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Client Alert

November 23, 2010

Temporary Exclusion of 100% of Gain on Qualified Small Business Stock

On September 27, 2010, the President signed into law the Small Business Jobs and Credit Act of 2010. As part of the Act, Congress included a temporary provision that allows the exclusion from taxable income of 100 percent of the gain from the sale of qualified small business stock acquired by or issued to a non-corporate investor after September 27, 2010, and before January 1, 2011 if the stock is held for more than five years. The provision also temporarily excludes the gain from such a sale for purposes of alternative minimum tax. Thus, no regular tax or alternative minimum tax is imposed on the sale of this stock if it is held for at least five years. The amount of gain eligible for the exclusion is limited to the greater of ten times the investor's basis in the stock or $10 million ($5 million if married filing separately) of gain from the sale of stock in the corporation. The exclusion applies only to stock acquired from the corporation and not to stock purchased from another stockholder.

"Qualified small business stock" is stock issued by a C corporation the gross assets of which do not exceed $50 million (including the proceeds received from the issuance of the stock) and which meets a specific active business test. The active business test requires that, during substantially all of the taxpayer's holding period for the stock, at least 80% of the value of the corporation's assets must be used by the corporation in the active conduct of one or more "qualified trades or businesses." Qualified trades or businesses do not include (i) certain professional services; (ii) real estate; (iii) certain financial services; (iv) leasing; (v) hospitality; (vi) farming; and (vii) mining. Thus, not more than 20% of the value of the assets of the corporation may be used in any of these prohibited businesses or consist of passive investment assets.

The temporary 100 percent exclusion is an attractive incentive to invest in small to mid-sized businesses organized as C corporations. This exclusion may also be beneficial for investors in companies that are currently organized as flow-through entities, including partnerships, limited liability companies and S corporations, that are expected to appreciate substantially over the next five years. Those companies must also have a current asset value of less than $50 million and be willing to convert to C corporation status.

Qualified businesses currently organized as partnerships, LLC's taxed as partnerships or S corporations that are considering converting to C corporation status to take advantage of this exclusion should also consider the negative consequences of converting to a C corporation. Those consequences include an entity level tax at corporate tax rates, a second level of taxation on distributed earnings, the inability to flow operating losses through to the owners, and a loss of flexibility of structuring the economic arrangement among the owners. Also, in order to take advantage of this exclusion, the ultimate sale of the company will need to take the form of a stock sale, and many buyers will pay less for a purchase of stock than for a purchase of the corporation's assets. In addition, while converting to a C corporation is relatively easy, converting back to a flow-through entity, other than by electing S corporation status, will trigger an immediate tax on the appreciation in value of the company's assets and may be cost-prohibitive. On the other hand, conversion from a flow-through entity to a C corporation results typically in simplified tax reporting because the company is no longer required to deliver Schedules K-1 to its owners, and the owners no longer need to prepare returns and pay taxes in states in which the company, but not the owner, owns property or conducts business.

For qualified small business stock acquired after December 31, 2010, the exclusion reverts to its historic level of 50% of the gain. The exclusion had previously temporarily been increased from 50% to 75% for qualified small business stock acquired after February 17, 2009, and before September 28, 2010.

If you have any questions concerning this client alert, please contact any member of the firm's Tax Group listed below and we would be happy to discuss any questions you might have.

Jeffrey T. Lawyer
(336) 747-6611
jlawyer@wcsr.com

Howard N. Solodky
(202) 857-4424
hsolodky@wcsr.com

C. Mark Wiley
(336) 721-3605
mwiley@wcsr.com

Michael R. Cashin
(336) 721-3696
mcashin@wcsr.com