

small business stock

Take advantage of preferential tax treatment available for
investments in certain small business stock.

SMALL BUSINESS STOCK TAX BENEFITS

Qualified small business (“QSB”) stock can qualify for preferential federal tax treatment, including:

- Deferral of gain if the proceeds are “rolled over” and used to buy another qualified small business stock;
- Reduced tax rates; or
- Ordinary loss rather than capital loss treatment.

SMALL BUSINESS STOCK TAX BENEFITS

The gain from the sale of QSB stock is eligible for a rollover which allows you to defer the tax on the gain. QSB stock is defined as stock:

- Issued by a domestic C corporation
 - with less than \$50 million of assets at the time of and immediately after issuance; and
 - which employs at least 80% of its assets in an active, qualified trade or business (see Note below for restriction);
- Held by a non-corporate taxpayer (LLCs and S corporations qualify); and
- Acquired by the taxpayer at original issuance (after August 10, 1993).

Note: *Businesses in certain industries, such as hospitality, financing, professional services, and mining, do not qualify for this treatment. Research and start up activities of a future trade or business may satisfy the active, qualified trade or business requirement even if the business has not yet produced revenue.*

If a taxpayer holds the QSB stock of any one corporation for five years or more, the gain eligible for the exclusion is limited to the greater of \$10 million or ten times the taxpayers’ basis in the QSB stock. The \$10 million amount must be reduced in subsequent years by the total eligible gain the taxpayer has excluded on earlier dispositions of the same corporation’s QSB stock in prior years.

The gain exclusion is analyzed separately for each taxpayer and each issuing corporation. Accordingly, a single taxpayer may exclude gain for investment in the QSB stock of diverse issuers.

If an individual holds the QSB stock by a pass-through entity, he or

she may still qualify for the exclusion if the individual taxpayer has held the stock consistently from the date of acquisition through the date of sale. Stock received by gift, death or distribution may also qualify as QSB stock. There are other opportunities for potentially broadening the holding period under Internal Revenue Code Section 1202 where QSB stock has been exchanged or converted.

Finally, taxpayers should also be aware that the state tax treatment may differ from the federal treatment of the gain.

REDUCED TAX RATES

Taxpayers who hold QSB stock for more than five years (based on the purchaser’s first date of ownership as a C corporation) may exclude at least a portion of the gain on the sale of the QSB stock from gross income. The amount of exclusion is staggered based on tax holding dates:

- 100% of the gain if the stock has a tax holding date that began after September 27, 2010, resulting from the enactment of PATH. This provision has been made permanent.
- 75% of the gain if the tax holding date began after February 17, 2009 and before September 28, 2010.
- 50% of the gain if the tax holding date began before February 18, 2009.

The tax rate on the gain not subject to the exclusion, if any, is 28%, meaning that the 50% exclusion yields an effective rate of 14%, compared to the capital gains tax rate of 20% presently in effect.

Note: *Eligible gain from any one corporation is subject to a cumulative limit for a given year of the greater of (a) \$10 million reduced by eligible gain taken in prior years or (b) ten times the cost of all qualified stock of the issuer disposed of during the tax year. If the taxpayer is married filing separately, the gain eligible for exclusion is 50% of the \$10 million limit or \$5 million.*

AMT ADJUSTMENTS

Although excludable for regular tax purposes, a portion of the excluded gain on the sale of QSB stock may be an AMT preference item. The preference rates are also based on stock purchase dates:

- No preference adjustment for the sale of stocks with a tax holding date beginning after September 27, 2010, as a result of the enactment of PATH. This provision has been made permanent.

chart

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SECTION 1202 TAX RATE SCHEDULE SALES

Year of purchase	Regular net tax rate*	AMT effective rate	Capital gain rate	Benefit if in AMT
Pre 2001-02/17/2009	15.9% ¹	16.88%	23.8%	6.92%
02/18/2009-09/27/2010	7.95% ²	9.42%	23.8%	14.38%
09/28/2010 and beyond	0% ³	0%	23.8%	23.8%

Planning Tip: Qualified small business stock held for five years can result in additional savings.

*As shown in the Tax Rate Schedule, the gain recognized from the sale of QSB stock is generally subject to the 3.8% net investment income tax which applies to capital gains. If all of the gain is excluded from gross income, it follows that the 3.8% net investment income tax would not apply. Further, this Schedule assumes that the taxpayer is in the highest applicable tax bracket.

¹(28% + 3.8%) x 50% subject to tax after 50% exclusion of gain

²(28% + 3.8%) x 25% subject to tax after 75% exclusion of gain

³(28% + 3.8%) x 0% subject to tax after 100% exclusion of gain

- 7% AMT preference adjustment of the amount excluded for all sales occurring prior to September 27, 2010.

Caution: Taxpayers with net capital losses, who take advantage of the exclusion, should be aware that the AMT preference will trigger utilization of those AMT capital losses.

ROLLOVER OF QSB STOCK

The Section 1045 rollover rules permit non-corporate taxpayers to defer gain on a sale of QSB stock under certain circumstances, even where the taxpayer has held the QSB stock for less than five years.

To qualify for this rollover option, a taxpayer must (a) own the stock for at least six months; (b) sell the stock; (c) reinvest the proceeds within 60 days of sale in other QSB stock; and (d) timely elect to apply Section 1045 on its federal tax return for the year during which the sale of QSB stock occurred. The replacement stock purchased in the rollover may qualify for a future rollover under the same rules. The basis in the replacement stock is reduced by the deferred gain from the rollover and the taxpayer inherits the holding period of the stock sold in determining whether the capital gain treatment is short-term or long-term. If the investment in the new QSB stock is less than the sale proceeds from the sale of the original stock, the difference is taxable at regular tax rates.

The rollover provision does not apply to stock of an S corporation.

Note: There is no carryover of holding period for purposes of determining the "more-than-six-months" requirement.

If the stock is held by a pass-through entity of which you are a partner or shareholder, the entity can buy replacement stock and elect a tax-free rollover of the gain. Otherwise, the pass-through entity can notify you of the gain and you can defer tax by buying the replacement stock directly. The 60-day rule still applies, beginning on the day the entity sells the QSB stock — rather than the date you are notified of the sale. In addition, there may be other limitations on the amount of gain that a partner may defer in this context.

Note: Rollovers into new QSB stock are still available as long as the replacement period is observed.

CLAIM ORDINARY — NOT CAPITAL — LOSSES

If you sell small business stock at a loss, you can classify up to \$100,000 (\$50,000 for an individual or a married person filing separately) of the loss as an ordinary, rather than a capital, even if the holding period exceeds 12 months. This loss may be included in the computation of net operating losses.

To qualify for this treatment, the taxpayer must have bought the stock at original issue and have held it continuously until

disposition. The issuing corporation must have had an initial capitalization of \$1 million or less at the time the stock was issued and have derived not more than 50% of its income from investment activities (interest, dividends, royalties, rents, annuities, and sales or property exchanges) during the five most recent taxable years.

Finally, it is critical that taxpayers seeking the benefits of these tax preferences maintain records sufficient to establish that they have satisfied the prerequisites, such as stock certificates showing the dates of stock acquisition.