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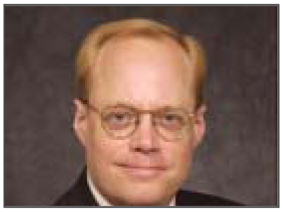

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Tax-Free In 2011: Qualified Small Business Stock

(Image credit: colourbox)

It's not often you get a tax holiday, even if you have to wait five years for your newfound tax freedom to bear fruit. Yet that's what we got when Congress passed amendments to the Qualified Small Business Stock ("QSBS") provisions earlier this year. See Which Year End Deals Are Tax Free? While the QSBS provisions are full of details and requirements, the new law seemed deceptively simple: if you bought qualifying stock between September 27, 2010 and December 31, 2010 and you managed to hold it for more than five years, you'd be in for a treat: Congress promised that when you sell it, you'll pay ***ZERO*** federal income tax. See Invest By Dec. 31 For Tax-Free Stock Break.

That's a pretty amazing benefit. There's considerable history to the QSBS provision, and the size of this benefit has grown. Since 1993, there's been a 50% exclusion which grew to a whopping 75% exclusion in 2009. More generous still, the exclusion grew to 100% for QSBS purchased after

September 27, 2010 and before January 1, 2011 if held more than five years. The new law even eliminates the alternative minimum tax preference for these sales. See Big Tax Changes In Small Business Tax Law. For more about QSBS, see Qualified Small Business Stock Ruling and Number Crunching and Qualified Small-Business Stock Gains.

Like speed dating, companies looking for funding and investors looking for tax-free gains were trying to find each other. They were in a hurry to get their stock deals done before New Year's eve, since the end of 2010 would usher out the 100% tax holiday too. That was a tall order in the few months remaining in 2010. Fortunately, Congress has given both sides of the equation more time.

Now you have until the end of 2011 to arrange your tax holiday. You'll need lawyers and accountants to verify that everything is in order whether you're an individual investor, an investment partnership (beware special partnership rules) or a company seeking to get investor dollars in the door. The promise of tax-free sales proceeds five years hence is alluring, a siren's song. But be wary as the rules can be unforgiving. Here are the bare bones.

QSBS Defined. 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; and
- Acquired by the taxpayer on original issuance.

There are many niceties to be observed. For example, detailed rules cover redemptions of stock. After all, there's a natural tendency for taxpayers to want to turn in their existing stock so they can get newly minted "tax-free" stock thereafter.

To combat this, 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. The same rule applies for two years ***after*** you acquire your stock. That totals four years spanning the time of your investment when a company stock ***repurchase*** from you or related persons will disqualify you from tax-free treatment. For details, see Beware Redemptions In Year-End Stock Investments.

Despite the technical rules, this is an outsize benefit. Of course, bear in mind you still may face state taxes when you sell unless your state conforms to the federal tax law. With an extra year of eligibility, though, this is a heck of a deal if you qualify. It's likely many will seek to qualify for this tax-free bonanza before the end of 2011.

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