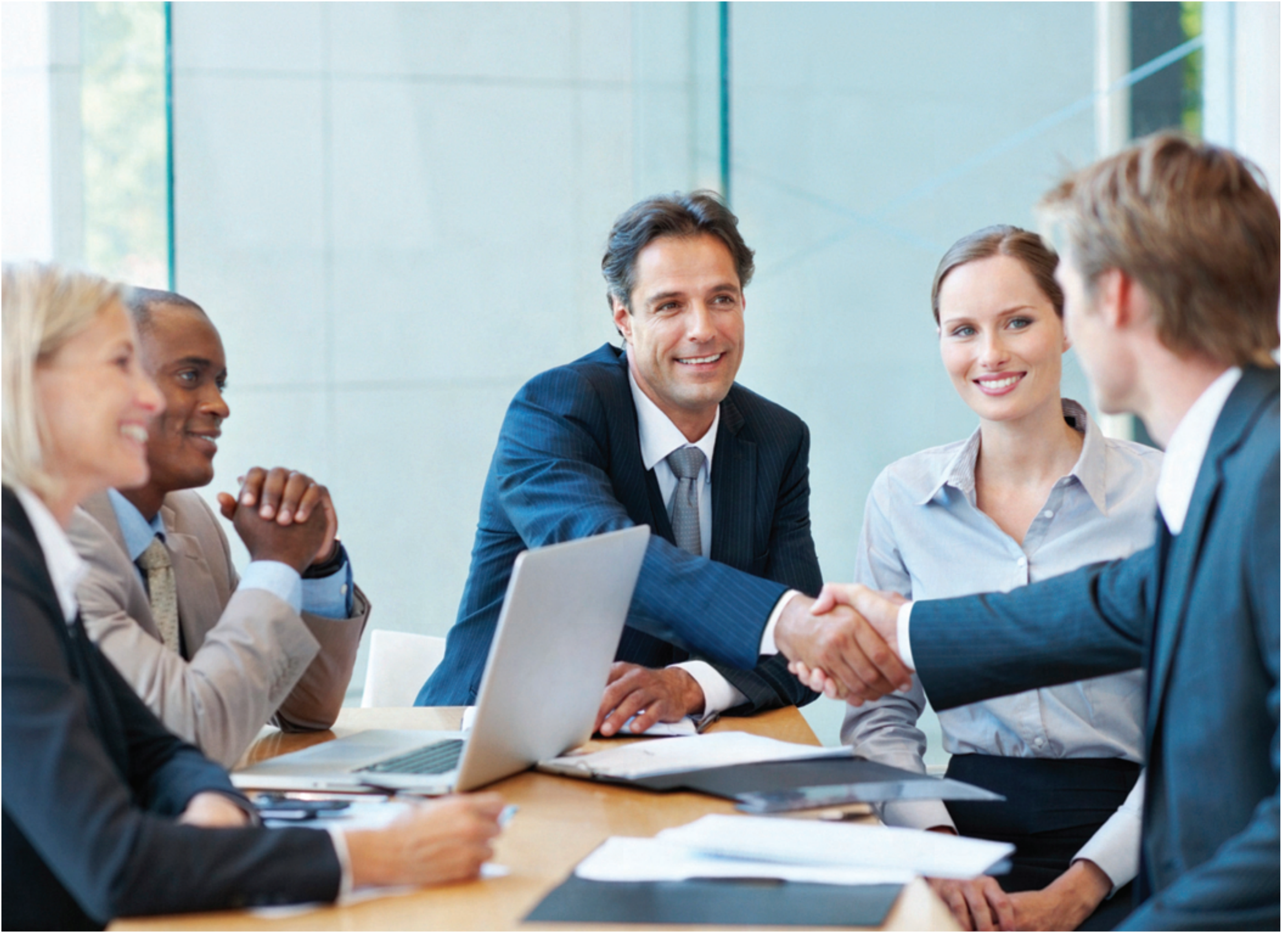

Tax Savings from the Sale of Qualified Small Business Stock

By Sidney J. Baxendale and Richard E. Coppage

Most tax professionals are familiar with the complex nature of the federal taxation of capital gains from the sale of common stock, but there are also tax savings opportunities for shareholders of qualified small business stock: the Internal Revenue Code (IRC) section 1045 capital gain rollover provision and the IRC section 1202 provision for the exclusion of capital gain. Moreover, the tax savings associated with these IRC sections will increase in 2013 when the capital gains rate rises to 20% and the 3.8% Medicare tax on investments commences. Shareholders who have held shares for more than five years can soon benefit from tax savings associated with the 75% and 100% exclusion under IRC section 1202.

The following discussion examines the expected future increases in tax savings and provides examples designed to quantify the tax savings as a percentage of the capital gain. This information can help individuals maximize their tax savings by deciding whether to utilize IRC section 1045, IRC section 1202, or a combination of both, by first applying the capital gain rollover

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provisions of IRC section 1045 and then excluding a percentage of the capital gain not rolled over using IRC section 1202.

Rollover of Capital Gain

If the sale of qualified small business stock results in a capital gain, the seller can avoid taxation of the gain by meeting the conditions under IRC section 1045. Qualified small business stock refers to stock in a C corporation that was issued after August 10, 1993, and acquired by the shareholder at its original issue in exchange for money or other property (not including stock), or as compensation for services provided (IRC section 1045[b][1]). Stock in a corporation will not be regarded as qualified small business stock unless at least 80% of the assets of the corporation are used in an active qualified trade or business—that is, any trade or business other than one involving the performance of services in the fields of accounting, actuarial science, architecture, athletics, brokerage services, consulting, engineering, health, law, performing arts, or any other trade or business where the principal asset is the reputation or skill of one or more employees. Other trade or business exclusions include banking, farming, financing, insurance, investing, leasing, mining, and restaurant or hotel management (IRC section 1202[e]).

