

Special Tax Benefit for Investors in Small Business Stock this Year

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Congress is encouraging investments in small business corporations by offering a special tax incentive for investors who purchase qualified small business stock ("QSBS") by the end of this year. Non-corporate investors who acquire QSBS in 2011 and hold the stock for at least five years can exclude from taxable income potentially 100% of the capital gain on the eventual sale. There is also no alternative minimum tax (AMT) liability for the QSBS gain exclusion. In addition to the exclusion of future gains, if the investment does not do well, the future loss may be fully deducted as an ordinary loss, rather than a capital loss.

But the tax benefit afforded by QSBS is based on a temporary provision in the law. In order to take advantage of this very unusual, and potentially very valuable tax opportunity, investors must act over the next few months, because only stock purchased this year will qualify for the QSBS tax benefits.

AMOUNT OF GAIN ELIGIBLE FOR EXCLUSION

For each future tax year in which the investor sells QSBS, the amount of gain eligible for the exclusion is limited to the greater of:

1. \$10 million (\$5 million for married persons filing separately), less the total amount of the QSBS gain excluded by the investor on sales of the stock in earlier years, or

2. ten times the taxpayer's total adjusted basis (purchase price) in QSBS of the corporation sold by the taxpayer that year.

For example, consider an individual who acquires 10,000 shares of QSBS on October 1, 2011 at \$15 per share, for a total cost of \$150,000. The individual sells all 10,000 shares in 2018 for \$20 million (\$2,000 per share). The maximum gain eligible for exclusion is the greater of (1) \$10 million, or (2) \$1.5 million, i.e., 10 times the investor's \$150,000 total basis in the 10,000 shares. Thus, this happy person can exclude \$10 million of the gain. The remaining balance of the gain would be taxed at the capital gains rate.

In the above example, if the individual initially invested \$150 per share for a total investment of \$1.5M, then \$15M of the gain would be excluded from taxable income. Had the initial investment been \$2M (\$200 per share), then the entire \$18M of gain would be tax free.

QUALIFICATION FOR QSBS

- QSBS is defined as any stock in a domestic C corporation that is acquired at its original issue (directly or through an underwriter) for money, property (not including stock), or as compensation for services. Stock that is purchased from an existing shareholder cannot qualify as QSBS.
- The stock must be held by a non-corporate investor such as an individual, partnership, limited liability company taxable as a partnership, or an S corporation.
- The corporation's aggregate gross assets must not exceed \$50,000,000 before and immediately after the issuance of the stock.
- During the investor's holding period, the corporation must use at least 80% of the value of its assets in the active conduct of at least one "qualified trade or business."

A "qualified trade or business" is defined in the negative. It is a business other than certain service businesses and professional activities, such as health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services, oil or gas production, hotel, motel, restaurant, or certain other types of businesses if the principal asset is the reputation or skill of employees.

RESTRICTIONS ON REDEMPTIONS

To prevent investors from turning in their existing stock in exchange for QSBS, there are rules that restrict redemptions. If an investor or a related person had stock redeemed by the corporation within two years before or two years after the investor purchased the new stock, the stock will not qualify as QSBS and the tax-free treatment will not apply on the future sale. This rule prevents an investor from selling his/her old stock back to the corporation and then having a related party acquire qualified "new" stock.

In addition, other stock redemptions by the corporation can disqualify the tax-free treatment on the future sale of QSBS if the redemptions are significant. The corporation that issued the stock must not make significant purchases of its stock during a two-year period which begins one year before the QSBS stock is issued and ending one year after the stock is issued. A significant redemption is one in which the redemption amount exceeds 5% of the aggregate value of all of the company's stock.

IS QSBS RIGHT FOR YOU? FACTORS TO CONSIDER

Although the temporary 100% gain exclusion is an attractive incentive to invest in small to mid-sized businesses, there are other factors that need to be considered. For instance, QSBS must be in a C corporation, which means there may be tax costs while the stock is being held. A C corporation is not a pass-through entity and thus, its income is subject to two levels

of tax: first at the entity level taxed at corporate tax rates, and second, at the shareholder level taxed on distributed earnings. The potential double tax on earnings during the operating years must be weighed against the potential tax benefit of the exclusion of gain upon the eventual sale of the investment.

Another important factor to consider is the structure of an eventual exit transaction. In order to take advantage of the gain exclusion, an ultimate sale of the company will have to be a stock sale, and not an asset sale. If the eventual exit transaction is an asset sale by the corporation, then there will be tax at the corporate level on any gain resulting from the sale of the company's assets, in addition to tax on the investor upon the distribution of the sale proceeds.

Timing is another factor to keep in mind. In order to qualify for the favorable tax treatment, the QSBS must be held for at least five years. If the anticipated time horizon for the investment is likely to be less than five years, then it may not make sense to structure the investment entity as a C corporation in order to qualify as a QSBS. That is because it will be subject to a double tax during operating years and on an eventual asset sale, with no offsetting tax benefits if the stock is sold in less than five years. In such a case it may be preferable to forego the potential QSBS tax benefits and instead structure the entity as an LLC or an S corporation.

In addition to the federal tax considerations, it is important to take into account the state tax ramifications when making an investment in QSBS. Not all states conform to federal tax laws, and states may differ in their treatment of the gain from the sale of QSBS.

CONCLUSION

Although the QSBS exclusion can provide significant tax benefits, it is important to realize that this type of investment may not be suitable for all investors or for all investments. In deciding whether or not to take advantage of this limited opportunity for tax-free investments, one must consider all the facts and circumstances in order to determine if the potential tax costs are worth the potential tax benefits.

The QSBS may provide extremely valuable tax benefits in appropriate circumstances. But in order to take advantage of this tax opportunity, investors must act before the end of this year. This is a limited tax incentive for investments made this year, and it is certainly worthwhile for investors to take this into consideration in coordinating the timing on investment, business and tax planning, and structuring new businesses or acquisitions.

The members of the Burns & Levinson Tax Group are experienced in this area, and can help you determine if an investment you are considering might qualify as QSBS, or whether you should make an effort to structure a proposed acquisition in order to qualify as QSBS.

For more information or questions regarding this Tax Update, please contact:

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