Paul Hastings
StayCurrent
A Client Alert from Paul Hastings
October 2010

New Law Creates Zero Percent Effective Tax Rate for Certain Qualified Small Business Stock

BY DOUGLAS A. SCHAAF & ERIKA B. MAYSHAR

For investors who purchase certain qualifying stock by December 31, 2010, at least $10 million of future appreciation can be entirely excluded from federal income tax. This recently-enacted tax break, applicable to "qualified small business stock," creates a powerful incentive for investors to act quickly and invest in qualifying companies before year-end.

Tax Benefit for Qualified Small Business Stock

Section 1202 of the Internal Revenue Code, originally enacted in the early 1990s, creates a partial tax exclusion for certain investments in qualified small business stock ("QSB stock"). The purpose of this tax provision is to stimulate new cash flow into start-up companies by reducing the effective tax rate on future stock gains. The benefits of Section 1202 are available to all noncorporate taxpayers who hold their QSB stock for at least five years before selling.

When first enacted, Section 1202 offered a meaningful tax break, since it allowed 50% of qualifying gains from the sale of QSB stock to be excluded from gross income. This 50% break reduced the effective tax rate on long-term capital gain from 28% (the rate in effect at that time) to 14%.

When tax rates on long-term capital gain were lowered to 20% in 1997 and then 15% in 2003, the benefit of Section 1202 became relatively insignificant. Most investors preferred to invest freely in stocks at a 15% tax rate rather than adhere to the limits of Section 1202 to achieve an effective 14% rate (the 50% exclusion could not be combined with the preferential tax rate). Moreover, a percentage of the gain excluded under Section 1202 was treated as a preference item for purposes of the alternative minimum tax ("AMT"), offsetting the benefits for many taxpayers.

As part of recent legislative efforts to stimulate the economy, the Section 1202 exclusion was raised from 50% to 75% for QSB stock acquired during most of 2009 and 2010. Then in September the Small Business Jobs Act of 2010 was enacted, further amending Section 1202 to exclude 100% of qualifying gain from gross income.

For QSB stock purchased between September 27, 2010 and December 31, 2010, a zero percent effective income tax rate will apply to at least the first $10 million of gain upon its ultimate sale if applicable requirements are met. Excluded gain from these investments will not be treated as a preference item for AMT purposes, so the benefits extend equally to AMT taxpayers.

What Is "Qualified Small Business Stock"?

Common or preferred stock meets the definition of "Qualified Small Business Stock" if the following requirements are met:

1. The stock must have been issued after August 10, 1993, when Section 1202 was enacted, and the investor must acquire the stock at original issuance. (To qualify for the 100% exclusion, the stock must have been issued from September 27, 2010 to December 31, 2010.)

    - The "original issuance" requirement is designed to encourage inflows of new capital into businesses. To prevent taxpayers from attempting to convert existing stock investments into QSB stock, Section 1202 does not apply if a corporation engages in certain redemption activity during the two years before or after the issue date.

2. The stock must have been acquired in exchange for money, property (except stock), or services (except services as an underwriter of the stock). The stock may be acquired through the exercise of an option or warrant, or the conversion of convertible debt. With certain exceptions described below, QSB stock cannot be obtained in exchange for other stock.

3. The stock must be in a domestic C corporation. Certain types of corporations are disqualified, such as DISCs, real estate investment trusts, and cooperatives.

4. Gross Assets Test for Issuing Corporation: In order to be a "qualified small business," the corporation must have aggregate gross assets of $50 million or less at all times from August 10, 1993 through date the stock is issued.

    - "Aggregate gross assets" means cash plus the aggregate adjusted tax bases of other property. This means that a corporation with assets having a fair market value far in excess of $50 million can nevertheless meet this test, if the aggregate asset bases do not exceed the threshold.

    - All corporations in a controlled group with more than 50 % ownership by a common parent are treated as one corporation for purposes of the gross assets test.

    - If the capital received by the corporation in exchange for issuance of the stock causes the assets to exceed $50 million, the stock cannot qualify as QSB stock. However, as long as the assets do not exceed the $50 million ceiling as of the issue date, the company's future growth will not impact the QSB status of the stock. Indeed, the very goal of Section 1202 is to stimulate this type of growth.

