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Qualified Small Business Stock: Important Deadline Is Getting Closer



It May Be Possible to Pay No Federal Tax on Gains

Gains from selling qualified small business stock (QSBS) issued between now and year end are eligible for a zero (0) percent federal income tax rate. Shares must be held for over five years to take advantage of this unbelievably good deal, and not all shares qualify.

Whether you are considering obtaining funding for your own business or acting as an investor for someone else's operation, here's what you should know about QSBS and the 0 percent tax rate.

Qualified Small Business Stock Basics

QSBS is stock in a C corporation that meets the definition of a qualified small business corporation (QSBC). In general, QSBCs are the same as garden-variety C corporations for all tax and legal purposes. The only exception is that QSBS gains are eligible for favorable federal income tax treatment.

The most important thing to understand right now is that gains from selling QSBS issued between now and year end are potentially eligible for a 100 percent federal income tax gain exclusion break, which equates to 0 percent federal income tax rate.

On the other hand, for QSBS issued *after* this year, the gain exclusion percentage will revert to the standard 50 percent unless Congress changes the law to provide something better.

Gain Exclusion Depends on Issuance

What Counts as QSBS?

To be eligible for the QSBS gain exclusion break, shares must meet a number of requirements set forth in Section 1202 of the Internal Revenue Code. These requirements include:

- The shares must be acquired after August 10, 1993 and they generally must be acquired upon original issuance or by gift or inheritance.
- The issuing corporation must be a qualified small business corporation (QSBC) at the stock issuance date and during substantially all the time you hold the shares.
- A QSBC must be a domestic C corporation. It cannot be an S corporation, foreign corporation, domestic international sales corporation (DISC), former DISC, regulated investment company

Date

The current super-generous 100 percent gain exclusion break is only available for QSBC shares issued *between* September 28, 2010 and December 31, 2011. Therefore, a share issuance deadline of December 31 of this year applies if you want to line yourself up to benefit from the 100 percent gain exclusion.

The standard 50 percent gain exclusion deal is available for QSBS issued *before* February 18, 2009 or *after* December 31, 2011. Therefore, qualified stock issued after this year will be eligible for the standard 50 percent gain exclusion unless Congress takes action.

An enhanced 75 percent gain exclusion is available for QSBS that were issued *between* February 18, 2009 and September 27, 2010.

Key Point: These gain exclusion breaks are not available for QSBS owned by C corporations. However, shares held by individuals, S corporations, and partnerships *are* eligible.

Five-Year Holding Period Requirement

In order to take advantage of the gain exclusion deal, you must hold QSBS for over five years. Therefore, the 100 percent gain exclusion break will only be available for sales that occur after September 28, 2015 at the earliest. For QSBC shares that have not yet been issued, the 100 percent gain exclusion will only be available for sales that occur sometime in 2016 at the earliest.

Excludable Gain Limits and Tax Rates

Congress placed limits on the amount of QSBS gain that is eligible for the gain exclusion break. In any tax year, a taxpayer's *eligible gain* (the amount of gain that qualifies for the applicable gain exclusion percentage of 100, 75, or 50 percent) is limited to the *greater* of:

1. 10 times the taxpayer's aggregate adjusted basis in the QSBS that is sold or
2. \$10 million reduced by the amount of eligible gain already taken into account by the taxpayer in prior tax years for sales of QSBS issued by the same corporation (\$5 million if you use married filing separate status). In effect, the \$10 million (or \$5 million) restriction is a lifetime limitation.

The amount of eligible gain that you cannot exclude (either 25 or 50 percent of the total eligible gain) is subject to 28 percent maximum federal income tax rate. That translates into an effective maximum rate on eligible gains of either: 0 percent if the 100

(RIC), real estate investment trust (REIT), real estate mortgage investment conduit (REMIC), a cooperative, a Section 936 corporation, or a corporation with a subsidiary that is a Section 936 corporation.

