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Congress Extends 100% Gain Exclusion for Small Business Stock

Favorable tax treatment applies to certain acquisitions of qualified small business stock in 2012 and 2013 and may influence choice-of-entity decisions.

In a little-noticed provision of the American Taxpayer Relief Act of 2012 (the Act), Congress extended the effective tax rate of 0% on the sale of qualified small business stock (also known as Section 1202 Stock) for a second time. The Act modifies Section 1202 of the Internal Revenue Code to provide that 100% of the eligible gain received by an individual taxpayer from the sale of qualified small business stock acquired after September 27, 2010, and before January 1, 2014, and held for more than five years, may be excluded from the taxpayer's income for federal tax purposes. In addition, the excluded gain under this temporary provision remains a nonpreference item for alternative minimum tax (AMT) purposes. Congress originally provided for the 100% gain exclusion in 2010 and later extended such treatment to qualified small business stock acquired in 2011, but it did not provide for such treatment with respect to stock purchased in 2012.[1] Thus, the Act both extends favorable tax treatment for such stock acquired in 2013 and retroactively applies such tax treatment to such stock acquired in 2012. As there is no guarantee that Congress will extend the 100% gain exclusion on small business stock acquired after 2013, investors planning to acquire qualified small business stock should consider doing so during 2013 to secure the benefits of the Act.

Scope of the Gain Exclusion

The gain exclusion is available only with respect to "qualified small business stock," which is stock of a C corporation that, at the time of the stock's issuance, has gross assets of $50 million or less. In general, the stock must be acquired by the investor at the time of the original issuance. Moreover, for substantially all of the time during which the taxpayer holds the stock, the corporation must be actively engaged in a qualifying trade or business. A qualifying trade or business can be any business other than banking, farming, natural resource extraction/production, or certain service businesses. Specifically, a business engaged in consulting, engineering, or leasing activities cannot be a qualifying trade or business.

The amount of gain that is eligible for exclusion under this provision is equal to the greater of (i) 10 times the taxpayer's basis in the stock or (ii) $10 million. Gain is eligible for exclusion only if it is derived by an individual, directly or indirectly, through an entity treated as a partnership for tax purposes. Special rules apply where the gain on qualified small business stock is allocable to an individual through a partnership, as well as for the calculation of tax basis for the purpose of the gain exclusion limitation. Gain above the applicable threshold amount is subject to capital gains tax and is generally subject to the 3.8% Medicare tax that applies to capital gains from the sales of stock beginning in 2013. Since gain below this threshold is not taken into account in computing taxable income, such gain is excluded from "net investment income," which is subject to the new 3.8%

1. Read more about the favorable tax treatment for qualified small business stock in our October 27, 2010, LawFlash, "New Law Temporarily Expands Favorable Tax Treatment of Certain Small Business Stock, " available at http://www.morganlewis.com/pubs/Tax_LF_LawExpandsFavorableTreatment_27oct10.pdf, and our December 23, 2010, LawFlash, "Favorable Tax Treatment of Certain Small Business Stock Extended for One Year," available at http://www.morganlewis.com/pubs/TaxLF_FavorableTaxTreatmentExtended_23dec10.pdf.

Medicare tax.

Generally, 50% of eligible gain on the sale of qualified small business stock purchased outside the specified window may be excluded from the taxpayer's income. In addition, some of the excluded gain is ordinarily treated as an AMT preference item and is therefore added back into the taxpayer's AMT income, which further reduces the benefit of the exclusion.

Implications

Although only temporary, the extension of the 100% gain exclusion on qualified small business stock under the Act may take on an increased role in choice-of-entity decisions between C corporations and "pass through" entities, such as limited liability companies (LLCs) or S corporations. From a tax perspective, pass-through vehicles have historically been the preferred choice of entity for most start-up businesses for several reasons, including the ability to distribute operational earnings with only one level of tax (at the owner level). More importantly, a pass-through entity also generally permits the tax-efficient sale of a business in a transaction structure that will allow the buyer to "step up" the asset tax basis of the purchased business and amortize its purchase price for tax purposes. While the size of this premium will vary greatly depending on the tax and investment profile of the buyer, it is often a key choice of entity consideration. However, the new 3.8% Medicare tax will increase the role of Section 1202 as an offsetting tax consideration in favor of C corporations as the choice of entity for those taxpayers who believe they can take advantage of the extended 100% gain exclusion for sales of Section 1202 Stock. As discussed above, the 3.8% Medicare tax does not apply to capital gains on qualified small business stock eligible for exclusion under Section 1202, whereas the 3.8% Medicare tax will apply to most capital gains generated by sales of equity in a pass-through entity (assuming the Medicare tax income thresholds are met by the selling owner).

Legislative proposals also may tip the needle in favor of a C corporation choice of entity for those taxpayers who believe they can take advantage of Section 1202. Currently, proposed tax reforms suggest the possibility of a broader shift in policy toward encouraging the use of C corporations, as opposed to pass-through entities. For instance, one major proposed reform intended to make the U.S. corporate tax system more competitive with tax systems of other countries involves reducing corporate income tax rates to as low as 25%, broadening the "base" for corporate tax revenues, and shifting to a "territorial," rather than worldwide, system of taxation. The future of these proposals is uncertain, but it is likely that the tax benefits of pass-through entities will not be expanded and may actually be limited. When combined with non-tax commercial reasons for choosing a C corporation, such as the general preference of venture capitalists to invest in C corporations and the use of C corporations for those businesses contemplating an IPO exit, these legislative proposals and Section 1202 may make the C corporation a more desirable choice of entity for some business owners.

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