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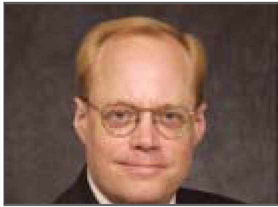

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Beware Redemptions In Year-End Stock Investments

It's not often individual investors get the chance to buy stock in a company and be guaranteed that any gain on sale will be tax-free. But that's what Section 2011 of the 2010 Small Business Jobs Act does through Dec. 31, 2010 for qualified small business stock. There's lots of interest in this provision, one designed to stimulate investments in small companies. If you buy qualifying stock before Jan. 1, 2011 and hold it for five years or more, there's ***no*** federal income tax when you sell it, not even AMT. See Invest By Dec. 31 For Tax-Free Stock Break.

One key requirement is that you buy your stock ***directly*** from the corporation not a third party. Plus, the stock must be newly issued, meaning you've injected fresh money into the company for new stock. To counteract someone qualifying for the tax-free benefit based on an old investment that's cashed out to make way for the new, the law includes a series of rules to ferret out prior stock ownership. Here's how it works:

Related Person Redemptions. If you or a related person had stock redeemed by the same company within two years ***before*** you buy your new stock, you don't qualify. A stock ***redemption*** is simply a sale of stock to the company itself, a kind of reverse of the company ***issuing*** stock. The same rule applies for two years ***after*** you acquire your stock.

That totals a four year period spanning the time of your investment when a company stock repurchase from you or your relatives will ***disqualify*** you from tax-free treatment. The "related person" rule covers your

brothers and sisters (either whole or half blood), your spouse, ancestors, and lineal descendants. Plus, even outside these relationships, some stock redemptions that occur within one year before or one year after your stock purchase will also disqualify your investment.

This is a narrower window. The two years before and two years after rule applies to redemptions from related persons. But other redemptions up to one year before or after your investment can disqualify you when made from non-relatives if they are "significant." That means redemptions of more than 5% by value of the company's stock.

What to Do? It may seem easy enough to determine if you or a person related to you was an investor in the company and had their stock redeemed during a four year window of scrutiny. It's not so easy to determine whether your tax-free treatment could be knocked out based on a "significant" redemption that has nothing to do with you or your family.

Plus, you not only have to worry about what the company did up to a year ***before*** you buy your stock, but also what the company might do for a year ***after*** you buy it. For that reason, consider requiring the company to agree that it hasn't made a "significant" redemption for the one year period before you invest, and that it agrees it will not do so for a year after you invest.

For further reading, see:

Which Year End Deals Are Tax Free?

IRS IR-2010-69, Recent Legislation Offers Special Tax Incentives for Small Businesses to Provide Health Care, Hire New Workers

Effects of New Small Business Legislation

Temporary Exclusion for 100% of Gain From Qualified Small Business Stock Acquired Before Year End

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