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Tax Law Update

CONGRESS EXTENDS 100% EXCLUSION FOR GAINS FROM SALES OF QUALIFIED SMALL BUSINESS STOCK

As a pleasant surprise to many investors, the recently enacted American Taxpayer Relief Act of 2012 (the "Act") extends the 100% exclusion for gains from sales of Qualified Small Business Stock ("QSB Stock") to QSB Stock acquired in 2012 (retroactively) and 2013.

Historically, non-corporate investors that sold QSB Stock held for five years or more were permitted under Section 1202 of the Internal Revenue Code to exclude 50% of the gain recognized on such sale when computing their federal income tax liability (increased to 75% generally for investments made in 2009 and 2010). The remaining 50% of gain, however, was taxed at a 28% rate, producing an overall tax rate of 14% (ignoring the alternative minimum tax) and only a minimal advantage over the general 15% long-term capital gain rate.

The Small Business Jobs Credit Act of 2010 increased the gain exclusion to 100% for purchases of QSB Stock made after September 27, 2010 and before January 1, 2011. The 100% exclusion was later extended to QSB Stock purchases made in 2011, and now the Act has further extended the 100% exclusion through the end of 2013.

LIMITATIONS: Many requirements must be met in order to qualify for the favorable gain exclusion rule, some of which are within the control of the issuer of the stock (and outside the control of the investor). The most notable requirements are as follows:

1. The stock must be stock in a "C" corporation.
2. In general, the stock must be acquired by the investor at original issuance.
3. At the time of the stock issuance, the corporation must have gross assets of $50 million or less (including assets received by the corporation in the stock issuance).
4. For substantially all of the time during which the investor holds the stock, the corporation must be actively engaged in a qualified trade or business. A qualifying trade or business does not include professional service organizations (law, accounting architecture, *etc.*), banking, farming, mining, or hotel and restaurant management.

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5. The corporation must use at least 80% of its assets, measured by value, in the active conduct of such qualified trade or business. Cash held for anticipated working capital needs generally qualifies but is capped at 50% of the assets of the corporation if the corporation has been in existence for at least two years.
6. No more than 10% of the corporation's assets may consist of stock or securities in other corporations (other than 50%-or-more owned subsidiaries) or real property not used in the active conduct of a business. Owning, dealing in, or renting real property is not an active business for this purpose.
7. The amount of gain that is eligible for exclusion under this provision is equal to the greater of (a) 10 times the investor's basis in the stock or (b) $10 million. Special rules apply for stock acquired in exchange for property.
8. The corporation cannot make significant redemptions during the two-year period starting one year before the particular investment.
9. The investor must generally hold the QSB Stock for five years. Under certain circumstances an investor may defer gain on the sale of QSB Stock in a reorganization or by reinvesting the proceeds of a sale into other QSB Stock, in which case the two holding periods are tacked together.

CALIFORNIA TAX TREATMENT: Although the California statute provides a 50% exclusion for QSB Stock that is similar to the federal exclusion, the availability of the California exclusion is currently uncertain.

California's standard for QSB Stock mirrors Section 1202 of the Internal Revenue Code, but also requires that the corporation use 80% of its assets in the conduct of business in California and maintain 80% of its payrolls in California. Recently, the California Court of Appeals declared the California QSB Stock exclusion to be unconstitutional under the Commerce Clause because it discriminates against investors in out-of-state corporations. Although the decision has been remanded to the trial court for further proceedings, the California taxing authorities have preemptively taken the position that the California QSB Stock exclusion is invalid and unenforceable as to all investors, including investors in corporations meeting the 80% of assets and payrolls requirement. Although it is uncertain to what extent the California QSB Stock exclusion will ultimately apply, clearly investors should not stop purchasing QSB Stock or seeking special federal tax treatment for such investments.

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