

Venture Capital & Emerging Companies Alert

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Fiscal Cliff Legislation Extends Tax Incentive to Invest in Small Businesses

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As a result of the recent “fiscal cliff” legislation, otherwise known as the American Taxpayer Relief Act of 2012 (2012 Tax Act), many individual investors are expecting future tax increases, either in the form of higher capital gains tax on their investment profits or higher income taxes on their salaries. The good news though is that the 2012 Tax Act extended a special tax incentive for investors who purchase stock in certain small businesses (Qualified Small Businesses as described below).

The Qualified Small Businesses tax incentive¹ now provides that investors who have purchased stock in Qualified Small Businesses after September 27, 2010 but before January 1, 2014 are entitled to exclude 100% of their capital gains on the sale or exchange of such small business stock if such stock is held for five years or more, subject to certain limitations on the small business and the investor’s gain as discussed below.²

Generally, to be a Qualified Small Business, the business must (a) be a domestic C-corporation; (b) have gross assets not in excess of \$50,000,000 (at all times since August 10, 1993, as well as immediately after the issuance of the stock); and (c) use more than 80% of its assets in the active conduct of a qualified trade or business (excluding certain businesses in the legal, banking, insurance, investing, farming and hospitality industries) during the time the taxpayer holds such stock.

The maximum gain an investor can exclude pursuant to this incentive (with respect to a particular corporation) is the greater of (a) 10 times the taxpayer’s basis in the stock, and (b) \$10,000,000, minus the gain taken in prior years in connection with the same Qualified Small Business.

While we applaud Congress’s initiative, we believe it would have created a greater incentive for investors if Congress decreased the holding period of the small business stock from five to two years. Nonetheless, given this significant exclusion on capital gains, investors and entrepreneurs should keep this incentive in mind when considering their tax strategies and investment opportunities for the coming year.

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Endnotes

¹ 26 U.S.C. 1202.

² Qualified Small Business Stock purchased before September 27, 2010 may qualify for an exclusion but not a 100% exclusion.

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