President Obama Proposes to Expand and Make Permanent Zero Capital Gains on Small Business Investments

February 15, 2012 By Dan Wright (Principal at Clark Nuber), and Karlyn Kurokawa (Associate at Clark Nuber)

On January 31, 2012, President Obama sent a Startup America Legislative Agenda to Congress that included a proposal to "expand and make permanent zero capital gains on small business investments," which is presumably a reference to making the 100% gain exclusion on Qualified Small Business Stock ("QSBS")**[1]** investments under Section 1202 of the Internal Revenue Code (which exclusion percentage expired as of December 31, 2011) permanent.

By way of background, recent changes to Section 1202 allow 100% exclusion from federal taxable income of gain realized (up to $10,000,000) by investors who made qualified investments after September 27, 2010 and before January 1, 2012. The 100% exclusion rule applies for both regular and Alternative Minimum Tax ("AMT") purposes. This rule change makes calculating the projected tax on sale very simple—qualifying gain is subject to zero federal income tax, period.

1 The Qualified Small Business Stock rules are complex. Consulting an informed tax advisor before making an investment is strongly recommended. Although multiple provisions of the Internal Revenue Code apply to QSBS, the focus of this article is on the exclusion rules under Section 1202 of the Internal Revenue Code. Highlights of those rules include the following requirements: (1) the stock must be original issue stock, (2) the corporation issuing the stock must be a "C" corporation for federal income tax purposes, (3) the aggregate gross assets of the corporation cannot exceed $50 million at the time of and immediately after investment, (4) the investor must hold the stock for more than 5 years, and (5) the corporation must hold an active trade or business throughout the entire holding period.

For investments in QSBS made prior to September 28, 2010, the benefits that investors have received have been minimal. While gain from the sale of QSBS purchased after August 10, 1993 and before February 18, 2009 is generally eligible for a 50% exclusion, the portion of the gain that is not excluded is generally subject to a 28% tax rate (not the current long-term capital gain rate of 15%). Accordingly, the effective tax rate for QSBS gains subject to the 50% exclusion is generally 14%. (As an aside, 14% may seem much more attractive if the capital gain rates return to 20-28% when the Bush tax cuts expire at the end of 2012, but when compared to the current long-term capital gain tax rate of 15% it is only a 1% tax break.)

The exclusion percentage was increased to 75% for investments made after February 17, 2009 and before September 28, 2010. For QSBS gains subject to the 75% exclusion, the effective rate is generally 7% (25% of the gain times the 28% capital gain rate). While this is significantly better than the 1% effective tax rate relief available under the 50% exclusion rules, it will be several years before investors will see this benefit. This is because the earliest that the 5-year holding period requirement will be met for these investments will be February 19, 2014. Note that the current AMT rules severely limit or eliminate the benefit to investors who happen to be subject to AMT in the year when they dispose of their QSBS. This is because a portion of the amount excluded under regular tax purposes is added back to Alternative Minimum Taxable Income ("AMTI") under the AMT rules.

In general, the amount of the AMTI add-back depends on when the stock is sold. For stock sold after May 5, 2003 and before January 1, 2013, a special 7% AMT inclusion rule applies. This means that 7% of the amount of gain excluded is included as an AMT preference item. In the case of stock subject to the 50% exclusion, this results in an effective AMT rate of 14.98%**[2]** for those in the 28% AMT bracket, barely under the 15% long-term capital gain rate.

2 On a $100 gain, $50 is included in both regular taxable income and AMTI. In addition, $3.50 (7% of the $50 excluded) is also included in AMTI as a preference item. This results in $53.50 of gain subject to the AMT rate of 28%, or $14.98. $14.98 tax on $100 gain yields an effective rate of 14.98%. This example assumes that the investor is subject to the highest AMT rate. Some investors may qualify for a lower AMT rate, depending on the amount of their AMTI.

For gain recognized beyond 2012 (unless a law change occurs), the AMT inclusion percentage is 28% for stock with a holding period beginning after December 31, 2000. In the case of such stock, which could be subject to either 75% regular tax exclusion rule and the 50% regular tax exclusion rule depending on when issued unless the 100% regular tax exclusion rule applies, the effective AMT rates of 12.88% (for stock subject to the 75% exclusion) and 17.92% (for stock subject to the 50% exclusion).

3 Among the other proposals included in the President's agenda are:
1. A 10% income tax credit on new small business payroll,
2. Permanently doubling the tax deduction for startup expenses from $5,000 to $10,000, and
3. Extending 100% depreciation for qualified property through 2012.

The President's proposals**[3]** are welcome news to investors and to small business owners who are trying to attract capital. However, given that 2012 is an election year, it's difficult to predict when and if we will see this proposal become law.