

NEWSSTAND

EAPD Business Law Update - Capital Gains Tax Holiday

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The recently enacted Small Business Jobs Act of 2010 (the "Act") includes an incentive to invest in start-up companies this year. The Act provides for a 100% exclusion of gain from the sale of qualified small business stock ("QSBS") acquired after September 27, 2010 and before January 1, 2011 and held for more than 5 years. For gain from the sale of QSBS to be excludible, a number of conditions must be satisfied (e.g., the stock must be stock of a C corporation that has gross assets that do not exceed \$50 million). Before the 2009 Recovery Act, noncorporate taxpayers could exclude 50% of their gain on the sale of QSBS held for more than 5 years (60% for certain empowerment zone businesses). Under the 2009 Recovery Act, the percentage exclusion for gain on the sale of QSBS was increased to 75% for stock acquired after February 17, 2009 and before January 1, 2011. Under the Act, the amount of the exclusion is temporarily increased to 100% of the gain from the sale of QSBS that is acquired after September 27, 2010 and before January 1, 2011 and held for more 5 years. In addition, gain from the sale of QSBS acquired during this window and held for the requisite time period is not subject to the alternative minimum tax (AMT).

The Act may offer a substantial advantage to noncorporate taxpayers who invest in small start-up businesses organized as C corporations this year, including holders of convertible debt that convert such debt into equity after September 27, 2010 and before January 1, 2011 and satisfy the 5-year holding period requirement. However, convertible debt purchased during the window and converted to equity on or after January 1, 2011 will not qualify for the 100% gain exclusion (the legislative history to Section 1202 provides that the holding period for stock acquired through the exercise of an option or through the conversion of convertible debt begins at the time of exercise or conversion, i.e., the holder of the option/debt instrument is not treated as acquiring such stock until exercise/conversion).

Additionally, as under prior law, a taxpayer who exchanges QSBS for other stock in a transaction described in Section 351 (contributions to a controlled corporation) or Section 368 (reorganizations) may preserve QSBS status for such newly acquired stock even if it is not otherwise QSBS. However, if the post-transaction corporation is not a qualified small business, QSBS treatment is limited to the amount of gain rolled-over into non-QSBS, i.e., on a subsequent disposition of the newly acquired stock, the benefits of Section 1202 are available only to the extent of the amount of gain that would otherwise have been recognized had the disposition of the QSBS not been subject to Section 351 or Section 368.