ALERTS AND UPDATES

Temporary Provisions of Small-Business Act Exclude Tax on 100 Percent of Gain on Qualified Small-Business Stock Through the Remainder of 2010

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The Small Business Jobs and Credit Act of 2010, signed into law by President Obama on September 27, 2010 (the "Act"), includes various tax provisions relating to small-business growth. Among these provisions is an amendment to section 1202 of the Internal Revenue Code of 1986 (the "Code") permitting the temporary exclusion of 100 percent of any gain on the sale of certain qualified small business stock ("QSBS"). The Code generally permits the exclusion of only 50 percent of the gain on the sale of QSBS; however, this was amended to exclude 75 percent for stock acquired after February 17, 2009, and before January 1, 2011. The Act now increases this exclusion to 100 percent, but only for the QSBS acquired between September 27, 2010, and December 31, 2010.

Overview

QSBS may only be issued by a "qualified small business." Code section 1202 generally requires that the issuer comply with the following:

- Be a domestic C corporation;
- Have aggregate gross assets that do not exceed $50 million; and
- Agree to submit such reports to the Internal Revenue Service and shareholders as the Internal Revenue Service may require.

In addition, Code section 1202 requires that the issued securities meet the following conditions in order to be QSBS:

- The stock must be originally issued to the taxpayer by a corporation that is a qualified small business on the date of issuance;
- During substantially all of the taxpayer's holding period, at least 80 percent of the corporation's assets must be used in the active conduct of one or more qualified trades or businesses;
- The corporation may not redeem more than a *de minimis* number of shares held by a taxpayer to which the QSBS is issued within a four-year period, beginning two years prior to the issuance of the QSBS; and
- There may be no "significant redemptions" of the issuing corporation's stock from any party during the two-year period beginning one year prior to the QSBS's issuance.

If the requirements outlined above for the qualified small business and its stock are satisfied, the tax benefits of Code section 1202 apply. Code section 1202 allows noncorporate taxpayers to exclude from gross income either 50 percent or 75 percent of the gain arising from the sale of QSBS, depending on the date of issuance. In order to benefit from the exclusion:

- The QSBS must be held for more than five years;
- The amount of gain that can be excluded by any single taxpayer with respect to a particular issuer is generally limited to the greater of $10 million or 10 times the adjusted basis of the QSBS; and

- A portion of any excluded QSBS gain is treated as an item of tax preference for alternative minimum tax purposes.

Impact of Act for Remainder of 2010

The Act amends Code section 1202 to provide a temporary exclusion of 100 percent of gain realized on the sale of QSBS acquired on or after September 27, 2010 and prior to January 1, 2011. In addition, during this limited period, the excluded gain is not treated as a preference item for purposes of the alternative minimum tax.

The Act may offer potentially significant income-tax benefits to noncorporate investors of qualified small businesses; however, these benefits are limited to stock acquired during the remainder of 2010. Provided the terms of the Act and the Code are satisfied, such investors would pay no federal income tax for the gain on QSBS.

For Additional Information

If you have any questions about this *Alert*, please contact any of the attorneys in our Corporate Practice Group, the attorneys in our Tax Practice Group or the attorney in the firm with whom you are regularly in contact.