Qualified Small Business Stock (QSBS) Year-End Considerations

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By Dan Wright

Noncorporate investors who sold or plan to sell QSBS in 2011 and are expecting a large tax windfall under Section 1202 of the I.R.C. ("Section 1202") will likely be disappointed. In general, the tax break under Section 1202 for gain realized by a noncorporate investor on the sale or exchange of QSBS in 2011, which is held by such investor as a capital asset and for a period of over 5 years, is about 1%. So why are people making such a big deal about Section 1202 as this year comes to a close?

Noncorporate investors who acquire QSBS after September 27, 2010, and before January 1, 2012, hold the stock for over 5 years, and then sell the stock at a gain will generally be able to exclude 100% of such gain (up to a minimum of $10 million) for both regular tax and AMT purposes. That's right, potentially a 0% federal income tax! Of course, this assumes all of the other tests in the fine print of the rules are satisfied.

If you are looking for ways to take advantage of Section 1202 before year-end, here are some considerations:

1. If you have a business that is held as a sole proprietorship, a single-member LLC or a partnership, then you should consider incorporating the business by the end of the year. For the 100% exclusion under Section 1202 to apply, the business has to be held as a domestic "C" corporation when the QSBS is issued to the investor or founder and during substantially all of their holding period of the QSBS. If the business has always had less than $50 million in

gross assets, the owners who receive original issue stock upon incorporation of the business can generally qualify for the 100% exclusion under Section 1202 (assuming all other tests are met). However, incorporating a business can have unexpected immediate and long-term tax and legal consequences, so be sure to get good advice before making the change.

2. If you are considering issuing stock options to key employees, board members, or service providers before the end of the year, think about using restricted stock instead. A stock option itself likely cannot qualify as QSBS, but stock received by exercising options likely can become QSBS on the date the option is exercised (i.e., when the stock is actually received), assuming the applicable requirements are met. On the other hand, restricted stock (with respect to which a valid Section 83(b) election is made at the time of issuance) likely can become QSBS when received, assuming the applicable requirements are met.

3. Make sure that investors actually receive stock before the end of 2011. Having the investor cut a check to the company in 2011 which will be held by the company until the round closes and the stock is issued to investors (in 2012) will not likely qualify the stock for the 100% exclusion under Section 1202. In other words, the classic “rolling close” on an investment round could be a problem for investors, if the close doesn’t occur before January 1, 2012.

4. If you are a CEO of a start-up, make sure that the company meets the detailed requirements under Section 1202 before you make any representations to potential investors. Because the 100% exclusion under Section 1202 is so beneficial to investors, this could become very contentious in 5 years when an investor is seeking the benefit in the midst of a delicate exit event. Few things are worse than having a disgruntled investor around when trying to close a deal. These requirements are much more complex than many executives (and even their advisors) often realize.

5. If you do invest in QSBS in 2011, track your purchase date (and cost basis) carefully. You don’t want to find out after the fact that you sold your stock too early to enjoy the 100% exclusion under Section 1202.

6. Want to make an investment through a pass-through entity? A partnership or “S” corporation can hold QSBS. As a partner/shareholder of such pass-through entity you can generally still enjoy the 100% exclusion under Section 1202 with respect to gain realized by the entity on the sale of QSBS allocated to you provided the applicable requirements are met. However, a requirement for the 100% exclusion under Section 1202 is that you must be a partner/shareholder on the date on which the pass-through entity acquired the QSBS and at all times thereafter until the entity sells the QSBS.

7. Do you hold a convertible note issued by a qualified small business? You should consider converting the note before the end of 2011. Although a convertible note itself cannot qualify as QSBS, stock received by converting the note likely can become QSBS on the date the stock is

issued, assuming the applicable requirements are met. Of course, to obtain the benefit of the 100% exclusion under Section 1202, the conversion would need to be completed (i.e., you receive your stock) before January 1, 2012. If you convert after the end of the year, the stock will be issued after the cut-off date, and it will not qualify for the 100% exclusion under Section 1202.

http://www.scribd.com/doc/76086535/QSBS

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*Please note that the views and opinions expressed in this guest blog post are not necessarily that of Davis Wright Tremaine and Joe Wallin.

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