Client Alert

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Recent Changes Make Permanent the 100% Exclusion of Eligible Gain from Sales of Section 1202 “Qualified Small Business Stock”

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Impact of New Legislation

The Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”) has amended Section 1202 of the Code[1] to permanently extend the 100% exclusion for eligible gain on sales of qualified small business stock (“QSBS”).[2] Under Section 1202 of the Code, an individual shareholder who has held QSBS for more than five years is eligible for a full or partial exclusion of eligible gain realized with respect to his or her QSBS. The portion of a taxpayer’s gain that is excluded under Section 1202 of the Code generally depends on when the QSBS at issue was issued to the taxpayer. As originally enacted in 1993, Section 1202 of the Code allowed for a 50% exclusion of the amount of eligible gain from the sale of QSBS held more than five years. A subsequent amendment to Section 1202 of the Code raised this percentage to 75% for QSBS acquired between February 18, 2009 and September 27, 2010. In 2010, the exclusion percentage was increased to 100% for QSBS acquired after September 27, 2010 and before January 1, 2012 (this period was later extended to QSBS issued in 2012, 2013 and 2014). The PATH Act has now effectively made the 100% exclusion applicable for 2015 and all years thereafter. The 100% exclusion applies for purposes of both the regular and the alternative minimum tax ("AMT").

Qualified Small Business Stock Defined

As described above, an individual shareholder who has held QSBS for more than five years is eligible for a full or partial exclusion of gain on the sale of their QSBS under Section 1202 of the Code. In order to qualify as QSBS, stock must be:

- issued by a “qualified small business” after August 10, 1993; and
- acquired by the taxpayer at original issuance in exchange for money, property (other than stock), or services; or acquired in a non-recognition transaction from a transferor meeting these requirements.

Qualified Small Business Defined

A qualified small business (“QSB”) is a corporation that meets the following requirements:

- It is a domestic corporation that has been a C corporation for substantially all of the taxpayer’s holding period.

[1] All “Section” references are to the Internal Revenue Code of 1986, as amended (the “Code”).
[2] See Section 126 of the PATH Act.

- The aggregate gross assets of the corporation at all times from August 10, 1993 until immediately after the issuance of the taxpayer's stock do not exceed $50 million. For this purpose, a corporation's aggregate "gross assets" are equivalent to its cash (including any cash contributed in connection with the current issuance) plus the aggregate adjusted bases of other property held by the corporation.

- During substantially all of the taxpayer's holding period for the stock, at least 80 percent of the corporation's assets have been used in the active conduct of a trade or business that is in a category other than any of the following:

    - Professional services (such as health, law, engineering, architecture, and brokerage services);
    - Banking, insurance, finance, leasing or similar businesses;
    - Farming;
    - Mining or natural resource production or extraction; and
    - Operating a hotel, motel, restaurant, or similar business.

  For purposes of the 80 percent test, after the corporation has been in existence for two years, the percentage of its cash and investment assets that will be treated as "used in the active conduct" of its business may be subject to a statutory limitation.

Annual Limitation on Gain Exclusion

The amount of gain from the QSBS of any particular issuer that any particular taxpayer may exclude under Section 1202 of the Code in any year is limited to the greater of:

- $10 million, reduced by the aggregate gain attributable to QSBS of that issuer excluded by that taxpayer in prior years; or

- 10 times the taxpayer's basis in his or her QSBS of that issuer disposed of in that year.

Treatment of Non-Excluded Portion

Any portion of QSBS gain that is not availed of the exclusion under Section 1202 is generally taxed at applicable capital gains rates. For shares acquired before September 28, 2010, a portion of the excluded gain is treated as an item of tax preference under the alternative minimum tax. Thus, the AMT may apply to claw back some of the gain excluded by Section 1202 of the Code, resulting in slightly higher effective rates on gain from QSBS acquired before September 28, 2010.

Prior Alerts Relating to Section 1202 QSBS

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