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Recent Changes Allow Tax-Free Receipt of up to $10 Million in Gain from the Sale of Small Business Stock

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One silver lining to the American Taxpayer Relief Act of 2012 (“ATRA”) is that it extended the 100% exclusion for capital gain on qualified small business stock (“QSBS”) acquired between 2010 and 2011 to include stock purchased in 2012 and 2013. It also eliminated the alternative minimum tax (“AMT”) that might otherwise apply to gain on QSBS acquired between 2010 and 2013 and mitigated the AMT effect for shares purchased in other years. These changes can allow certain taxpayers to recognize up to $10 million in tax-free gain. In the face of the many increases in tax rates enacted under ATRA, the extension of the 100% QSBS exclusion and the permanent mitigation of the applicable AMT rules provides significant relief to noncorporate taxpayers who invest in businesses with assets of $50 million or less.

Taxpayers who purchased QSBS in September 2010 or later will not be eligible to realize the benefit of the 100% gain exclusion until September 2015 at the earliest. Nonetheless, the changes made by Congress under ATRA are relevant now both for taxpayers who are making decisions about whether to invest in small businesses as well as entrepreneurs who are making decisions about what type of entity to form in starting a new business. Additionally, taxpayers who acquired QSBS in 2012, before ATRA retroactively extended the 100% exclusion to stock acquired in 2012, may be entitled to QSBS benefits when they sell their shares in 2017 or later, and should not overlook the potential benefits available.

QUALIFIED SMALL BUSINESS STOCK DEFINED

Under Section 1202,[1] an individual shareholder who has held QSBS for more than five years is eligible for a full or partial exclusion of gain on the sale of his or her QSBS.[2] In order to qualify as QSBS, stock must be:

- issued by a “qualified small business” after August 10, 1993;[3] and
- acquired by the taxpayer at original issuance in exchange for money, property (other than stock), or services; or acquired in a nonrecognition transaction from a transferor meeting these requirements.[4]

QUALIFIED SMALL BUSINESS DEFINED

A qualified small business (“QSB”) is a corporation that meets the following requirements:

- It is a domestic corporation that has been a C corporation for substantially all of the taxpayer’s holding period for his or her stock.[5]

[1] All Section references herein are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

[2] Section 1202(a)(1).

[3] Section 1202(c)(1).

[4] *Id.* Qualified nonrecognition transfers include gift, death, and transfers from a partnership to a partner. In these cases, the transferee will be treated as having the same method of acquisition and holding period as the transferor. *See* Section 1202(h).

[5] Sections 1202(d)(1) and 1202(c)(2)(A).

- The aggregate gross assets of the corporation at all times from August 10, 1993 until immediately after the issuance of the taxpayer's stock do not exceed $50 million.[6] For this purpose, a corporation's aggregate gross assets are its cash (including any cash contributed in connection with the current issuance) plus the aggregate adjusted bases of other property held by the corporation.

- During substantially all of the taxpayer's holding period for the stock, at least 80% of the corporation's assets have been used in the active conduct of a trade or business that is in a category *other than* any of the following:

    - professional services (such as health, law, engineering, architecture, and brokerage services);
    - banking, insurance, financing, leasing, or similar businesses;
    - farming;
    - mining or natural resource production or extraction; and
    - operating a hotel, motel, restaurant, or similar business.[7]

GENERAL RULE OF GAIN EXCLUSION

The portion of a taxpayer's gain that is excluded under Section 1202 generally depends on when the taxpayer acquired the stock. For QSBS acquired between September 28, 2010 and December 31, 2013, 100% of the gain is excludable.[8] For QSBS acquired between February 18, 2009 and September 27, 2010, 75% of the gain is excludable.[9] For stock acquired at any other time, 50% of the gain is excludable.[10] The date on which the taxpayer sells his or her stock is not relevant to the amount of gain that is excludable, provided that the five-year holding period is met.

The amount of gain from the QSBS of any particular issuer that any particular taxpayer may exclude under Section 1202 is limited to the greater of:

- $10 million, reduced by the aggregate gain attributable to QSBS of that issuer excluded by that taxpayer in prior years,[11] or

- 10 times the taxpayer's basis in his or her QSBS of that issuer disposed of in that year.[12]

Any portion of QSBS gain that remains subject to tax (because it exceeds the per-issuer limits or is in excess of the exclusion percentage for the applicable year) is taxed at a 28% rate.[13] Additionally, in any year in which the

[6] Section 1202(d)(1)(A).

[7] Section 1202(e)(3).

[8] Section 1202(a)(4).

[9] Section 1202(a)(3).

[10] Section 1202(a)(1). Additionally, QSBS of certain corporations operating in an enterprise zone is eligible for a 60% exclusion. Section 1202(a)(2).

[11] Section 1202(b)(1)(A).

