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NEWSLETTER

Eligible Gain Exclusion for Qualified Small Business Stock

In general, the gain of the value of stock is not recognized until the stock is sold. Once the stock is sold, it is subject to a capital gains tax on the sales price less the taxpayer's adjusted basis in the stock. Internal Revenue Code Section 1202 codifies an exclusion on the gain of qualified small business stock ("QSBS") for non-corporate taxpayers.

What is IRC § 1202?

Section 1202 provides an exclusion from federal income tax to any non-corporate taxpayer of the gain on the sale of QSBS held for more than 5 years.

What is Exclusion?

Depending on the date the taxpayer obtained the QSBS, the exclusion is between 50-100%, but cannot exceed the greater of $10,000,000 or 10 times the aggregate adjusted tax basis of the stock.

For the purposes of Section 1202, the adjusted tax basis is equal to the amount of cash plus the fair market value of any property contributed to the corporation in exchange for the stock.

Date Stock Was Acquired	Percent Exclusion from Federal Tax
Before February 18, 2009	50%
February 18, 2009 - September 27, 2010	75%
September 28, 2010 and later	100%

What are the requirements for Qualified Small Business Stock?

- QSBS must be from a domestic C corporation;
- QSBS must be from a "qualified business" (see below);
- QSBS must be held for at least 5 years;
- QSBS must have been acquired at its "original issuance," meaning directly from the corporation, and not through another shareholder or third-party; and
- for the first six months that the taxpayer owns the QSBS, the business must be an "active business."

What is a Qualified Business?

A qualified business is any domestic C corporation that has aggregate gross assets not in excess of $50,000,000, including before and immediately after the issuance of the stock.

What is an "active business"?

A business qualifies as an "active business" if at least 80% of the value of its assets are used in the active conduct of one or more "qualified trades or businesses" (see below).

What is a Qualified trade or business?

A qualified trade or business means any trade or business other than:

- a service business in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of 1 or more of its employees;

- an insurance, financing, leasing, investing, or similar business;
- a farming business;
- a business involving the production or extraction of oils, minerals, gases, and other similar substances; and
- a business operating a hotel, motel, restaurant or similar business.

Example.

To demonstrate the benefit of Section 1202, suppose a taxpayer purchases QSBS for $10,000 in October 2010, and five years later, having met all the requirements discussed above, sells the QSBS for $100,000; the taxpayer's basis in the QSBS would be $10,000 and the gain would be $90,000. The $90,000 gain on the sale of the stock would not be subject to federal income taxes.

If you are considering starting a business that will be seeking outside investment, or you are considering investing in a start-up or small business, we recommend you contact an attorney or accountant well versed in QSBS to determine how you may benefit from Section 1202.

Please call with any questions.

Sincerely,
Citron & Deutsch