SMALL BUSINESS LEGISLATIVE COUNCIL

CAPITAL GAINS TAXATION ON INVESTMENTS IN SMALL BUSINESS STOCK

STATUS

The American Taxpayer Relief Act, Public Law 112-240, extends the temporary increase in the amount of the exclusion from capital gains tax through December 31, 2013. The temporary amount is 100 percent.

Previously, the Small Business Jobs Act, Public Law 111-240, temporarily increases the amount of the exclusion from 75 percent to 100 percent of the gain from the sale of qualifying small business stock that is acquired after September 27, 2010 and before January 1, 2011 and held for more than five years.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (TRUIRJCA), Public Law 111-312, extended the temporary increase in the amount of the exclusion from capital gains tax through December 31, 2011. The temporary amount has been 100 percent.

The percentage in 2012 reverted to 50 percent, the "original" amount before the several temporary increases. ATRA is in effect a retroactive increase for 2012.

LAW

This is a modification of an existing provision of the tax code, Section 1202. It was enacted in 1993.

In the small business community in the late 1970's there was considerable discussion about investment tax credits for investing in small business and "rollovers" (i.e. deferral of tax consequences) when an investor used the proceeds of the sale of an investment in a small business for an investment in another small business. A rollover provision can be found in Section 1045 of the Internal Revenue Code. Section 1202 has its roots in that dialogue.

Under Section 1202, taxpayers other than corporations may exclude 50-percent (60 percent for certain empowerment zone businesses) of the gain from the sale of certain small business stock acquired at original issue and held for at least five years.

The taxable portion of the gain is taxed at a maximum rate of 28 percent. Under current law, 7 percent of the excluded gain is a tax preference subject to the alternative minimum tax (AMT). The AMT preference is scheduled to increase to 28 percent of the excluded gain on eligible stock acquired after December 31, 2000 and to 42 percent of the excluded gain on stock acquired on or before that date.

The amount of gain eligible for the exclusion by a taxpayer with respect to any corporation during any year is the greater of (1) ten times the taxpayer's basis in stock issued by the corporation and disposed of during the year, or (2) $10 million reduced by gain excluded in prior years on dispositions of the corporation’s stock. To qualify as a small business, the corporation, when the stock is issued, may not have gross assets exceeding $50 million (including the proceeds of the newly issued stock) and may not be an S corporation.

The corporation also must meet certain active trade or business requirements. For example, the corporation must be engaged in a trade or business other than: one involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any other trade or business where the principal asset of the trade or business is the reputation or skill of one or more employees; a banking, insurance, financing, leasing, investing or similar business; a farming business; a business involving production or extraction of items subject to depletion; or a hotel, motel, restaurant or similar business. There are limits on the amount of real property that may be held by a qualified small business, and ownership of, dealing in, or renting real property is not treated as an active trade or business

There are a number of other restrictions and requirements relating to specific situations. It is a complicated section depending on the specific fact pattern.

Under American Recovery and Reinvestment Act (ARRA), the exclusion was temporarily increased to 75 percent for stock acquired after February 17, 2009 and in 2010. The SBJA and TRUIRJCA pushed it to 100 percent and extended it.

OUTLOOK

Since the increase was temporary, it is in the “pool” with all other expired and expiring tax provisions.