[12] Section 1202(b)(1)(B).

[13] Section 1(h)(4)(A)(ii).

AMT impact is not entirely eliminated (e.g., for shares acquired before September 28, 2010 or after December 31, 2013), the AMT may apply to claw back some of the gain excluded by Section 1202, resulting in slightly higher effective rates on gain from QSBS. Gain on QSBS purchased between September 28, 2010 and December 31, 2013 is exempt from the AMT and therefore entirely exempt from tax (up to the $10 million or 10-times-basis limit described above).[14] The table at the conclusion of this alert shows the effective tax rates for gain on QSBS purchased in different years.

Gain that is exempt from tax under Section 1202 should also be exempt from the 3.8% Medicare tax applicable to capital gain on stock, which took effect January 1, 2013. The Medicare tax is imposed on individuals at a rate of 3.8% on the lesser of net investment income or modified adjusted gross income in excess of $200,000 (in the case of an unmarried taxpayer) or $250,000 (for couples filing jointly).[15] "Net investment income" includes only gain that is taken into account in computing taxable income.[16] Accordingly, income that is excluded under Section 1202 should also be excluded from the 3.8% Medicare tax.

TREATMENT OF STOCK HELD THROUGH PASS-THROUGH ENTITIES

In certain circumstances, a taxpayer's share of QSBS gain attributable to an interest in a pass-through entity—such as a partnership, an S corporation, a regulated investment company, or a common trust fund—can be eligible for exclusion under Section 1202.[17] In order for gain allocated to an individual by a pass-through entity to qualify for this treatment, the gain must be:

- attributable to the sale or exchange of stock that has been held for more than five years and that is QSBS in the hands of the pass-through entity (treating the pass-through entity as an individual for purposes of the rules described above),[18] and
- includable in the taxpayer's income as a result of his or her holding the interest in the pass-through entity on the date on which the pass-through entity acquired the QSBS and at all times until the disposition of the QSBS by the pass-through entity.[19]

The $10 million or 10-times-basis per-issuer limitation described above applies at the taxpayer level. For these purposes, the taxpayer must treat any gain on QSBS held through a pass-through entity as gain from a direct disposition of the stock of the issuer and must take into account his or her proportionate share of the basis of the pass-through entity in the QSBS in calculating the gain on the stock.[20] Increases in the taxpayer's percentage interest in the pass-through entity after the date on which the entity acquired the QSBS are ignored in determining the amount of gain eligible for exclusion in the hands of the taxpayer.[21]

[14] Section 1202(a)(4).

[15] Section 1411(a)(1).

[16] Section 1411(c)(1)(A)(iii).

[17] Section 1202(g).

[18] Section 1202(g)(2)(A).

[19] Section 1202(g)(2)(B).

[20] Section 1202(g)(1)(B).

[21] Section 1202(g)(3).

TREATMENT OF STOCK RECEIVED IN SECTION 351 OR 368 TRANSACTIONS

In limited cases, if a taxpayer exchanges QSBS for the stock of another corporation, the stock received by the taxpayer may be treated as QSBS.[22] This rule applies in the case of:

- reorganizations described in Section 368 (where the QSB is acquired by another corporation and shareholders exchange QSBS for stock of the acquiring corporation); and
- corporate formation transactions described in Section 351 (where shareholders of a QSB transfer their QSBS to a new corporation and the transferring shareholders "control" the new corporation after the transfer, along with others transferring cash or property to the new corporation at the same time).[23]

In both of these cases, stock of the acquiring corporation or of the new corporation is treated as QSBS even though it would not otherwise so qualify. If the acquiring corporation or the new corporation is itself a QSB, then the stock of the corporation received in exchange for the QSBS is treated in full as QSBS. If the acquiring corporation or the new corporation is not itself a QSB, then the shares in the corporation received in the exchange will be treated as QSBS only to the extent of the gain that would have been recognized at the time of the Section 368 or Section 351 transaction had the original QSBS been sold in a taxable transaction at that time.[24] In other words, the gain exclusion under Section 1202 will be preserved to the extent of the value of the QSBS at the time of the Section 368 or Section 351 transfer. Special rules apply if there are successive transfers of QSBS in multiple reorganizations or corporate formations.[25]

TREATMENT OF CERTAIN REDEMPTION TRANSACTIONS

In order to prevent taxpayers from circumventing the requirement that QSBS be newly issued, the QSB issuer may not redeem its stock within specified time periods. Under Section 1202(c)(3), stock acquired by the taxpayer is not treated as QSBS if the issuer purchased stock from the taxpayer, or a from person "related" to the taxpayer, at any time during the four-year period beginning two years before the issuance of the stock in question. In general, a shareholder would be related to the corporation for this purpose if he or she directly or indirectly owned more than 50% of the corporation's stock.[26] In addition, stock issued by a corporation will not be QSBS if, during the two-year period beginning on the date one year before the issuance of the stock, the issuer made one or more purchases of its stock with a total value exceeding 5% of the aggregate value of all of its stock as of the beginning of the two-year period.[27] These restrictions are subject to *de minimis* exceptions described in the applicable Treasury regulations.[28]

SECTION 1202 AS A PLANNING TOOL FOR START-UPS

Section 1202 may affect an entrepreneur's decision to form a start-up business as a limited liability company ("LLC"), an S corporation, or a partnership. Start-ups often choose to form a pass-through entity such as an LLC

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[22] Section 1202(h)(4).

