

October 29, 2010

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extends the 100% exclusion for capital gains to sales of qualified small business stock, or QSBS, purchased after September 27, 2010 and on or before December 31, 2011, and held for more than five years before sale. This Alert provides further information about this temporary tax benefit¹.

What are the requirements for, and limitations on, the 100% exclusion?

- The QSBS must be acquired after September 27, 2010 and before January 1, 2012.
- The QSBS must be held more than five years before sale.
- The amount of gain eligible for the exclusion is limited to the greater of \$10 million or ten times the taxpayer's investment in the QSBS.

What is Qualified Small Business Stock?

QSBS is stock of a domestic corporation meeting the following requirements:

- The stock is acquired in an original issuance from the corporation.
- The stock must be acquired in exchange for money or other property (not including stock), or as compensation for services.
- The aggregate gross assets of the corporation at all times since inception up to the time immediately *after* the stock issuance do not exceed \$50,000,000.
- Gross assets are generally defined as the sum of the corporation's cash and the tax basis of its other assets, subject to certain exceptions.
- During substantially all of the taxpayer's holding period at least 80% of the corporation's assets are used in active conduct of the "qualified business."
- A qualified business is any business other than certain service businesses, banking, farming, lodging and certain mining and natural resource operations.
- Certain exceptions to the 80% requirement apply to working capital reserves and initial startup company funding.
- The corporation must not have undertaken certain disqualifying redemptions.
- The corporation must submit any reports required by the IRS for QSBS issuers.
- Currently, no such reports are required.

Who is eligible for the exclusion?

Only non-corporate taxpayers qualify, including individuals, estates, trusts, LLC and partnership owners (so long as the entity is not classified as a corporation for income tax purposes) who are non-corporate taxpayers, and S corporation shareholders. Certain special rules apply to persons owning through LLCs, partnerships and S corporations.

What about QSBS purchased outside the 100% exclusion window?

Stock purchased after December 31, 2011, or before September 28, 2010, may qualify as QSBS if it meets the conditions described above. However, such stock will not be eligible for the 100% exclusion (unless extended by Congress).

- For QSBS acquired after February 17, 2009, and before September 28, 2010, the exclusion percentage is 75%.
- For QSBS acquired before February 18, 2009 or after 2011, the exclusion percentage is 50%.
- However, except for this limited period during which the 100% exclusion applies, the excluded QSBS gain is an alternative minimum tax ("AMT") preference item, which substantially reduces the benefit of the exclusion for many taxpayers.

What are the specific benefits of the new temporary exclusion?

Under the temporary 100% exclusion, the gain on any sale of QSBS purchased after September 27, 2010 and on or before December 31, 2011 and held for more than five years will be subject to neither regular income tax nor the AMT. By contrast, only 50% - 75% of the gain on QSBS acquired outside the 100% exclusion window is eligible for exclusion, and the excluded portion is normally an item of tax preference for AMT purposes, meaning

most of the benefit is effectively reversed for taxpayers subject to the AMT. Thus, the temporary exemption of the gain from the AMT calculation, as well as the higher exclusion percentage, create significant savings when compared to the tax burden on an eligible sale of QSBS acquired outside the 100% exclusion window.

What about QSBS acquired by gift or in other nontaxable exchanges?

Special "tacking" rules apply to QSBS acquired in certain nontaxable transactions. The interplay of these rules with the 100% exclusion window is unclear, particularly for QSBS originally purchased before the 100% exclusion window and transferred to a new holder during the 100% exclusion window in a nontaxable transaction. In some cases, such as a gift or partnership distribution, it appears that the new recipient may be ineligible for the 100% exclusion even if the gift or distribution occurs during the 100% exclusion window, while in other cases (such as a tax-free reorganization) the outcome may be different.

Planning Possibilities

Potential tax planning considerations during this temporary 100% exclusion window include the following. Each of these strategies involves advantages, disadvantages and traps for the unwary. These strategies are not viable in all cases. It is critical to consult counsel before taking any of these steps.

- Forming and issuing stock of a startup corporation before year-end.
- Timing a company equity financing to occur before year-end.
- Converting an existing LLC or partnership into a corporation.
- Converting convertible debt to stock.
- Investing in additional stock of an existing corporation.
- Exercising an employee stock option.
- Exercising an investor warrant.
- Issuing compensatory stock grants to employees.

If you have questions about the capital gain exclusion for QSBS investments before year-end please contact one of our tax attorneys or your regular Cooley contact.

¹ *Updated 12/20/2010 to reflect changes in The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010.*

Circular 230 Disclosure

The following disclosure is provided in accordance with the Internal Revenue Service's Circular 230. Any tax advice contained in this alert is intended to be preliminary, for discussion purposes only, and not final. Any such advice is not intended to be used for marketing, promoting or recommending any transaction or for the use of any person in connection with the preparation of any tax return. Accordingly, this advice is not intended or written to be used, and it cannot be used, by any person for the purpose of avoiding tax penalties that may be imposed on such person.

This content is provided for general informational purposes only, and your access or use of the content does not create an attorney-client relationship between you or your organization and Cooley LLP, Cooley (UK) LLP, or any other affiliated practice or entity (collectively referred to as "Cooley"). By accessing this content, you agree that the information provided does not constitute legal or other professional advice. This content is not a substitute for obtaining legal advice from a qualified attorney licensed in your jurisdiction, and you should not act or refrain from acting based on this content. This content may be changed without notice. It is not guaranteed to be complete, correct or up to date, and it may not reflect the most current legal developments. Prior results do not guarantee a similar outcome. Do not send any confidential information to Cooley, as we do not have any duty to keep any information you provide to us confidential. When advising companies, our attorney-client relationship is with the company, not with any individual. This content may have been generated with the assistance of artificial intelligence (AI) in accordance with our AI Principles, may be considered Attorney Advertising and is subject to our [legal notices](#).

Key Contacts

Mark Windfeld-Hansen Palo Alto	mwindfeldhansen@cooley.com +1 650 843 5111
---	---

This information is a general description of the law; it is not intended to provide specific legal advice nor is it intended to create an attorney-client relationship with Cooley LLP. Before taking any action on this information you should seek professional counsel.

Copyright © 2023 Cooley LLP, 3175 Hanover Street, Palo Alto, CA 94304; Cooley (UK) LLP, 22 Bishopsgate, London, UK EC2N 4BQ. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley LLP as the author. All other rights reserved.