

Tax Law Update

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Section 1202 Qualified Small Business Stock: A Little Recognized But Valuable Opportunity

Budd Lerner's tax law department provides sophisticated advice to individuals, closely held businesses, partnerships and public corporations on all aspects of federal and state tax law. Our attorneys address a full spectrum of corporate and personal tax concerns, including:

formation of corporations, partnerships, limited liability companies and other business entities;

tax implications of acquiring existing businesses;

reorganizations of corporations, partnerships and other entities;

tax aspects of corporate and real estate transactions;

dissolution and disposition of businesses and assets;

federal and state tax litigation; and

income and sales tax audits.

The Small Business Jobs Act of 2010 amended Section 1202 of the Internal Revenue Code of 1986, as amended (the "Code") to provide for a temporary 100% exclusion for certain taxpayers from gross income for regular income tax and Alternative Minimum Tax ("AMT") purposes on the gain from any sale or exchange of qualified small business stock ("QSB Stock") acquired after September 27, 2010 and before January 1, 2011. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the January 1, 2011 date for acquiring QSB Stock eligible for the 100% regular income tax and AMT exclusion to January 1, 2012. In order to qualify for the exclusion, the taxpayer must not be a corporation and must hold stock in a qualifying C-corporation which was issued after the date of the Revenue Reconciliation Act of 1993. President Obama has recently proposed making the 100% exclusion permanent but the status of this proposal is uncertain at this time.

If the 100% exclusion is not extended beyond January 1, 2012, the amount of the exclusion from regular income tax and AMT purposes under Code Section 1202 will revert to its historical amount of 50%. Under the American Recover and Reinvestment Act of 2009, the 50%

exclusion was previously increased to a 75% exclusion of gain from the sale of exchange of QSB stock acquired after February 17, 2009 and before January 1, 2011.

A. Four Main Requirements

There are four main requirements that must be satisfied before gain on the sale of stock is eligible for the exclusion under Code Section 1202. These requirements are (1) the stock is acquired by the taxpayer at "original issue" in exchange for money or other property or as compensation for services performed for such corporation (other than services performed as an underwriter of such stock); (2) the issuing corporation is a "qualified small business"; (3) the issuing corporation is an "eligible corporation" and meets the "active business requirements" of Code Section 1202 (e) and (4) the QSB Stock is held by the taxpayer for more than five years.

I. Original Issuance

Pursuant to Code Section 1202(e)(1)(b), QSB Stock must generally be acquired at "original issue" in exchange for money or other property, or as compensation for services performed for such corporation

continued on next page . . .

(other than services performed as an underwriter of such stock). The legislative history to Code Section 1202 indicates that stock received in connection with the performance of services is treated as issued by the corporation and received by the taxpayer when included in the taxpayer's gross income in accordance with rules of Code Section 83.

2. Qualified Small Business

Code Section 1202(d)(1) defines a "qualified small business" as a domestic C corporation if (i) the aggregate gross assets of such corporation (or any predecessor thereof), at all times on or after the date of enactment of the Revenue Reconciliation Act of 1993 and before the issuance of the stock being tested for potential qualification as QSB Stock, do not exceed \$50 million; (ii) the aggregate gross assets of such corporation immediately after the issuance of the stock being tested for potential qualification as QSB Stock (determined by taking into account amounts received in the issuance) do not exceed \$50 million; and (iii) such corporation agrees to submit to the IRS and its shareholders any "reports" that the IRS may "require to carry out the purposes of" Code Section 1202. The term "aggregate gross assets" means the sum of the amount cash and the aggregate adjusted basis of all of the other property of the corporation (with the adjusted basis of any property contributed to the corporation being determined as if the basis of the property being contributed to the corporation were equal to its fair market value as of the time of such contribution).

