July 2013, II

Startups: Extended Window of Opportunity Available By Way of Section 1202

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Investors and owners of startups are always looking to maximize the potential value of a business and realize that value at some point in the future. Taxation is an important driver of the value of a business. While taxation should not be the only consideration in investment decisions, it should play a role in an investors' due diligence before making an investment.

Over the years, Congress has provided for a variety of incentives to encourage taxpayers to invest in small businesses. Recently, via changes to Section 1202 of the Internal Revenue Code ("IRC"), Congress has made these incentives more generous. In fact, one of these incentives is so generous that it calls for a complete exemption from federal income tax. This incentive is an excellent way for an investor to jump into or continue his or her investment in the lucrative startup field. It is also a great way for a startup company to attract investment from outside investors.

In 1993, Congress enacted Section 1202 of the IRC. This section provides for an exclusion from gross income of 50% of the gain recognized on the sale or exchange of qualified small business stock ("QSBS") held for more than five years. Since its enactment, Congress has increased the percentage of gain that can be excluded from gross income. For example, in years past, the percentage of gain exclusion increased to 75%. Currently, for stock acquired after September 27, 2010 and before January 1, 2014, the exclusion rate is a whopping 100%. This means that a taxpayer selling QSBS does not have to pay tax on the sale of that stock if held for more than five years. This total exemption is a great tool for investors and startup companies. Additionally, the gain on the sale of stock below the threshold is not subject to the 3.8% Medicare tax on net investment income.

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The 100% gain exclusion is limited though. The gain eligible for exclusion is equal to the greater of $10 million or 10 times the investor's basis in the stock. Thus, not all gain is excludable from gross income, so an investor should carefully consider the consequences of selling QSBS if the gain from such sale is above this threshold.

QSBS is defined as stock of a domestic "C" corporation that has gross assets of $50 million or less. For stock to qualify as QSBS, it must be issued by a corporation that uses at least 80% of its assets in an active trade or business and issued after August 10, 1993. The investor must acquire the stock at the time of original issuance. Furthermore, during the time the investor holds the stock, the corporation must actively engage in a qualifying trade or business. Most trades or businesses qualify with the exception of banking, farming, natural resource engineering, and certain service businesses. Additionally, the corporation issuing the QSBS generally cannot own (i) real property that is not used in the active conduct of a qualified trade or business with a value exceeding 10% of its total assets; or (ii) portfolio stock or securities with a value exceeding 10% of its total assets in excess of liabilities.

A great aspect of Section 1202 is that an individual does not have to hold the stock. The gain exclusion is possible if the QSBS is held by a pass-through entity such as a partnership, "S" corporation, regulated investment company, or common trust fund. However, there are certain requirements that must be met in order for an entity other than an individual to qualify for nonrecognition treatment. First, all eligibility requirements with respect to the QSBS must be met. Second, the entity must hold the QSBS for more than five years. Finally, an individual must have held an ownership interest in the pass-through entity at the time the individual acquired the QSBS and at all times thereafter.

Interestingly enough, Section 1202 may impact the choice of form for a startup company as well. From the startup standpoint, a pass-through entity, such as an LLC or partnership, makes the most sense in choice of form. The benefits of choosing an LLC or partnership over the corporate form generally allow for a tax-efficient sale of the business and stepped-up basis of the assets sold. However, gain may still be recognized on the sale of interests in a pass-through entity. Section 1202 provides an added incentive to organize as a taxable "C" corporation because investors may be eligible to exclude 100% of the gain from the sale of QSBS.

There is no guarantee that Congress will extend the 100% gain exclusion after 2013. Thus, investors planning to acquire QSBS and startup companies wishing to form should seriously consider doing so in the coming months in order to obtain the benefits of Section 1202.

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