small business stock

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

EisnerAmper

SMALL BUSINESS STOCK TAX BENEFITS

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

- Rollovers of gain if the proceeds are used to buy other qualified small business stock,
- Reduced tax rates, or
- Ordinary loss rather than capital loss treatment.

SALE OF QSB STOCK

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 corporation
    - with less than $50 million of assets at the time of and immediately after issuance; and
    - which uses 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.*

If a taxpayer holds the QSB stock for 5 years or more, the gain eligible for the exclusion is limited to the greater of $10 million or 10 times the taxpayers' basis in the QSB stock.

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 rules for potentially broadening the holding period under Internal Revenue Code section 1202 where QSB or 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 5 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 begins 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 begins after February 17, 2009 and before September 28, 2010.
- 50% of the gain if the tax holding date begins 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) 10 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.
- 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.*

chart 5

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%	16.88%	23.8%	6.92%
02/18/2009-09/27/2010	7.95%	9.42%	23.8%	14.38%
Post 09/28/2010	0%	0%	23.8%	23.8%

Planning Tip: *Qualified small business stock held for 5 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.*

ROLLOVER OF QSB STOCK

The Section 1045 rollover rules permits non-corporate taxpayers to defer gain on a sale of QSB stock under certain circumstances.

To qualify for this rollover, a taxpayer must (a) own the stock for at least 6 months and (b) reinvest the proceeds within 60 days of sale in other QSB stock. 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 inherits the holding period of the stock sold for determining whether the capital gain treatment is short-term or long-term. If the reinvestment in the new QSB stock is less than the sale proceeds, 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-6-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 if married filing separately) of the loss as an ordinary, rather than a capital, loss 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, you must have bought the stock at original issue and 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 preceding 5 years.