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Favorable Tax Treatment of Certain Small Business Stock Extended for One Year

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Signed into law on December 17, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Act) extends the temporary favorable tax treatment of gain resulting from the sale of qualified small business stock initially provided by the Small Business Jobs Act of 2010. Under this provision, investors who acquire stock in certain small business corporations in 2011 will receive a tax benefit that is more generous than what is ordinarily available. As discussed in an earlier LawFlash,[1] prior to the Act the favorable treatment applied only to qualified small business stock acquired between September 27, 2010 and December 31, 2010.

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, 2012, 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 as well as for the calculation of tax basis for the purpose of the gain exclusion limitation.

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[1] Read more about the favorable tax treatment in our October 27, 2010 LawFlash, "New Law Temporarily Expands Favorable Tax Treatment of Certain Small Business Stock," available online at http://www.morganlewis.com/pubs/Tax_LF_LawExpandsFavorableTreatment_27oct10.pdf.

Gain above the applicable threshold amount is subject to capital gain tax, as well as the 3.8% Medicare tax that applies to capital gain from the sales of stock beginning in 2013.

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

Investors planning to make an acquisition of qualified small business stock should consider doing so prior to the end of 2011, 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:

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