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August 13, 2001

New Bill Would Eliminate Capital Gains On Stock Investments in New Companies

Summary

A bill introduced to the Senate on June 28, 2001 by Senator Joseph Lieberman and Senator Orrin Hatch¹ would eliminate capital gain treatment entirely under specific circumstances on stock investments in new companies and dramatically increase the size of companies eligible for this exclusion.

Current Law

Section 1202 of the Internal Revenue Code currently provides a 50% exclusion for taxpayers, other than corporations, on any gain from the sale or exchange of qualified small business stock² held for more than 5 years. The exclusion applies only if the investments are made directly in stock³ and not secondary trading. In addition, the current law places a limitation on the amount that may be excluded per taxpayer of 10 times the stock's basis or \$10 million, whichever is greater.

Purpose Behind the Proposed Changes

According to the research presented by the Senators, economic conditions have caused private investors to become reluctant to invest money in start-up companies. Their data show a considerable slowdown in venture capital in recent times. The boom of the late 1990s saw 610 initial public offerings of stock in 1997, 362 in 1998, 501 in 1999 and 379 in 2000. Midway through 2001, only 50 companies have gone public.

According to Senator Lieberman, the purpose of the bill is to encourage investors "to form capital for entrepreneurial firms so they can spur economic growth, create high wage jobs, and ensure American competitiveness into the 21st Century." Senator Lieberman added that "because this incentive applies to founders' stock and employee stock options, and not just stock offered to outside investors, it provides a powerful incentive for the human infrastructure and culture that drives and grows our nation's entrepreneurial firms."

Providing a business tax incentive to investing corporations will encourage them to continue to make critical investments in emerging fields.

¹ S.1134 (Also introduced in the House of Representatives, H.R.2383)

² Qualified small business stock is defined as any stock in a domestic C-corporation whose aggregate gross assets do not exceed \$50 million. In addition, at least 80% of the company's assets must be used by the corporation in the active conduct of one or more qualified trades or businesses or future qualified trades or businesses. Most service businesses would not qualify.

³ Includes founders' stock, stock options, venture capital, public offerings, common, preferred or convertible preferred stock and stock received as compensation.

Proposed Changes

The new bill proposes several changes to existing law in an effort to increase venture capital spending in small companies. Specifically, the new bill would:

- Provide a 100% exclusion, or zero capital gains rate, for stock purchased in a new company versus 50% under the current law
- Entitle both individuals and corporations to the exclusion versus only entitling individuals currently
- Increase the capitalization ceiling under the definition of “small corporation” to \$300 million adjusted for inflation going forward, from \$50 million with no adjustment today
- Reduce the holding period to 3 years from 5 years
- Eliminate the per-issuer limitation on taxpayer’s eligible gain of the greater of 10 times the stock’s basis or \$10 million
- Broaden the definition of “qualified small trade or business” by eliminating the exclusion for any business operating a hotel, motel, restaurant, or similar business
- Increase the Alternative Minimum Tax (AMT) exemption to 100% from 50%

What it all means

If the proposed changes are enacted into law, this bill will provide an attractive incentive for corporate investors for the first time by permitting them to avoid taxable gains on qualified small business stock and greatly expand the number of companies where this treatment is available. In addition, founders and employees of the company would be entitled to tax-free gains on company stock, including that received as compensation for services.

Furthermore, employees holding stock options in qualifying companies will still pay ordinary income tax on the gain between the strike price and the price at exercise. However, once the employee owns the common stock, all future capital gains will be eliminated so long as the holding period is met. Employees holding stock options in qualifying small businesses will now have even more incentive to exercise their options as soon as possible to limit their exposure to taxes, including exercise before vesting subject to repurchase.

The above changes will apply to stock issued after the effective date of the law.

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Specific questions concerning this topic should be addressed to corporate counsel. General questions may be addressed to Louis Taormina or Beverly Aisenbrey in our New York office at (212) 986-6330. Copies of this letter and other published material are available on our website at www.fwcook.com.