# Congress Extends 0% Inclusion for Gains on Small Business Stock Acquired Before December 31, 2011

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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Relief Act"), signed by President Obama on December 17, 2010, extends the 100% exclusion for gains on qualified small business stock ("QSB Stock") under Section 1202 of the Internal Revenue Code (the "Code") through December 31, 2011. This 100% exclusion applies for both regular federal income tax and alternative minimum tax ("AMT") purposes, subject to the limitations described below.

## Background

Section 1202 of the Code provides, as a general matter, that a non-corporate investor may exclude from federal taxable income 50% of any gain realized from the sale of QSB Stock held for more than five years. The benefits of Section 1202 are limited, however, by the fact that long-term capital gain from the sale of QSB Stock is subject to federal income taxation at a maximum rate of 28%. Thus, the effect of the 50% exclusion is to yield a maximum tax rate of 14% on the gain realized from the sale of QSB Stock (compared to the 15% rate currently in effect with respect to long-term capital gain from most other types of assets). In addition, a portion of the gain excluded under Section 1202 must be included in income for AMT

purposes, resulting in a 14.98% rate of tax for those investors subject to the AMT.

The Creating Small Business Jobs Act of 2010 provided temporary relief by providing that 100% of any gain realized from the sale of QSB Stock acquired by a non-corporate investor between September 27, 2010 and December 31, 2010 is excluded from federal taxable income, provided the five-year holding period requirement is met and subject to the limitations described below. In addition, no portion of the excluded gain is includable in income for AMT purposes. The 2010 Tax Relief Act extends this 100% exclusion to QSB Stock acquired by a non-corporate investor through December 31, 2011.

## Requirements for Treatment as Qualified Small Business Stock

For stock to qualify as QSB Stock, the following requirements generally must be satisfied:

- The investor must acquire the stock at original issuance in exchange for cash, property (other than stock), or as compensation for services (other than as an underwriter of the stock).
- The stock must be issued by a domestic C corporation that does not have aggregate gross assets in excess of $50 million anytime prior to or immediately after the issuance of the stock.
- The issuer must satisfy the "active business" requirement during substantially all of the investor's holding period. The active business requirement requires that the corporation use at least 80% of its assets in the active conduct of one or more "qualified trades or businesses." Professional services, financial and brokerage services, banking, and insurance businesses, among others, do not qualify as qualified trades or businesses.

In addition, redemptions of the corporation's stock two years before or after the issuance of the QSB Stock may cause the stock not to qualify as QSB Stock.

### Limitation on Exclusion of Gain

The amount of gain that an investor is eligible to exclude under Section 1202 is generally limited to

the greater of: (i) $10 million, reduced by the amount of gain attributable to the issuer's stock already excluded by the investor in prior tax years; and (ii) 10 times the aggregate adjusted basis of all of the issuer's QSB Stock disposed of by the investor during the current tax year.

**Conclusion**

Investors should consider the significant benefits that may be available to them by investing in QSB Stock. Similarly, issuers should consider that their stock may be more attractive to investors if it qualifies as QSB Stock. Nonetheless, due to the complex requirements under Section 1202 of the Code, investors and issuers should consult with their tax advisors regarding their specific circumstances prior to relying on Section 1202.

For more information on this or other corporate tax matters, contact Julie Hogan Rodgers or A. William Caporizzo.

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