[23] *Id.* "Control" for this purpose means ownership of 80% or more of the voting stock and 80% or more of each class of nonvoting stock. *See* Section 368(c).

[24] Section 1202(h)(4)(B).

[25] Section 1202(h)(4)(D).

[26] *See* Sections 1202(c)(3), 267(b), and 707(b).

[27] Section 1202(c)(3)(B).

[28] *See* Treasury regulations section 1.1202-2.

or an S corporation in order to sidestep the entity-level tax payable by C corporations on their operating income. Although section 1202 requires the use of a C corporation in order to obtain its benefits, many start-ups have no taxable income in their early years (despite the success of their business model) due to favorable tax allowances and deductible items. This means that the use of a C corporation by such a business may well not represent a significant cost, while section 1202 would afford the opportunity to eliminate a substantial amount of tax when the QSB shares are subsequently sold.

Furthermore, both start-ups and existing QSBs can issue QSBS to employees and founders in exchange for services rendered to the company (other than services as an underwriter)[29] as well as property. The extremely broad definition applicable to "property" under Section 1202 by reason of Section 351 may allow some planning flexibility for employees and founders of QSBs.[30] Under Section 351, "property" encompasses virtually anything that can be "identified, valued, and transferred," including inchoate intangible property such as a nonbinding letter of intent and other amorphous intangible assets such as goodwill.[31]

In the case of an entrepreneur deciding whether to form an entity taxable as a C corporation or a partnership, Section 1202 might provide sufficient incentive through 2013 to organize business operations as a C corporation (or an LLC taxable as a C corporation), given the temporary exemption from shareholder-level tax on QSBS and the fact that virtually all of the features of a partnership investment can be replicated using a corporate (or LLC taxable as a C corporation) structure. The exemption from federal income tax, AMT, and the Medicare tax make the sale of QSBS acquired from 2010 through 2013 significantly more advantageous from a tax perspective than the sale of an interest in or the assets of a partnership.

IMPACT OF NEW LEGISLATION

ATRA's extension of the 100% gain exclusion on QSBS acquired from 2010 through 2013 as well as its permanent reduction of the AMT clawback to 7% of excluded gain for stock acquired in other years have made Section 1202 extremely attractive to noncorporate investors in small businesses. These provisions are welcome relief in light of the significant tax increases to capital gain after 2012 (including the 3.8% Medicare tax). Investors who have recently acquired stock of small businesses, investors who are considering investing in small businesses, and entrepreneurs who are making entity formation choices all should be aware of the noteworthy benefits associated with an investment in QSBS.

Investors who acquired QSBS in January 2008 or earlier will begin to realize the benefit of the reduction in the AMT clawback as early as this year if they sell their QSBS. Taxpayers who purchased QSBS after September 27, 2010 will be able to sell their QSBS without incurring any tax liability as early as the end of September 2015.

[29] Section 1202(c)(1)(B)(ii).

[30] Section 1202 contains several general references to Section 351 but no specific statutory definition of "property" for purposes of Section 1202. However, given that a transfer of an appreciated asset to a corporation in exchange for stock would need to satisfy the "property" requirement of Section 351 in order to be nontaxable, it would strain credibility to suggest that Congress intended for a taxpayer to be subject to an altogether different requirement for purposes of Section 1202. For further discussion, see David Strong, *Section 1202 Qualified Small Business Stock*, Aug. 11, 2011, available at http://www.mofo.com/files/Uploads/Images/110811-Section-1202-Qualified-Small-Business-Stock.pdf.

[31] *U.S. v. Stafford*, 727 F.2d 1043, 1052 (11th Cir. 1984).

EFFECTIVE TAX RATES ON QSBS*

Acquisition Date	Effective Rate	AMT Effective Rate
Aug. 11, 1993 – Dec. 31, 2000	**14%**	**14.98%**
Jan. 1, 2001 – Feb. 17, 2009	**14%**	**14.98%**
Feb. 18, 2009 – Sept. 27, 2010	**7%**	**8.47%**
Sept. 28, 2010 – Dec. 31, 2013	**0%**	**0%**
Jan. 1, 2014 or later	**14%**	**14.98%**

*In each instance, assumes QSBS held for at least five years before sale.

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