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Emerging Company Capital - 2010 Q-4 Represents a 3 Month Window For Stock Investments to Qualify for Zero Capital Gains Tax Rate

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Introduction

The Small Business Jobs and Credit Act of 2010 ("**2010 Small Business Act**"), signed by President Obama on September 27, 2010, contains an amendment to an existing tax incentive for investments in small business corporations that offers a potential zero capital gain tax rate for investments made during the fourth quarter of 2010. This amendment will benefit individual investors who invest either directly in qualifying small businesses or indirectly through private equity and venture capital funds that invest in qualifying small businesses (in either case qualifying small businesses includes specialized small business investment companies ("SBICs") licensed to operate under the Small Business Investment Act of 1958).

The catch, however, is that the tax incentive requires that the investment be made within a three-month window that closes at the end of 2010.

Capital Gain Exclusion on Qualified Small Business Stock QSBS)

Under an investment incentive enacted in 1993, capital gain realized on investments in qualified small business stock ("*QSBS*") held for more than five years is taxed at a 14 percent effective tax rate (based on a stated 28% capital gain rate and a 50 percent exclusion of capital gain from gross income). QSBS status requires meeting certain requirements governing the type of beneficial owner, size of the corporate issuer's assets, and nature of its business activities. The original QSBS provision, which also characterizes a portion of the gain exclusion as a tax preference item subject to alternative minimum tax ("**AMT**"), became less attractive with the reduction of the regular capital gain tax rates to 20 percent in 1997 and then to 15 percent in 2003.

In early 2009, in response to the freezing of the capital markets, Congress reduced the potential effective capital gain tax rate for QSBS to 7 percent for regular tax purposes (by increasing the gain exclusion to 75 percent and subjecting 25 percent of the gain to a 28 percent rate) for investments between February 18, 2009 and December 31, 2010. However, since under the 75 percent gain exclusion there is an effective AMT rate of 12.88 percent, even the 75 percent gain exclusion does not yield a material rate reduction in the context of the current regular 15 percent capital gain tax rate.

The 2010 Small Business Act modified the QSBS gain exclusion in a meaningful way by converting it to a 100 percent gain exclusion (the " **2010 QSBS Provision**") although only on a temporary basis. Unlike the two prior versions of the QSBS tax incentive in 1993 and 2009, the 2010 Small Business Act does not treat a portion of the QSBS gain as a tax preference item for AMT purposes. Qualifying 2010 QSBS Provision investments, however, must be made prior to December 31, 2010.

Qualifying As QSBS

To qualify for the QSBS gain exclusion, the following requirements must be met:

1) the stock must be issued by a domestic corporation taxed as a regular C corporation;

2) the stock must be purchased directly from the corporate issuer;

3) the shareholder must be either an individual or certain pass-thru entities for tax purposes with individual members or participants that generally report allocable shares of capital gain on a pass-thru basis;

4) the corporation must have gross assets of $50 million or less (measured by the adjusted tax basis rather than fair market value) on the date the stock is issued;

5) the corporation must be engaged in a qualified trade or business, or start-up activities or certain research and experimental activities; and

6) the stock must be held for more than five years before sale.

QSBS Gain Ceiling and AMT

The amount of gain that can be excluded by any single taxpayer with respect to a particular issuer is limited to the greater of $10 million or ten times the adjusted basis of the QSBS. The per investor ceiling will continue to apply to gain excluded under the 2010 QSBS Provision.

Most significantly, the 100 percent exclusion also applies for AMT purposes, thereby eliminating the AMT preference item treatment that rendered the original 1993 and 2009 QSBS provisions less attractive. Under the 1993 and 2009 provisions, a portion of the gain includible in income for AMT purposes is taxed at a maximum rate of 28 percent.

Eligible Small Business Criteria

A variety of activities including professional services, banking, insurance, financing, leasing, farming and resort type businesses, as well as any trade or business where the principal asset is the reputation or skill of one or more of its employees, are expressly excluded from qualifying for small business status. The active business standard requires that at least 80 percent of the assets of such corporation are used in one or more qualified trades or businesses. The active business requirements are deemed satisfied for any corporation during the period that it qualifies as a SBIC licensed to operate under Section 301(d) of the Small Business Investment Act of 1958.

The gross asset and active business determinations are to be applied on an aggregate basis to members of a parent-subsidiary controlled group. Look-thru rules apply to assets and activities of more than 50 percent owned subsidiaries. The IRS has still not issued regulations under the QSBS provision that would among other things address issues arising with respect to the active business standard and gross asset measurement.

Early Exit – Opportunities For Rollover of QSBS Gain and Tax-Free Exchanges

If QSBS stock is sold before 5 years, the inherent gain may be “rolled over” tax-free under two potential approaches.

Under the original QSBS provisions, QSBS gain realized in a sale after a 6-month holding period can be rolled over on a tax-free basis within 60 days into QSBS of another qualified small business. Another rollover possibility is for QSBS to be exchanged in a tax-free reorganization for acquiring corporation stock that is not QSBS in which case the gain inherent on the exchange will remain potentially eligible for the gain exclusion upon sale of the acquiring corporation stock. A final play would be a rollover in the fourth quarter of 2010 of already purchased QSBS into new QSBS of another qualified small business to fund a qualifying investment under the 2010 QSBS Provision.

In each case, it is not entirely clear how the IRS would apply the differing gain exclusion rules where the investment transactions implicate some combination of the 50 percent, 75 percent and 100 percent gain exclusion provisions. Nevertheless, whatever the technical uncertainties in methodology for reporting purposes, these various rollover and reinvestment strategies offer the potential for tax-free sale of QSBS stock before the expiration of the 5-year holding period without disqualification of QSBS benefits.

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