5. Active Business Test for Issuing Corporation: At least 80 % of the value of the corporation's assets must be used in the active conduct of a business, both at the time the stock is issued and during substantially all of the investor's holding period.

    - A few lines of business are excluded from the benefits of Section 1202, including service professions such as health, law, accounting, engineering, hospitality, and financial services.

- Research and start-up activities are considered active businesses even if the company is not yet profitable.
- A parent corporation owning more than 50 percent of a subsidiary is considered to own a pro rata share of the subsidiary's assets and to conduct a pro rata share of the subsidiary's business activities. Thus, stock in a holding company can meet the active business requirement due to this look-through rule.
- If more than 10% of the value of the corporation's assets consists of stock in corporations other than subsidiaries, or real estate not used in an active business, the corporation is disqualified.

How Much Gain Can Be Excluded?

The amount of gain that can be excluded from gross income under Section 1202 for any particular corporation over a taxpayer's lifetime is limited to the greater of (i) 10 times the taxpayer's basis in the stock or (ii) $10 million. This limitation applies on a per-issuer basis, allowing an investor to utilize the exclusion for multiple QSB stockholdings in different companies. Gain in excess of the excluded amount is taxable at the generally applicable long-term capital gain rate (currently 15% for the remainder of calendar year 2010).

Assume an investor purchases QSB stock in Corporation A on November 1, 2010 for a nominal amount. Six years later, he sells half of the stock for a gain of $6 million. 100 % of this gain will be excluded from gross income if the requirements of Section 1202 are satisfied. If the investor sells the remaining stock in year seven, at an additional gain of $7 million, the first $4 million of this amount will be excluded. The remaining $3 million will be subject to the applicable long-term capital gain rate. However, if the investor had also purchased QSB stock in Corporation B, that stock could be sold at a gain and be eligible for a separate $10 million exclusion under Section 1202.

Members of partnerships and S corporations can exclude certain pass-through gains triggered by the entity's sale of QSB stock investments. If the partner has owned a continuous interest in the partnership (or S corporation, as the case may be) since the QSB stock was purchased, she can exclude an amount of eligible gain in proportion to her partnership interest on the date of purchase.

Transactions that Preserve QSB Stock Status

A taxpayer who receives QSB stock from the original purchaser as a gift or bequest inherits the stock's QSB status. The recipient is treated as having acquired the stock in the same manner as the transferor and having held it for the same period.

QSB status can be preserved even for an investor who exchanges QSB stock for non-QSB stock in certain tax-free transactions under Section 351 or 368. For example, if as part of a recapitalization an investor exchanges his QSB stock for new stock in the same corporation, the new stock is treated as QSB stock even though the company's assets may far exceed the $50 million ceiling at the time of the recap. The new stock will be treated as QSB stock to the extent of inherent gain at the time of the transaction.

Investors Must Take Action by December 31, 2010 to Achieve Maximum Tax Benefit

Congress has created a very short window for investors to take advantage of the 100% exclusion for QSB gains: stock must be purchased by December 31, 2010 in order to qualify.

Holders of convertible debt or vested options in qualified small businesses should consider exercising before year-end in order to take advantage of this provision. Taxpayers who invest in multiple qualified small businesses can potentially shield from tax at least $10 million of gain per corporation.

Entrepreneurs seeking financing prior to January 1, 2011 should consider this tax benefit potentially available to investors in determining whether to operate in a C corporation form or the generally advantageous pass-through form of a limited liability company or S corporation.

Most states have parallel provisions to Section 1202 that reduce the applicable state income tax attributable to QSB stock gains. It remains to be seen whether these states will adopt the 100% exclusion through December 31, but at a minimum a 50% exclusion should be available.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Atlanta

Philip J. Marzetti
404-815-2258
philmarzetti@paulhastings.com

Chicago

Ziemowit T. Smulkowski
312-499-6056
ziemowitsmulkowski@paulhastings.com

Los Angeles

Alexander M. Lee
213-683-6160
alexanderlee@paulhastings.com

New York

Andrew M. Short
212-318-6018
andrewshort@paulhastings.com

Orange County

Douglas A. Schaaf
714-668-6221
dougschaaf@paulhastings.com

Erika Mayshar
714-668-6262
erikamayshar@paulhastings.com

Palo Alto

Thomas S. Wisialowski
650-320-1820
thomaswisialowski@paulhastings.com