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Invest By Dec. 31 For Tax-Free Stock Break

As if you didn't have enough to worry about this year end, here's one more. If you do it before January 1, 2011, you can buy stock in up to a $50 million company and, provided that you hold it for five years, you won't pay ***any*** federal income tax when you sell—not even long term capital gain rates. But conditions are tough and there's little time.

Since 1993, individuals have been able to exclude 50% of their gain on selling "qualified small business stock" (QSBS) held for at least five years. With all the focus on the expiring 15% capital gain rate, this QSBS benefit is even better if you qualify. But like an infomercial, wait, there's more!

This exclusion was increased to a whopping 75% for QSBS acquired after February 17, 2009 and before January 1, 2011. But wait, there's still more! The latest tax law just increased it to **100%** for QSBS held for more than five years if you buy it after September 27, 2010 and before January 1, 2011. The new law even eliminates the alternative minimum tax (AMT) preference item for these sales. See Big Tax Changes In Small Business Tax Law. For more about QSBS, see Qualified Small Business Stock Ruling. See also Number Crunching and Qualified Small-Business Stock Gains.

Is there enough time left to close a stock purchase and take advantage of this tax-free deal? Companies and investors need to find each other, strike a deal, do due diligence, and close the deal. But some small companies and investors will succeed. Some small companies are now actively marketing stock offerings saying they comply. Companies that need funding have big incentives. Investors do too given the absence of federal income taxes.

QSBS Defined. If you think this tax-free deal is easy, beware of the many hurdles to QSBS treatment. To qualify as QSBS, stock must be:

- Issued by a C corporation with no more than $50 million of gross assets when issued;
- Issued by a company using at least 80% of its assets by value in an active trade or business (excluding personal services, finance, farming, restaurants, hotels, etc);
- Issued after August 10, 1993;
- Held by a non-corporate taxpayer;
- Acquired by the taxpayer on original issuance; and
- Held for more than five years.

To qualify for no federal income tax on sale, the QSBS must be purchased after September 27, 2010 and before January 1, 2011. Then you must hold it for at least five years. When you sell, the 100% exclusion from tax is as good as it gets.

In contrast, the 50% and 75% exclusions were from the historical 28% rate. That meant a seller qualifying for the 50% exclusion actually paid 14%, and a seller excluding 75% paid 7%. With the prevailing 15% rate we've all come to know and love, QSBS benefits were often ignored. Plus, the AMT headaches could be huge. Regarding AMT and QSBS, see Number Crunching and Qualified Small-Business Stock Gains.

Could Congress take away the 100% exclusion in a few years, even if you relied on it in investing? Conceivably, but this seems unlikely. If you qualify, buy and hold for five years, and get in high gear to purchase your piece of the QSBS pie before January 1, 2011, you should be golden.

For further reading, see:

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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