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Exclusion from Tax for Stock Issued by Qualified Small Business Corporations

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On November 3, 2010 and January 18, 2011, we issued client alerts discussing the opportunities provided by the Section 1202 exclusion from tax on gain realized on the sale of certain stock issued by a "qualified small business corporation" (a "QSBC"). These alerts discussed Congress' increase of the exclusion percentage to 100% with respect to stock issued by a QSBC between September 27, 2010 and December 31, 2011. On January 2, 2013, the president signed the American Taxpayer Relief Act ("ATRA"), which again extended the increase in the 1202 exclusion to 100%; this time for stock issued by QSBCs during calendar years 2012 and 2013. ATRA also includes other important provisions impacting taxes, including changes in the income tax and capital gains tax rates for taxpayers with incomes above certain thresholds.

Benefits of the Exclusion

The 100% exclusion shields up to $10 million (or, if greater, 10 times the amount of the taxpayer's investment in the stock) of gain recognized on the sale of stock issued by a QSBC after September 27, 2010 and no later than December 31, 2013, so long as the taxpayer holds the stock for more than five years prior to sale. This exclusion of gain applies not only to the computation and payment of federal income taxes (including the new 3.8% "Medicare" tax on net investment income and the alternative minimum tax), but may also shield the gain from state income taxes (unless the state, like California, includes an "add back" when calculating state income taxes).

The 100% exclusion is primarily an incentive for QSBCs to raise new equity capital before the end of 2013. As such, it is an incentive for individuals, estates, and trusts seeking investment opportunities in start-up and other early stage corporate ventures as well as existing small and middle-market corporations.

Certain Eligibility Requirements Apply

1. **A QSBC must issue the stock.** A QSBC is an entity classified as a C corporation that engages in certain types of active businesses, as discussed in our previous alerts. In addition, at all times between August 10, 1993 and the date the company issues the stock to a qualified shareholder, the value of the corporation's gross assets must not exceed $50 million.
2. **The taxpayer must purchase the stock from the QSBC.** To be eligible for gain exclusion, the taxpayer must purchase the stock after September 27, 2010 and no later than December 31, 2013 directly from the QSBC and not from another shareholder.
3. **Eligible taxpayers are limited.** Eligibility for the gain exclusion is limited to shareholders who are individuals, estates, and trusts. C corporation shareholders are not eligible for the exclusion.
4. **The exclusion is only applicable to appreciation in stock value after issuance.** This limitation means that the Section 1202 exclusion is not applicable to so-called "built-in gain." Accordingly, if a taxpayer transfers property other than cash to a QSBC in exchange for stock issued by the QSBC,

the 1202 exclusion will not shield the appreciation on that property from tax. However, if the contribution is not taxed because of Section 351, the tax on the appreciation will not be assessed until the QSBC stock is sold.

5. **The taxpayer must hold the stock for more than five years before sale.** The Section 1202 exclusion only applies to QSBC stock that an eligible shareholder holds for over five years before sale. However, subject to certain restrictions, a shareholder may sell stock within five years after the QSBC issues it and not recognize gain from the sale provided that the shareholder uses the proceeds to acquire newly issued QSBC stock (a "Section 1045 Roll Over"). When QSBC stock is sold and reinvested in a Section 1045 Roll Over transaction, the holding period of the old shares is added to the holding period of the new shares.

Eligible Transactions and Planning Considerations

1. **Formation and funding of start-ups.** Those organizing a start-up or early stage company that meets the eligibility requirements for a QSBC should consider organizing as a C corporation instead of as an S corporation, partnership, or limited liability company taxed as a partnership. Aside from the investment incentives presented by the 100% Section 1202 exclusion, organization as a C corporation may provide certain federal income and employment tax benefits not available to pass-through entities.
2. **Shorter-term investments.** Investors who anticipate holding QSBC stock for fewer than five years may still want to consider acquiring QSBC stock no later than December 31, 2013. These investors will be able to take advantage of the 100% exclusion if they reinvest the proceeds of any sale of such stock in another QSBC in a Section 1045 Roll Over and otherwise meet the requirements described here and in our previous alerts.
3. **Incentive for new financings.** QSBCs can use the December 31, 2013 deadline to help drive new equity financings this year. The exclusion percentage is scheduled to return to 50% for QSBC stock issued after December 31, 2013.
4. **Sales of operating divisions and assets.** Businesses interested in selling a division or other assets that constitute a qualified small business during 2013 should consider marketing the tax benefits of the 100% Section 1202 exclusion to potential buyers who are eligible taxpayers.
5. **Conversion of pass-through entities.** Although the legislative glitch described below creates some risk, existing flow-through entities may consider reorganizing as QSBCs to allow their eligible owners to obtain the benefit of the 100% Section 1202 exclusion. As noted previously, this type of conversion may shield future appreciation in the value of those businesses (and not built-in gain). In addition, the C corporation structure has other benefits. Individuals interested in this possibility should consult an attorney.

Confusion Caused by the New Legislation

ATRA added a "technical amendment" to the Section 1202 75% (applicable to stock issued by a QSBC after February 17, 2009 through September 27, 2010) and 100% exclusion rates. The amendment states that the "acquisition" of QSBC stock for purposes of determining its exclusion percentage (*i.e.*, 75% or 100%) "shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223." The legislative history of related legislation suggests that Congress intended that this technical correction apply only in the case of a Section 1045 Roll Over transaction. There is no indication in the legislative history of ATRA that Congress intended to change any other provisions of Section 1202. However, read in a vacuum, the language of the technical correction could be read as indicating that stock issued by a QSBC in exchange for property in a Section 351 transaction was issued on the date on which the contributed **property** was acquired as opposed to the date on which the **stock** was issued. This interpretation is contrary to other provisions of Section 1202 that were not amended by ATRA.

This glitch in the drafting of the ATRA technical correction to Section 1202(3) and (4) has been brought to the attention of the Congressional tax legislation committees. We understand that the committees are considering methods to clarify Congress' intent with respect to the technical correction.

Conclusion

The recent extension of the 100% exclusion from tax on the sale of QSBC stock issued before the end of this year provides many tax-planning opportunities for start-ups, early stage ventures, and small and middle-market businesses. If you are interested in exploring the possibilities presented by the extension of the 100% exclusion or any other aspects of ATRA, we urge you to contact a member of the K&L Gates tax or emerging growth and venture capital groups.

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