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Federal Tax Alert

Subject:

Capital Gain Exclusion on Small Business Stock

Background

On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010 (the "Jobs Act"). One of the more intriguing provisions of the Jobs Act is the 100% exclusion from gross income of capital gains from the sale of certain qualified small business stock. Generally this provision will allow taxpayers to pay no federal tax on up to \$10 million in gain from the sale of certain qualified small business stock.

Details

The capital gain exclusion for qualified small business stock, contained in section 1202, has been in existence since 1993. Generally the amount excluded from gross income was 50% of eligible gains, although the excluded portion was increased to 75% for stock issued in 2009 and most of 2010. The includible portion of the gains was generally taxed at a 28% capital gains rate. Furthermore, an amount equal to seven percent of the amount excluded from gross income was a preference for alternative minimum tax purposes, which had the effect of increasing alternative minimum taxable income. (Section 57(a)(7)).

Because of the increased tax rate on the portion not excluded from gross income and the alternative minimum tax preference, most taxpayers enjoyed very little or no federal benefit for the section 1202 exclusion. Some taxpayers did enjoy some state tax benefit from the exclusion. For example, California taxpayers typically enjoyed reduced California taxes as a result of the exclusion.

With this recent change, however, taxpayers in general will be able to exclude up to \$10 million in gain from gross income with no preference for alternative minimum tax purposes. The window for this opportunity is short. Taxpayers must acquire the qualified small business stock after September 27, 2010, and before January 1, 2011. Clearly the provision was designed to encourage the formation of small businesses prior to year-end with the goal of the creation of new jobs. To be eligible for the exclusion the qualified small business stock must be held for more than five years. Thus, the earliest one can benefit from the 100% exclusion would be 2015.

Qualification For Section 1202 Exclusion: To qualify for the 100% exclusion, all of the limitations applicable to investments in qualified small businesses must be met, including the following:

- The qualified small business stock must be acquired after September 27, 2010, and before January 1, 2011.

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- The qualified small business stock must be held for more than five years (subject to certain exceptions for qualifying tax-free “rollovers”).
- The exclusion applies only to non-corporate taxpayers – including pass-through entities such as partnerships, S corporations, regulated investment companies, and common trust funds.
- The small business must be a domestic C corporation and the stock purchased must be purchased by the investor upon original issuance from the corporation (directly or through an underwriter).

• The small business corporation generally must use 80% of its assets (by value) in a qualifying active business (which excludes certain types of businesses, such as financial institutions, farms, professional service firms, hotels and restaurants, and similar businesses) for substantially all of the investor’s holding period. Active trade or business is defined as follows:

- Start-up activities in connection with

1. investigating the creation or acquisition of an active trade or business,
2. creating an active trade or business, or
3. activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.

- Activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures.

- Activities with respect to in-house research expenses, assets used in such activities shall be treated as used in the active conduct of a qualified trade or business. Any determination under this provision shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination.

- The small business must not have made certain redemptions of its stock prior to or following the acquisition of the stock.
- The aggregate gross assets (defined generally as cash plus the aggregate adjusted tax basis of other property) held by the small business must not exceed \$50,000,000 at any time before or immediately following the investment by the investor (including amounts received by the small business from the investor).

In addition, there is a per-issuer limit on gains eligible for the exclusion equal to the greater of \$10,000,000 or ten times the adjusted tax basis of stock issued by the small business and disposed of by the investor during a particular year.

Section 1202 is not elective. A section 1202 gain must be reported as such on the taxpayer’s return by reporting 100% of the gain and then excluding the appropriate exclusion percentage at the time of the gain –75% for qualified small business stock acquired after February 17, 2009, and before September 28, 2010; 50% if the stock qualifies under the rules prior to February 18, 2009; and 100% if the stock was acquired after September 27, 2010, and before January 1, 2011, and the stock was held for more than five years.

There are no income tax regulations providing guidance under section 1202 and only a few rulings have been issued. There is some question as to whether the gain excluded prior to the 2009 change in the law is a total of \$10,000,000 excluded for one stock over multiple years with an annual exclusion cap of 50% of \$10,000,000. This ambiguity was pointed out by a well-known tax scholar who mentioned in one of his treatises that taxpayers can take this position due to a statement in IRS Publication 550 and a literal reading of the provisions of section 1202. This recent change in the law clearly allows the full \$10,000,000 exclusion versus \$5,000,000 (\$10,000,000 times 50%) or \$7,500,000 (\$10,000,000 times 75%).

Planning Opportunities: Individual or pass-through clients desiring to start up a new company or invest in new companies should consider taking advantage of the new 100% exclusion and acquire newly-issued qualified small business stock prior to year-end. Employees or directors holding stock options in qualified small businesses should consider exercising the options before the end of 2010.

Those founders that had originally chosen the limited liability company or partnership form of business for their start-up business may wish to reconsider their method of taxation. A conversion from an entity taxed as a partnership to one taxed as a C corporation may qualify for qualified small business status if the requirements discussed above are satisfied and the method chosen to incorporate is appropriate.

Unfortunately, an existing S corporation would not be eligible to be converted into an eligible C corporation that would qualify for the 100% exclusion with respect to any stock that shareholders currently hold at the time of conversion.

Follow-on investments in either cash or property in exchange for stock as an original issuance from the corporation or through an underwriter also qualify for exclusion of a small business stock gain.

In the above opportunities, these transactions would result in the acquisition of qualified small business stock as long as the aggregate gross assets held by the small business does not exceed \$50,000,000 at any time before or immediately following the investment by the investor.

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