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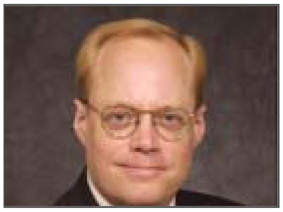

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THE TAX LAWYER

Nov. 2 2010 — 9:24 am

Which Year End Deals Are Tax Free?

"Tax free" is a phrase that gets virtually everyone's attention for good reason. No one likes paying taxes, even if you are as patriotic as Joe Biden. If you can legally pay less, it seems silly not to.

To get good tax results tomorrow sometimes requires tax steps today. The Small Business Jobs Act of 2010, H.R. 5297, included a tax-free stock deal, provided you buy your stock before January 1, 2011 and hold it five years or longer before you sell. There are several key rules, and I've summarized them here.

You can make any size investment, but you must buy the stock ***directly*** from the company (not a third party) and you must hold it yourself, not through another corporation. Plus, the company you're investing in must:

- Be a "C" corporation having $50 million or less of gross assets when you invest; and
- Use at least 80% of its assets (measured by value) in an active trade or business.

As long as you hold the stock for five years or more, there's no federal income tax when you sell, regardless of what happens to capital gain rates. It's even free of alternative minimum tax (AMT).

Get an Opinion. Small companies are doing their best to attract investors between now and year-end. Companies that qualify for this tax-free deal are saying so, marketing themselves as a rare tax-free investment. Still, do your own due diligence to make sure your investment qualifies and that you've teed up a deal that is truly tax free. That usually means hiring your own lawyer or accountant to check it out.

What's Active? One of the big issues is what qualifies as an "active" business. The company must use at least 80% of its assets (measured by value) in the active conduct of one or more qualified businesses. "Qualified" excludes service businesses; oil and gas; banking or investing; and motels or similar businesses. Beyond those prohibited categories, though, the main issue is whether the business is "active."

Fortunately, though, start-up and research and development operations, including in-house research activities, are considered used in an active trade or business even if they haven't yet generated any income. Assets held for working capital needs can also be treated as used in the active conduct of a qualified business.

However, there are limits on the amount of portfolio stock and real estate a corporation can hold and still be considered engaged in the active conduct of a qualified trade or business.

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

Robert W. Wood practices law with Wood & Porter, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009, Tax Institute), he can be reached at wood@woodporter.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.