Full Qualified Small Business Stock Capital Gain and AMT Exclusions Set to Expire at Year-End

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A key component of the Small Business Jobs Act of 2010, as extended by the 2010 Tax Relief Act, which was designed to spur investment in emerging companies throughout the U.S., is set to expire on December 31, 2011. The Jobs Act amended Section 1202 of the Internal Revenue Code ("Code") to allow non-corporate taxpayers the opportunity to exclude from gross income and Alternative Minimum Tax ("AMT") up to 100% of the gain recognized from the sale or exchange of Qualified Small Business Stock ("QSBS") purchased from September 28, 2010 through December 31, 2011. There has been no formal legislative proposal to extend the end-date or otherwise make the exclusions permanent. Accordingly, qualified small business issuers and their investors and employees should consider whether the current exclusions warrant taking certain actions by year-end.

Background

Prior to the Jobs Act, the Code allowed a non-corporate taxpayer to exclude from gross income up to 50%-75% of any gain from the sale or exchange of QSBS held for more than five years. However, the Code previously required that 7% of the amount excluded from gross income be treated as a "preference" item and subject to AMT. The Jobs Act has temporarily increased the federal taxable income exclusion to 100% and concurrently provided that the excluded amount would not constitute AMT income. Without further legislative action prior to year-end, the gross income exclusion for sales and exchanges of QSBS will return to a 50% exclusion level and the 7% AMT income treatment will be reimposed on taxpayers.[1]

Requirements for QSBS Treatment

There are a number of requirements that must be satisfied by issuers and taxpayers to qualify for QSBS treatment on the sale or exchange of stock.

Issuer Requirements

C-corporation

Only C-corporations are eligible to be qualified small businesses. S-corporations, limited liability companies, partnerships, REITs, DISCs, cooperatives and certain other issuers cannot issue QSBS.

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[1] Readers of this client alert should refer to an earlier client alert issued by our firm http://www.paulhastings.com/assets/publications/1740.pdf which originally outlined the requirements and opportunities surrounding Section 1202 as revised under the Small Business Jobs Act of 2010.

Active Business

During substantially all of the taxpayer's required five-year holding period, which starts on the date the shares are issued to the taxpayer, the issuer must meet the "active business requirements" of the Code. This requires that during the five-year period at least 80% of the issuer's assets, measured by value, shall be used by the issuer in the active conduct of one or more "qualified trades or businesses." Many technology, life sciences, and venture-backed operating companies should meet the qualified trade or business test. Banking, insurance, financing, leasing, and other businesses where the principal asset is the reputation or skill of one or more of its employees do not qualify.

Limited or No Repurchases within Designated Periods

In order for stock issued to a taxpayer to qualify for QSBS treatment, the issuer may not repurchase any stock from the taxpayer during the two-year period immediately prior to, and the two-year period immediately following, the issuance of the stock proposed to be treated as QSBS. In addition, stock will not qualify as QSBS if the issuer redeems stock from the stockholders with an aggregate value exceeding 5% of the aggregate value of all the corporate stock during the one-year period immediately prior to, and the one-year period immediately following, the issuance of the stock proposed to be treated as QSBS. These restrictions are subject to limited exceptions for repurchases following the termination of employment or other services.

Maximum Gross Assets

The aggregate gross assets of the issuer, including any predecessor, at all times on or after August 10, 1993, through immediately following (and after giving effect to) the issuance of the stock proposed to be treated as QSBS, cannot exceed $50 million. For purposes of the rules, "aggregate gross assets" equals the sum of the amount of cash and the aggregate adjusted basis of all other property of the issuer. Stock that otherwise qualifies as QSBS will not lose its status as QSBS in the event the value of the issuer's aggregate gross assets later exceeds $50 million.

For purposes of convertible stock, the aggregate gross asset test is measured at the time the convertible stock is issued to the taxpayer. For purposes of stock acquired by a taxpayer through the exercise of stock options or warrants, or through the conversion of convertible debt, the determination as to whether the gross asset test is met is made at the time of exercise or conversion, when the underlying stock is issued to the taxpayer. Restricted shares are deemed issued to the taxpayer on the date they vest unless the taxpayer submits a valid "83(b)" election with respect to the stock, in which case the stock is deemed issued on the effective date of the 83(b) election.

Investor Requirements

No C-corporations

Generally, any non-corporate taxpayer can take advantage of the QSBS exclusion. For individuals who hold shares through partnerships, S-corporations, limited liability companies taxed as partnerships, and other pass-through entities, the shares held by the entity generally may qualify as QSBS if the stock met the QSBS requirements in the hands of the pass-through entity and the individual taxpayer held an interest in the pass-through entity on the date the entity acquired the QSBS.

Stock Acquired at its "Original Issue"

The stock must be acquired by the taxpayer directly from the issuer or through an underwriter in exchange for money or other property, or as compensation for services performed for the issuer.

Five-Year Holding Period

QSBS must be held for more than five years, beginning on the date the shares are deemed issued. Preferred stock, restricted stock and stock underlying options, warrants, and convertible debt are deemed issued on the same date used to measure the issuer's aggregate gross assets. The holding period of stock received by a taxpayer by gift, by inheritance, or from a pass-through entity includes the period the stock was held by the donor, decedent or pass-through entity, respectively, if the stock qualified as QSBS in the hands of the transferring entity.

Maximum Excluded Amount

The Code limits the amount that may be excluded as QSBS eligible gain for any particular corporation over a taxpayer's lifetime is limited to the greater of (i) $10 million, or (ii) ten times the taxpayer's aggregate adjusted basis of the QSBS issued by the issuer and disposed of by the taxpayer during the taxable year. This limitation applies on a per-issuer basis, allowing an investor to utilize the exclusion for multiple QSB stockholdings in different companies. An individual taxpayer's basis in QSBS held by a pass-through entity is the taxpayer's proportionate share of the pass-through entity's adjusted basis in the stock on the date the entity acquired the QSBS from the issuer. Gain in excess of the excluded amount is taxable at the generally applicable capital gain rate (currently 15%).

Considerations Before Year-End

Assuming the exclusions set to expire at year-end are not extended, smaller businesses and their investors and employees should consider whether to capitalize on the current gross income and AMT exclusions. In particular:

- Small businesses and investors contemplating an equity financing in early 2012 should consider whether the current tax exclusions justify seeking to complete the financing in 2011.
- Entrepreneurs seeking financing prior to January 1, 2012 should consider the 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.
- Holders of convertible debt and exercisable options and warrants issued by qualified small businesses should consider whether the current exclusions offer a reason to convert or exercise the convertible securities by year-end.
- Qualified small business issuers also should note that restricted stock awards made in 2011, when combined with a taxpayer's timely 83(b) election, can allow the restricted stock holder to potentially take advantage of the current exclusions.

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