WSGR ALERT

OCTOBER 2010

IMPORTANT TAX PLANNING OPPORTUNITY IN 2010 FOR INVESTORS IN SMALL BUSINESSES

The recent enactment of the Small Business Jobs and Credit Act of 2010 (SBJCA) may provide a substantial tax benefit to investors who acquire qualified small business stock (QSBS) on or after September 28, 2010, and before January 1, 2011. **Entrepreneurs and investors considering forming or making investments in qualifying corporations, including owners of unincorporated businesses considering incorporation, should be aware of the potential advantages of acquiring QSBS during the relevant time frame.**

Under the law prior to the enactment of the SBJCA, Section 1202 of the Internal Revenue Code of 1986, as amended, allowed an individual taxpayer to exclude 50 percent of any gain from the sale or exchange of QSBS held more than five years. This exclusion was increased to 75 percent for QSBS acquired after February 17, 2009, and before 2011. A portion of the excluded gain has been treated as an item of tax preference for alternative minimum tax purposes.

Under the SBJCA, an investor may exclude 100 percent of the gain from the sale or exchange of QSBS held more than five years that is acquired after September 27, 2010, and on or before December 31, 2010. Importantly, such gain is also eligible for exemption from alternative minimum tax, thus effectively eliminating tax on such gain.

QSBS Background

Stock of a small business generally qualifies as QSBS if the stock meets certain requirements, including: (i) the small business is a domestic C corporation; (ii) the taxpayer acquired the stock at its original issue in exchange for money or other property (not including stock) or as compensation for services; (iii) the small business is engaged in a qualified trade or business and uses 80 percent (by value) of its assets in the active conduct of one or more qualified trades or businesses; (iv) the aggregate tax basis of the small business's assets on the date after the stock is issued (including proceeds received in exchange for the stock) is $50,000,000 or less; and (v) with certain *de minimis* exceptions, the small business has not made any repurchases of stock within the two-year period starting one year prior to the date the stock was issued. A "qualified trade or business" is defined as any trade or business other than (i) any trade or business involving the performance of services, such as accounting, engineering, or consulting, or any other trade or business where the principal asset is the reputation or skill of one or more of its employees; (ii) any banking or financial business; (iii) any farming business; (iv) any mining or oil or gas business; and (v) any business of operating a hotel, motel, restaurant, or similar business.

In addition to the exclusions described above, under Section 1045 of the Internal Revenue Code, a taxpayer who (i) holds QSBS for more than six months (the original QSBS); (ii) sells the original QSBS in an otherwise taxable transaction; and (iii) during the 60-day period beginning on the date of such sale, purchases new QSBS (replacement QSBS) generally will recognize gain on its original QSBS only to the extent that the proceeds from such sale exceed the amount invested in the replacement QSBS.

Please contact an attorney in Wilson Sonsini Goodrich & Rosati's tax practice with any questions regarding the benefits of QSBS status and the application of the SBJCA.

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