

## WSGR ALERT

NOVEMBER 2011

# REMINDER: IMPORTANT TAX PLANNING OPPORTUNITY IN 2011 FOR INVESTORS IN SMALL BUSINESSES

This WSGR Alert serves as a reminder to our clients and friends that investors who acquire qualified small business stock (QSBS) before January 1, 2012, may receive a substantial tax benefit as a result of changes to the tax laws made by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Act) that are scheduled to expire at the end of this year. **Entrepreneurs and investors considering forming or making investments in qualifying corporations, including owners of unincorporated businesses considering incorporation and holders of convertible debt in qualifying corporations, should be aware of the potential advantages of acquiring QSBS before 2012.**

Under prior law, Section 1202 of the Internal Revenue Code of 1986, as amended, allowed an individual taxpayer to exclude 50 percent of any gain from the sale or exchange of QSBS held for more than five years (subject to certain per-issuer limitations). This exclusion was increased to 75 percent for QSBS acquired during certain periods after February 17, 2009. A portion of the excluded gain was treated as an item of tax preference for alternative minimum tax (AMT) purposes.

In 2010, Section 1202 was amended to: (i) permit an investor to exclude 100 percent of the gain from the sale or exchange of QSBS held for more than five years and (ii) exempt all of such gain from the AMT if the QSBS was acquired after September 27, 2010, and on or before December 31, 2010. Under the 2010 Act, this preferential tax treatment was extended and applies to QSBS acquired on or before December 31, 2011. Unless further extended by future legislation, the treatment of QSBS acquired after

December 31, 2011, and held for more than five years will revert to the 50 percent gain exclusion, with a portion of the gain treated as an item of tax preference for AMT purposes.

### QSBS Background

Stock of a small business generally qualifies as QSBS if the stock meets certain requirements, including that: (i) the small business is a domestic C corporation; (ii) the taxpayer acquired the stock at its original issue in exchange for money or other property (not including stock), or as compensation for services; (iii) the small business is engaged in a qualified trade or business and uses 80 percent (by value) of its assets in the active conduct of one or more qualified trades or businesses; (iv) the aggregate tax basis of the small business's assets on the date after the stock is issued (including proceeds received in exchange for the stock) is \$50,000,000 or less; and (v) with certain *de minimis* exceptions, the small business has not made any repurchases of stock within the two-year period starting one year prior to the date the stock was issued. A "qualified trade or business" is defined as any trade or business other than (i) any trade or business involving the performance of services, such as accounting, engineering, or consulting, or any other trade or business where the principal asset is the reputation or skill of one or more of its employees; (ii) any banking or financial business; (iii) any farming business; (iv) any mining, oil, or gas business; and (v) any business operating a hotel, motel, restaurant, or similar business.

In addition to the exclusions described above, under Section 1045 of the Internal Revenue

Code, an individual taxpayer who (i) holds QSBS for more than six months (the original QSBS); (ii) sells the original QSBS in an otherwise taxable transaction; and (iii) during the 60-day period beginning on the date of such sale, purchases new QSBS (replacement QSBS) generally will recognize gain on its original QSBS only to the extent that the proceeds from such sale exceed the amount invested in the replacement QSBS.

Please contact an attorney in Wilson Sonsini Goodrich & Rosati's tax practice with any questions regarding the benefits of QSBS status and the application of the 2010 Act.



Wilson Sonsini Goodrich & Rosati  
PROFESSIONAL CORPORATION

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