3. Eligible Corporation and the Active Business Requirement

Under Code Section 1202(e)(4), an "eligible corporation" is a domestic C corporation other than (a) a domestic international sales corporation or a former domestic international sales corporation; (b) a corporation with respect to which an election under Code Section 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect; (c) regulated investment companies; (d) real estate investment trusts; (e) real estate mortgage investment conduits and (f) cooperatives. An "eligible corporation" satisfies the "active business requirement" for any period if during such period at least 80% (by value) of the assets of such corporation are used by such corporation in the active conduct of one or more "qualified trades or business". Under

Code Section 1202(e)(3), the term "qualified trade or business" means any trade or business other than:

(a) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;

(b) any banking, insurance, financing, leasing, or similar business;

(c) any farming business (including the business of raising or harvesting trees);

(d) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under Code Sections 613 or 613A; and

(e) any business of operating a hotel, motel, restaurant, or similar business.

4. Five-Year Holding Period Requirement

In general, the holding period of QSB stock begins on the date of issuance. Special rules apply in regard to computing the holding period if the QSB Stock is acquired as a gift, by inheritance or as a transfer from a partnership or in connection with a corporate reorganization.

B. Amount Excluded

Under Code Section 1202(a)(4) and Code Section 57 (a) (7), 100% of the gain realized from the sale or exchange of QSB Stock acquired after September 27, 2010 and before January 1, 2012 is excluded from gross income tax and alternative minimum tax purposes. Code Section 1202 (b)(1) limits the aggregate amount of excludable "eligible gain" under Code Section 1202 (a)(1) with respect to QSB Stock to the greater of (1) \$10 million (reduced by the aggregate amount of any "eligible gain" previously excluded by the taxpayer for prior taxable years as a result of QSB Stock issued by the same corporation) and (2) 10 times the aggregate adjusted bases of QSB Stock issued by such corporation and disposed of by the taxpayer during the taxable year.

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C. Potential Rollover of Gain

Code Section 1045 allows a taxpayer to defer recognition of gain from the sale of QSB stock if the taxpayer purchases replacement QSB stock within a 60 day period beginning on the date of the sale. The replacement stock must be acquired by "purchase" (i.e. in a transaction in which the taxpayer receives a cost basis).

D. Planning Possibilities

Regardless of whether the Code is amended to either extend the 100% exclusion for QSB stock after January 1, 2012 or to make the current 100% exclusion permanent, QSB stock presents potential planning opportunities. Factors to be considered include the corporate level tax to be incurred during the operational phase of the corporation and that only non C-corporation taxpayers can potentially benefit from Code Section 1202. Under Code Section 1202(g), an individual taxpayer's allocated gain from a pass-through entity (such as a limited liability company or an S corporation) owning QSB stock can benefit from the exclusion of Code Section 1202.

Code Section 1202 can provide a significant tax savings to founders and angel investors upon their exit from new ventures. While Code Section 1202 has a few requirements, the potential tax savings for Code Section 1202 should not be ignored when choosing whether to establish a new business venture or enterprise as a limited liability company, subchapter S corporation or as a C-corporation whose shareholders may potentially benefit from Code Section 1202. Due to the requirements of Code Section 1202, it is a decision that must be made upon the formation of the new venture or enterprise.

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James Fitzsimmons is a shareholder in the corporate and business law department whose practice focuses on advising emerging growth companies; forming corporations, limited liability companies, partnerships and joint ventures; advising on venture capital financing, mergers and acquisitions, divestitures and workouts; and developing, licensing and transferring intellectual property rights in the e-commerce, computer (software and hardware) and biotechnology industries. ■

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John Bradley's practice is concentrated in business planning matters, including representing both buyers and sellers in the acquisition and sale of businesses; counseling clients in regard to the formation of business entities and joint ventures; and providing counsel on general corporate matters including negotiating and preparing employment contracts for executives, designing incentive compensation arrangements and benefit plans and negotiating and structuring financing arrangements. He has an expertise in tax matters including, advising on taxable and tax free mergers and acquisitions; counseling closely held corporations, partnerships, limited liability companies and joint ventures; and analyzing tax issues associated with business arrangements. His practice includes representing clients before the Internal Revenue Service, the New Jersey Division of Taxation, other State administrative agencies, Federal Courts and the Tax Court of New Jersey and providing advice regarding the tax consequences of settlements. ■