PUBLICATION

Congress Extends Exclusion for Investors in Qualified Small Businesses

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Among the taxpayer-favorable aspects of the American Taxpayer Relief Act of 2012 (Act), the 100 percent exclusion from gross income of gain on the sale of Qualified Small Business Stock (QSBS), provided for in section 1202 of the Internal Revenue Code, was extended for an additional year. Therefore, gain from the sale of QSBS purchased during the period between September 2010 and December 31, 2013 will not be subjected to tax, provided certain requirements are met.

Historically, this exclusion only provided taxpayers with a 50 percent exclusion (75 percent for QSBS purchased between February 2009 and September 2010) from gross income attributable to gain from the sale of QSBS, with the remaining non-excluded gain taxed at the 28 percent rate. The 50 percent exclusion and higher 28 percent rate resulted in an effective tax rate of approximately 14 percent (7 percent for QSBS purchased between February 2009 and September 2010).

The purpose of this exclusion is to encourage investment in new ventures. Therefore, certain requirements for qualification exist, which include the following:

- The stock must be purchased or acquired by a contribution of property or services at the time of its original issuance by the corporation and must be held for a period of more than five years;
- The interest held must actually be stock in the Qualified Small Business (not warrants, etc.);
- The holder of QSBS may be any taxpayer, including a partnership; however, corporations are not eligible to claim this exclusion;
- The maximum amount of gain eligible for exclusion with respect to a single issuer is the greater of $10 million or 10 times the taxpayer's basis in the QSBS; and
- The corporation issuing the stock must be a "Qualified Small Business," which among other requirements means the corporation is a C corporation, has no more than $50 million in gross assets prior to the issuance of such QSBS, and employs at least 80 percent of its assets (measured by value) in the active conduct of one or more trades or businesses, but generally excluding service businesses.

Barring any further extensions of this 100 percent exclusion, the 50 percent exclusion will return for QSBS purchased after December 31, 2013. This is an important development for those taxpayers that are interested in making investments in startup or otherwise qualifying small corporations during the 2013 calendar.

Should you have any questions regarding the qualification of a specific investment under this exclusion from income tax, or have any other questions regarding the effects of the Act, please contact one of the attorneys in the Firm's Tax Department.