- To be a QSBC, the corporation must actively conduct a qualified business. Qualified businesses do *not* include rendering services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, other businesses where the principal asset is the reputation or skill of employees; banking, insurance, leasing, financing, investing, or similar activities; farming; production or extraction of oil, natural gas, or other minerals for which percentage depletion deductions are allowed; or the operation of a hotel, motel, restaurant, or similar business.
- To be a QSBC, a corporation's gross assets cannot exceed \$50 million: (1) at all times on or after August 10, 1993 and before the stock is issued and (2) immediately after the stock is issued. If after the stock is issued the corporation grows and exceeds the \$50 million threshold, it will not lose its QSBC status for that reason.

Key Point: Before concluding that you are investing in a QSBC, consult with your tax adviser. We have summarized the most important QSBC eligibility rules here, but there are many more.



Another QSBS Break: Tax-Free Rollover

In addition to the QSBS gain exclusion explained in this article, there's also a tax-free gain rollover break. Under it, the amount of QSBS

percent gain exclusion applies; or 7 percent if the 75 percent exclusion applies; or 14 percent if the 50 percent exclusion applies.

Any gain *in excess* of the eligible gain amount is taxed as a garden-variety stock sale gain. Therefore, a 15 percent maximum federal rate applies to excess gains that are recognized through 2012. For 2013 and beyond, the maximum rate on excess gains is scheduled to increase to 18 percent.

AMT Preferences on Excluded Gains

For alternative minimum tax (AMT) purposes, 7 percent of the excluded gain from a pre-2013 QSBS sale counts as income. For post-2012 excluded gains, the AMT preference is scheduled to increase to 28 percent unless Congress takes action. For taxpayers that are subject to the AMT, these preferences can reduce or even almost eliminate the expected tax savings from selling QSBS.

Now for the good news: There is no AMT preference for QSBS gains that qualify for the 100 percent exclusion. Therefore, the advertised 100 percent gain exclusion break is actually for real. There is no regular federal income tax hit and there is no AMT hit either. So there is an honest 0 percent maximum federal income tax rate on eligible gains from QSBS that are issued between September 28, 2010 and December 31, 2011 and held for more than five years!

Summary

When a start-up business can meet the definition of a QSBC if it is incorporated, the conventional wisdom that it is always best to operate as a pass-through entity (S corporation, partnership, or LLC) may be incorrect, due to the tax breaks offered to QSBS owners.

To sum up:

- The *American Recovery and Reinvestment Act of 2009* increased, from 50 percent to 75 percent, the amount of gain that could be excluded on qualified small business stock. The *Small Business Jobs Act of 2010* went further, completely eliminating the tax on gain of qualified stock issued after the date of enactment through the end of 2010. Later that year, the *Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act* extended this tax break through the end of 2011.
- For the QSBS gain exclusion deal to be available, you must hold the stock for over five years. The super-generous 100 percent gain exclusion deal will not be available for shares issued after December 31, 2011, unless Congress grants an extension. So time may be of the essence if you want to cash in on the 100 percent gain exclusion deal.
- For the tax-free gain rollover break to be available, you must hold the stock for over 6 months.
- There may be state taxes due on gains.
- For questions in your situation, consult with your tax adviser.

gain you must recognize for federal income tax purposes is limited to the excess of the QSBS sales proceeds over the amount you reinvest to acquire other QSBS during a 60-day period beginning on the date of the original sale. The rolled-over gain reduces the basis of the new QSBS (the "replacement shares"). However, you must hold QSBS for more than six months to qualify for the gain rollover deal.

If the replacement shares still meet the definition of QSBS when you sell them, you'll be eligible for the applicable gain exclusion break, as long as you've held the shares for more than five years. Count the holding period of your original QSBS (the shares you sold in the rollover transaction) plus your holding period of the replacement shares.

Key Point: In essence, the rollover deal allows you to sell your original QSBS without owing any federal income tax and without losing eligibility for the gain exclusion break when you eventually sell the replacement shares.

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