designed to spur economic investments in small business (hence the name of the implementing legislation – The Small Business Jobs Act). Thus, an investor with capital to invest must consider the tax advantages of purchasing QSBS. Qualifying small businesses should promote their status as such to potential investors.

Additionally, shareholders of existing business may also take advantage of amended Section 1202. Investments made by existing shareholders between September 27, 2010, and January 1, 2012, may qualify for Section 1202 treatment.

Further, while QSBS must generally be issued by a domestic C corporation between September 27, 2010, and January 1, 2012, Section 1202 may permit noncorporate entities to convert to a C corporation and obtain the tax advantages from amended Section 1202. The conversion to a C corporation may extend the benefits of Section 1202 to investments made either before or after conversion and to investments made prior to September 27, 2010.

Additional Information

Should you have any questions, please contact one of the attorneys shown above or another member of the Tax Department at Friday, Eldredge & Clark.