TAX EXCLUSIONS FOR SALE OF STOCK ISSUED BY QUALIFIED SMALL BUSINESS CORPORATIONS BECOMES PERMANENT — AT LEAST TEMPORARILY

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Over the past several years, Congress has sought to incentivize investment in small businesses by allowing taxpayers to exclude gains in certain small business stock sales. Gradually, Congress continued to increase these incentives from 50% to 75% and then to 100%, but for temporary periods only with sunset provisions that required Congressional reauthorization. The most recent extension expired January 1, 2015. On December 18, 2015, Congress passed the Protecting Americans from Tax Hikes Act ("**PATH**"), which included a permanent extension of Section 1202. Taxpayer gains on qualifying small business stock obtained after September 27, 2010 can qualify for 100% exclusion. Unlike previous extensions that Congress set to expire on a set date, the PATH Act extended the 100% exclusion indefinitely. Otherwise, the 100% tax exclusion in Section 1202 remains unchanged.

Only taxpayers recognizing gains from stock issued by certain qualifying small businesses can take advantage of this exclusion. Section 1202 allows eligible taxpayers to exclude 100% of gains on the sale of certain stock issued by a "qualified small business corporation" (a "**QSBC**"). This *Alert* will further explain, for purposes of Section 1202, the qualifications to be an eligible taxpayer and QSBC and the gains that can be excluded.

WHAT GAINS ARE EXCLUDED?

100% of gains recognized on the sale of stock issued by a QSBC after September 27, 2010, up to $10 million (or, if greater, 10 times the amount of the taxpayer's investment in the stock), can be excluded under Section 1202. The taxpayer must have held the stock for more than five years prior to sale. The exclusion applies not only to federal income taxes, including the alternative minimum tax, but taxpayers may also be able to exclude gains from state income taxes under Section 1202 (depending on state law). Such exclusions apply to founders and investors alike.

ELIGIBILITY REQUIREMENTS

We have discussed the eligibility requirements and opportunities provided by the Section 1202 exclusion in great detail in *Alerts* on November 3, 2010, January 18, 2011, and February 4, 2013. In this *Alert*, we provide a high-level summary of the Section 1202 eligibility requirements.

1. **A QSBC must issue the stock.** A QSBC is an entity classified as a C corporation that engages in certain types of active business, excluding any trade or business involving services in 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 one or more employees. Additionally, banking, investing, insurance, financing, leasing, and other similar businesses are excluded, along with farming businesses, and any business operating a hotel, restaurant, or similar business. At all times between August 10, 1993, and the date the corporation issues the stock to a qualified shareholder (including the amount invested and the stock issued in the qualified shareholder's purchase), the value of the corporation's aggregate gross assets must not exceed $50 million. In certain limited cases, the gross assets of related companies may be evaluated together. Section 1202 requires the corporation to submit the necessary reports to the IRS and to the shareholders to determine the gross assets of the corporation.
2. **Taxpayer eligibility.** The taxpayer must be an individual, estate, or trust, and must have purchased the stock after September 27, 2010, directly from the QSBC and not from another shareholder.
3. **Exclusion applies only to appreciation in stock value.** The exclusion does not apply to so-called "built-in gain." Accordingly, if the taxpayer transfers property other than cash to a QSBC in exchange for stock issued by the QSBC, the exclusion does not apply to the appreciation on that property from tax. However, if the contribution is not taxed because of Section 351, the tax on the appreciation will not be assessed until the QSBC stock is sold.
4. **Five-year holding period.** The taxpayer must hold the shares for more than five years before the sale. However, subject to certain restrictions, a shareholder may sell stock within five years and not recognize gains from the sale provided that the shareholder uses the proceeds to acquire newly issued QSBC stock (a "Section 1045 Rollover"). When QSBC stock is sold and reinvested in a Section 1045 Rollover transaction, the holding period of the old shares is credited to the holding period of the new shares.

ELIGIBLE TRANSACTIONS AND PLANNING CONSIDERATIONS

Section 1202 provides investors opportunities to capture greater gains in their investment portfolios through the exclusion of qualifying gains from income taxes. Accordingly, investors and corporations alike may wish to consider some of the following when planning to invest or create a start-up.

5. **Formation and funding of start-up companies.** Those organizing a start-up, early stage company that will otherwise meet the eligibility requirements for a QSBC should consider organizing as a C corporation instead of an S corporation, partnership, or limited liability company taxed as a partnership. In addition to the Section 1202 exclusion discussed in this *Alert*, organizing as a C corporation provides certain federal income and employment tax benefits not available to pass-through entities.
6. **Shorter-term investments.** In some situations where the five-year holding period is not met, taxpayers may be able to convert their shares without losing the benefits of Section 1202's 100% exclusion by reinvesting in a Section 1045 Rollover Transaction.

7. **Sales of operating divisions and assets.** Businesses interested in selling a division or other assets that on their own would constitute a QSBC should consider marketing the tax benefits of the 100% exclusion to potential buyers who are eligible taxpayers.
8. **Conversion of pass-through entities.** Existing pass-through tax entities (i.e., S corporations, limited liability companies, and partnerships) may consider reorganizing as a QSBC to allow their eligible owners to obtain the benefit of the 100% exclusion. As noted in our prior *Alerts*, this type of conversion may allow for the exclusion of gains on future appreciation in the value of those businesses after the date of the reorganization (but not built-in gain). In addition, the C corporation structure has other benefits. Individuals interested in the possible benefits of converting to a C corporation to benefit from the 100% exclusion or other benefits should consult an attorney.

"PERMANENT" EXTENSION MAY BE TEMPORARY

Although Congress amended Section 1202 to remove the expiration date for investors to purchase qualifying QSBC stock, some rumblings in Washington, D.C., suggest that the amendment may be temporary as a method to push Congress toward more significant tax reform. The government affairs advisors at K&L Gates are keeping track of new tax reform developments in Washington, D.C.

CONCLUSION

The recent permanent extension of the 100% exclusion from tax on the sale of QSBC stock provides many tax-planning opportunities for start-ups, early stage ventures, and small and middle-market businesses. If you are interested in exploring the possibilities presented by the permanent extension of the 100% exclusion, we urge you to contact a member of the K&L Gates tax or emerging growth and venture capital groups.

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