FOLEY HOAG LLP

Taxation Alert

Qualified Small Business - 100% Tax Exemption Set to Expire at Year End

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In 2010, Congress enacted legislation which could provide investors who acquire qualified small business stock ("QSBS") before the end of 2011 with a significant tax benefit. The law permits an exclusion of 100% of the gains realized on the sale of QSBS if the QSBS was acquired by the investor after September 27, 2010 and on or before December 31, 2011 and held for more than five years. Under the temporary total exclusion, excluded gains also are exempt from the alternative minimum tax. As a result, under this exclusion, the effective federal income tax rate on qualifying capital gains generally will be zero. The maximum amount of gain eligible for the exclusion with respect to the stock of a single issuer is the greater of $10 million or 10 times the investor's basis in the stock of the issuing corporation.

Although there has been a proposal to make this temporary total exclusion permanent, it is uncertain whether such legislation will be enacted or whether there will be any extension of the temporary total exclusion beyond the end of this year. Unless Congress acts, QSBS acquired after December 31, 2011 will revert to the original QSBS rules, which generally provide for a 50 percent exclusion of gain from qualifying sales of QSBS, subject to the alternative minimum tax.

Eligible Investors

Only non-corporate investors, including individuals, estates and trusts, qualify for the benefits of the QSBS gain exclusion rules. A non-corporate investor that owns an interest in a flow-through entity (such as an LLC, partnership or S corporation) also may be eligible for the exclusion with respect to their share of the gain from the sale of QSBS held by the flow-through entity, provided that certain special rules are satisfied.

Qualified Small Business Stock

Stock is QSBS only if the following requirements are met: (1) the investor must have acquired the stock at original issue from the corporation in exchange for money or property (other than stock) or as compensation for services to the corporation (other than as an underwriter of the stock); and (2) the issuer of the stock is a "qualified small business".

Acquired at Original Issue

The tax benefits of the QSBS exclusion are available to investors (including service providers and founders) that acquire stock (but not options, warrants, phantom stock rights or debt) from the issuing corporation. As previously described, the stock must be acquired from the corporation in exchange for money or property (other than stock) or as compensation for services (other than as an underwriter). For this purpose:

- **Conversion of debt; exercise of warrants or options.**The conversion of debt into stock and the exercise of investor warrants or employee stock options are treated as the acquisition of stock at original issue.
- **Conversion of LLC or partnership to C corporation.**If an LLC or partnership is converted into a C corporation, C corporation stock issued in the conversion to members or partners of the LLC or partnership is treated as the acquisition of stock at original issue. However, the temporary total exclusion would only apply to any appreciation in value of the C corporation stock that occurs after the conversion transaction.

For stock to qualify as QSBS, the issuer of the stock generally must satisfy the following requirements:

- The issuer must be an eligible domestic C corporation. DISCs, RICs, REITs, REMICs, FASITs, cooperatives and certain other special types of corporations are not eligible corporations.
- The aggregate gross assets of the issuer must not have exceeded $50 million (as determined under special rules) at any time from inception up to the time immediately after the issuance of stock to the applicable investor.
- The corporation must submit any reports that the IRS requires. Currently, the IRS has not created any reporting requirements for QSBS issuers.
- The issuer must use at least 80 percent (by value) of its assets in the active conduct of one or more qualified trades or businesses during substantially all of the applicable investor's holding period. It should be noted that:
    - A number of types of businesses are expressly excluded from being "qualified trades or businesses." For example, any trade or business involving the performance of services in the fields of health, law, engineering, consulting, financial services and many other types of services business will not qualify. In addition, hotel and restaurant, oil and gas, banking or investment, farming and certain other types of businesses will not qualify.
    - Research and start-up activities in connection with a future qualified trade or business generally may be treated as the active conduct of the qualified trade or business, regardless of whether these activities have generated any gross income.
    - For purposes of the 80 percent test, in addition to assets clearly used in the active conduct of a qualified business, the following assets also may be counted as used in the active conduct of the business: (1) assets held for working capital needs; and (2) assets held for investment that are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or to finance increases in the corporation's working capital needs. If a corporation has been in existence for at least two years, however, no more than 50 percent of the assets of the corporation will qualify as used in an active trade or business by reason of the rules described in (1) and (2).
    - There are limitations on the amount of portfolio stock and real estate that a corporation may hold and still be considered engaged in the active conduct of a qualified trade or business.
    - An otherwise eligible corporation that is licensed to operate as a "specialized small business investment company" (or SSBIC) under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993) is deemed to satisfy the active business requirements.

Certain redemptions by the issuing corporation of its stock within two years (or one year, in some cases) before or after the issuance of stock may disqualify the issued stock from QSBS status.

Foley Hoag is happy to provide you with more information on specific opportunities and to offer strategic advice on taking advantage of this temporary exclusion.

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