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New Tax Benefits for Investing in Small Businesses

The global economic meltdown has caused investors to take a new look at investing in private companies and the tax breaks that might arise from such investments. The recently enacted federal stimulus package contains such a tax break, excluding 75 percent of the gain on the sale of shares of certain companies from federal taxation. This tax break serves to encourage investment in startup companies that would normally have difficulties enticing capital investment.

Section 1241(a) of the American Recovery and Reinvestment Act of 2009 amended Section 1202(a)(3) of the Internal Revenue Code so that 75 percent of the gain on Qualified Small Business Stock (QSBS) held for more than five years is excluded in determining taxable income. As a result, gain from the sale of QSBS to which the 75 percent gain exclusion applies is taxed at effective rates of 7 percent on the regular income tax and 12.88 percent under the alternative minimum tax regime.

Who might be interested in this tax break for investments in small businesses? First, company founders and entrepreneurs who use their own capital to establish companies and develop new products and technologies. The return on their efforts and risk taking will be enhanced by lower tax rates. Second, QSBS would be of interest to investors in a startup business because of the potential to provide a greater after-tax return when the investment in a successful company is cashed out. Corporate investors are not eligible for the QSBS exclusion.

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In order to qualify for the 75 percent exclusion, the QSBS must be acquired after Feb. 17, 2009, and before Jan. 1, 2011. For shares acquired before or after these time periods, the gain exclusion is 50 percent or 60 percent depending upon certain other criteria.

QSBS is defined in Section 1202(c) as stock that meets the following conditions:

a. issued by a domestic C corporation after Aug. 10, 1993;
b. acquired by the shareholder directly from the company;
c. acquired by an individual in exchange for cash, services or property other than securities;
d. the issuing corporation has gross assets not exceeding $50 million at the time the investment is made; and
e. the corporation uses at least 80 percent of its assets in the active conduct of one or more qualified trades or businesses.

There are some exceptions to the requirement that QSBS be acquired directly from the company. Gifts, transfers at death, transfers from a partnership, corporate organizations, stock conversions, options, warrants or convertible debt provide exceptions to the original issue requirement.

At least 80 percent of the corporation's assets must be used in the active conduct of a qualified trade or business. Consequently, QSBS benefits are principally available for manufacturing, technology, retail, distribution and similar businesses. A qualified trade or business excludes services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletes, financial services, brokerage services, farming business, oil and gas production, and any business of operating a hotel, motel, restaurant or similar business.

The exclusion for each eligible corporation applies only to the extent that the gain does not exceed the greater of (a) 10 times the taxpayer's adjusted basis in the stock disposed of during the tax year or (b) $10 million ($5 million for married individuals filing separately) reduced by gain excluded in earlier years from sales of stock in the corporation.

While QSBS status can provide a significant tax benefit when a shareholder sells shares, a prudent investor will consider the various tax forms for entities when analyzing a potential investment. Use of pass-through entities such as partnerships, limited liability companies or S corporations can provide beneficial tax results to an owner. The investment risks and tax costs of a successful investment are among the factors to be considered when investing in a privately held company.

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