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ALERT

Federal Law Excludes 100% of Gains on Qualified Small Business Stock Acquired By December 31, 2010

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On September 27, 2010, President Obama signed the Small Business Jobs Act of 2010 aimed at encouraging investment in small businesses. One of the Act's most important provisions is the amendment of Internal Revenue Code Section 1202 that permits the temporary exclusion of 100 percent of the gains on the sale or exchange of qualified small business stock. However, taxpayers must act within limited time periods to take advantage of this provision as the 100 percent exclusion only applies to qualified small business stock acquired between September 27, 2010, and December 31, 2010. After January 1, 2011, the gain exclusion will revert to 50 percent.

The benefits of this provision may apply to franchised businesses, both on the franchisor and franchisee side, as long as the investment satisfies the conditions set forth below.

Note: This provision does not apply to businesses that operate hotels or restaurants.

Prior Law

Prior to February 2009, Internal Revenue Code Section 1202 provided that 50 percent of a non-corporate taxpayer's gain on the sale of qualified small business stock held for more than five years would be excluded from gross income. Under the American Recovery and Reinvestment Act of 2009, the exclusion was increased to 75 percent for stock purchased from February 17, 2009, to December 31, 2010, in order to encourage investment in small businesses.

What Is Qualified Small Business Stock?

Qualified small business stock may only be issued by a qualified small business. To classify as a qualified small business, the corporation must:

(1) Be a domestic C corporation;

(2) Have aggregate gross assets of $50 million or less at all times from August 10, 1993, through the date the stock is issued; and

(3) Agree to submit reports to the Internal Revenue Service (IRS) and its shareholders as required by the IRS.

It is important to note many small businesses are organized as S corporations or limited liability companies and not C corporations because of the tax benefits offered by such entity structures. However, the 100 percent gains exemption does not apply to those types of entities. Accordingly, a company should weigh the benefits of exemption against the tax benefits offered by other entity structures – such as a limited liability company. Given the significant tax implications, it would be prudent to consult a tax advisor before making any decisions regarding entity choice.

To qualify as qualified small business stock, the securities must meet several conditions.

(1) The stock must be "originally issued" to the taxpayer by a corporation that is a qualified small business on the date of issuance. The stock can be originally issued by a qualified small business

directly or through an underwriter. Since the stock must be originally issued to the taxpayer, notes and warrants do not qualify as qualified small business stock. However, if an outstanding note converts into stock before December 31, 2010, then it may qualify as qualified small business stock.

(2) 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. Qualified trades or businesses generally do not include the performance of certain professional activities (i.e., law, medicine, engineering, architecture, accounting, etc.), banking, finance, farming, mining or the operation of hotels and restaurants.

(3) The corporation may not redeem more than a *de minimis* number of shares held by a taxpayer to which the qualified small business stock is issued within a four-year period, beginning two years prior to the issuance of the qualified small business stock. This is to encourage long-term investment.

(4) 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 qualified small business stock's issuance. As a result of such requirement, investors may want to negotiate covenants restricting disqualifying redemptions in their stockholder or investor rights agreements.

Tax Benefits

If the requirements outlined above are satisfied for a qualified small business and qualified small business stock, then the taxpayer may exclude 100 percent of its gain realized on the sale of its qualified small business stock acquired between September 27, 2010, and December 31, 2010. During this period, the excluded gain is not treated as a preference item for purposes of the federal alternative minimum tax. In addition, the amount of gain would also escape taxation by states that base taxation on federal taxable income. In order to reap these benefits:

- The qualified small business stock 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 qualified small business stock; and
- A portion of any excluded qualified small business stock gain is treated as an item of tax preference for alternative minimum tax purposes.

Thus, when starting a franchised business, you, as an investor in your new corporation, and fellow investors in your corporation may be entitled to a significant tax break if you invest by December 31, 2010. Please note that investing after this date may still entitle you to receive a break on a smaller scale.

If you have questions about this Alert or concerning the availability or restrictions of the tax benefits provided by the Small Business Jobs Act of 2010, please contact Elizabeth D. Sigety at 215.918.3554 or esigety@foxrothschild.com, Lauren W. Taylor at 215.918.3625 or lwtaylor@foxrothschild.com or any other member of the firm's Franchising, Licensing & Distribution Practice.