Morgan Lewis
alert
tax lawflash
www.morganlewis.com

New Law Temporarily Expands Favorable Tax Treatment of Certain Small Business Stock

October 27, 2010

The Small Business Jobs Act of 2010 (the Act), signed into law on September 27, includes a provision that expands the existing favorable tax treatment of gain resulting from the sale of qualified small business stock. Under this provision, investors who purchase stock in certain small business corporations by the end of 2010 will receive a tax benefit that is more generous than what is ordinarily available.

Under the Act, 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, 2011, 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 is not a preference item for alternative minimum tax (AMT) purposes. Therefore, the Act temporarily prevents the AMT from offsetting the benefits of the gain exclusion. This marks the first time that an effective tax rate of 0% is in place with respect to qualified small business stock.

The 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 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.

The percentage of eligible gain on the sale of qualified small business stock purchased outside the window above that may be excluded from the taxpayer's income is generally 50%. However, the exclusion percentage was increased by earlier legislation to 75% for qualified small business stock acquired after February 17, 2009 and before January 1, 2011.

Investors planning to make an acquisition of qualified small business stock should consider doing so prior to the end of 2010, so as to take advantage of the increased exclusion provided for in the Act.

If you have any questions or would like more information on any of the issues discussed in this LawFlash, please contact either of the following members of the Morgan Lewis Tax Practice:

Philadelphia

Paul A. Gordon	215.963.5568	pgordon@morganlewis.com
Gabriel A. Quihuis	215.963.4796	gquihuis@morganlewis.com

About Morgan, Lewis & Bockius LLP

With 23 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, regulatory, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—nearly 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Minneapolis, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend, please see http://www.morganlewis.com/circular230.