EXEMPTION ON GAIN OF SMALL BUSINESS STOCK

A TAX BENEFIT THAT MAY BE DIFFICULT TO CAPTURE

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Background

In 1993, the Qualified Small Business Stock (QSB) provision was enacted granting a 50% exemption on the gain on sale of shares of a qualified small business. The provision, known as section 1202, was largely ignored, however, because the benefits were not worth the effort. This was due to the fact that a) the regular capital gains rate dropped gradually from 28% to 15%, b) the exemption was treated as a preference item for alternative minimum tax, c) business could not plan ahead due to uncertainty, numerous changes in the law and sunset provisions and d) the intricate and vague requirements were too difficult and costly to implement. The provision attracted some attention in 2010-2011 when, for a brief period, the exemption was raised to 100% and the preference treatment was eliminated. Fortunately, the American Taxpayer Relief Act of 2012, signed into law on January 2, 2013, made the 100% exemption retroactive to January 2012 and effective until January 1, 2014.

The Benefit

For qualifying shares of qualifying corporations acquired between September 28, 2010 and January 1, 2014, and held for more than 5 years, the shareholder may exempt 100% of the gain on the sale of qualified shares limited to the greater of $10 million or 10 times the basis in the stock. For a $10 million gain at a capital gains rate of 15%, the tax savings would be $1.5 million, and at the 20% rate, the savings would be $2 million. At these levels of savings, most investors would be interested in claiming such a benefit.

The Requirements

The rules for determining if a small business qualifies are subject to interpretation as the IRS has not issued the necessary regulations, which would clarify the application of the intricate restrictions and ambiguities of the provision. Overall, there are four major requirements:

1. The stock must be of a C Corporation that was acquired at “original issuance” and redemptions must be limited as per the regulations;
2. The gross assets must be $50 million or less (some assets are measured at cost and others at fair market value);
3. The company must meet the eligibility and active business requirements during the shareholder’s holding period which includes rules on working capital, real estate and portfolio investments, and
4. The shares must be held for at least 5 years and 1 day.

Documentation

The IRS and the National Venture Capital Association (Sample Investor Rights Agreement Par 5.4: Qualified Small Business Stock) require that the company submit to its investors any reports that are mandatory under the tax law to enable such investors to claim the benefit on their tax return. Without adequate documentation, an investor may ultimately have difficulty in sustaining this tax benefit.