

CLIENT MEMORANDUM

January 17, 2013

**IMPACT OF THE AMERICAN TAXPAYER RELIEF ACT
ON QUALIFIED SMALL BUSINESS STOCK**

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012 (the “2012 Tax Relief Act”). Among other provisions, the 2012 Tax Relief Act renews and extends the 100 percent capital gain exclusion relating to gain realized on “qualified small business stock” (QSBS).

Under Internal Revenue Code Section 1202 , taxpayers (other than corporations; discussions on pass-through entities can be found below) that recognize gain from the sale of QSBS held for more than five years may exclude 50% of such gain from gross income for income tax purposes. The Small Business Jobs Act of 2010 (the “2010 SBJA”) amended Section 1202 of the Internal Revenue Code of 1986 (as amended, the “IRC”) to permit the temporary exclusion of 100 percent of any capital gain realized on the sale of certain QSBS, but only for QSBS acquired between September 8, 2010 and December 31, 2010. This date was extended to January 1, 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “2010 Tax Relief Act”). The 2012 Tax Relief Act renews and extends this 100 percent exclusion period until January 1, 2014. Furthermore, the extension applies retroactively, such that the exclusion now applies to QSBS acquired [on or after September 27, 2010 and prior to January 1, 2014](#). This *Client Memorandum* summarizes the impact of the 2012 Tax Relief Act on taxpayers holding QSBS.

A. Defining Qualified Small Business Stock

1. “Qualified Small Business”

QSBS may only be issued by a “qualified small business,” within the meaning of IRC Section 1202, which requires that the issuer:

- Be a domestic C corporation;

- Have aggregate gross assets of no more than \$50 million at all times since August 10, 1993, through and immediately following the issuance of the QSBS; and
- Agree to submit such reports to the IRS and stockholders as the IRS may require to carry out the purposes of IRC Section 1202.

Stock issued by an S corporation does not qualify as qualified small business stock, even if the S election is later revoked. However, subsequently acquired stock may qualify.

In calculating whether a corporation meets the aggregate gross asset test, subject to certain exceptions, cash is valued at face value and other assets are valued at their adjusted tax bases.

In general, gain from stock issued to “flow-through entities” such as partnerships, limited liability companies and S corporations should qualify under Section 1202. However, the amount of the qualifying gain is limited to the interest held by the partner or member or S corporation shareholder on the date the stock is acquired. This limitation may be significant in certain venture fund settings when the general partners’ interests fluctuate over time.

IRC Section 1045 allows qualified taxpayers to roll over proceeds from the sale of a QSBS held for at least six months, when the proceeds are used to purchase another QSBS. This effectively defers the tax due on any gain on the stock.

2. “Qualified Small Business Stock”

IRC Section 1202 provides that securities meet the following requirements in order to qualify as QSBS:

- The stock must be “originally issued” to the taxpayer by a qualified small business on the date of issuance;

- During substantially all of the taxpayer's holding period, at least 80 percent of the issuer's assets (by value) must be used in the active conduct of qualified trades or businesses;
- The issuer must be an "eligible corporation" during substantially all of the taxpayer's holding period;
- The issuer may not directly or indirectly redeem more than a *de minimis* number of shares held by a taxpayer to which the QSBS is issued (or certain related parties), within a four-year period beginning two years prior to the issuance of the QSBS; and
- There may be no significant redemptions of the issuer's stock from any party during a two-year period beginning one year prior to the issuance of the QSBS.

Stock can be **originally issued** within the meaning of IRC Section 1202 by the qualified small business directly or through an underwriter. It can be acquired in exchange for money or other property (other than stock), or as compensation for services other than underwriting. Special rules apply to stock received by a partner from a partnership, and to stock received in a reorganization pursuant to IRC Section 368(a)(1)(F) or to stock received through the conversion of other stock in the same issuer.

Qualified trade or business is defined as any trade or business other than certain specifically excluded activities, mainly professional activities such as law or medicine, banking and finance, farming, mining and the operation of hotels and restaurants. It includes start-up activities and certain research and experimentation activities.

In calculating **the 80 percent requirement**, a corporation is treated as owning its proportionate share of the assets of any subsidiary in which it holds more than 50 percent of the combined voting power or value. Reasonable working capital for qualified trades or businesses, or assets that are reasonably expected to be used within two years to finance research and experimentation in qualified trades or businesses, count toward the 80 percent requirement.

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Other than these cash assets, no more than 10 percent of the value of an issuer's assets less its liabilities may consist of securities of corporations other than its controlled subsidiaries, and no more than 10 percent of the value of the issuer's total assets may consist of real estate not used in the active conduct of its qualified trades or businesses.

Certain entities that enjoy special tax privileges under other IRC sections are excluded from the definition of an “**eligible corporation**.” For example, regulated investment companies, real estate investment trusts and cooperatives may not issue QSBS.

B. Limitations

If the requirements associated with the issuance of QSBS are satisfied, significant tax benefits may be enjoyed by the holders of QSBS. In order to benefit from the tax reliefs, among other things:

- the taxpayer must hold QSBS for more than five years;
- Gains realized on certain “offsetting short positions” of the taxpayer are limited;
- The amount of gain that can be excluded by a single taxpayer is generally limited to the greater of \$10 million or ten times the adjusted basis of the QSBS.

For further discussion on this topic, please contact our attorneys.

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