The stock acquired by the shareholder will not be considered qualified small business stock if, at any time during a four-year period beginning two years before the issuance of such stock, the corporation purchased any of its stock from the shareholder or from a person related to the shareholder (IRC section 1202[c][3]). In addition to meeting the requirements for qualified small business stock, the stock must have been held by a noncorporate shareholder for more than six months (IRC section 1045[a]), and the qualified small business stock of another corporation must be purchased during a 60-day period beginning on the date of the sale. If the necessary conditions are met, all or a portion of the capital gain may be rolled over; thus, the tax on the gain rolled over may be postponed.

If the sale and purchase is accomplished to permit a rollover, the taxpayer must recognize the capital gain only up to the proceeds from the sale of the stock, minus the cost of any qualified small business stock purchased during the 60-day period (IRC section 1045[a]). IRS Publication 550, *Investment Income and Expenses*, clarifies the above rule by stating, "If this amount is less than the amount of your capital gain, you can postpone the rest of that gain. If this amount equals or is more than the amount of your capital gain, you must recognize the full amount of your gain" (p. 67, 2011). The "amount" refers to the proceeds from the sale of the stock, minus the cost of the newly purchased stock, as stated under IRC section 1045(a). Any portion of the capital gain that is not recognized is regarded as a rollover capital gain. The basis of the newly purchased stock is the purchase price less the rollover capital gain (IRS Publication 550, 2011).

Any recognized gain would be taxed at the capital gains tax rate, which is currently

EXHIBIT 1
Federal Income Tax Advantages of Rollover of Entire Capital Gain

	Tax Rates Starting in 2013 Capital Gain of $200,000		
	Rollover of Capital Gain	No Rollover of Capital Gain	Tax Advantage of Rollover
Proceeds from sale of 40,000 shares at $15 per share	$ 600,000	$ 600,000	
Original cost of 40,000 shares at $10 per share	400,000	400,000	
Amount of capital gain on sale of stock	$ 200,000	$ 200,000	
Amount reinvested in qualified small business stock within 60 days	$ 600,000	$ 0	
Taxable capital gain in year of stock sale	$ 0	$ 200,000	
Capital gains tax rate[1]	23.8%	23.8%	
Capital gains taxes in year of stock sale	$ 0	$ 47,600	$ 47,600
Adjusted cost basis of newly purchased stock:			
Purchase price of new stock	$ 600,000		
Less capital gain not taxed (rolled over)	(200,000)		
Adjusted cost basis of newly purchased stock	$ 400,000		

[1] Capital gain rate of 20% plus Medicare tax rate of 3.8%

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15%. Without congressional action extending that rate, it is scheduled to increase to 20% in 2013. In addition, recognized capital gains will be subject to a 3.8% unearned income Medicare contribution tax in 2013 for high-income taxpayers. The investment income subject to the 3.8% tax is the lesser of 1) the net investment income or 2) the excess of modified adjusted gross income over a threshold amount ($250,000 for taxpayers filing jointly and $125,000 for taxpayers filing separately, per IRC section 1411).

Example: full rollover of capital gain. This example, which shows the federal income tax advantages of the rollover of capital gain, relies on the following assumptions:

- A taxpayer joins with another entrepreneur to start a company that manufactures accessories for golf carts.
- The taxpayer (married or single) is highly paid, with a marginal capital gains tax rate of 20% in 2013. He is also subject to the 3.8% Medicare tax on investment income starting in 2013.
- The company was organized as a C corporation in the United States after August 10, 1993, and each of the two entrepreneurs was issued 40,000 shares in exchange for a cash investment of $400,000.
- During all years of the corporation's existence, the assets of the corporation were devoted solely to the manufacture of golf cart accessories, and the company was very successful. The corporation has not redeemed any of the shares that were issued to the two entrepreneurs.
- After owning the stock for several years, the shareholder sold his 40,000 shares for $15 per share in 2013 ($5 per share more than the original cost of the shares). Thus, the selling shareholder has a capital gain of $200,000 ([$15 – $10] × 40,000) on the sale of the stock.
- The shareholder who sold the 40,000 shares for $15 per share ($600,000) purchased $600,000 worth of shares of qualified small business stock in another C corporation within 60 days after selling the 40,000 shares.

Exhibit 1 shows that the capital gain on the sale of the 40,000 shares was $200,000 ($600,000 – [40,000 shares × $10]), and the entire $600,000 in proceeds from the sale are reinvested within 60 days after the sale. Because the proceeds from the sale minus the cost of the purchased shares is zero ($600,000 – $600,000), and zero is less than the $200,000 capital gain, the entire $200,000 may be rolled over; as a result, the entire $200,000 capital gain avoids taxation in the year of the sale. Using the tax rates effective for 2013, $47,600 ($200,000 × [20% + 3.8%]) of capital gain tax would be avoided. Of course, when the newly acquired stock is sold at some future date, the $200,000 gain may be taxed at that time. If this sale of the shares had occurred in 2012, the tax savings would be only $30,000 ($200,000 × 15%).

In addition, Exhibit 1 shows that because the $200,000 capital gain was not taxed, the cost basis of the newly purchased stock is reduced by the amount of the capital gain. The cost basis of the newly purchased shares is $600,000, but the adjusted cost

EXHIBIT 2
Federal Income Tax Advantages of Rollover of Portion of Capital Gain

	Tax Rates Starting in 2013 Capital Gain of $200,000		
	Rollover of Capital Gain	No Rollover of Capital Gain	Tax Advantage of Rollover
Proceeds from sale of 40,000 shares at $15 per share	$ 600,000	$ 600,000	
Original cost of 40,000 shares at $10 per share	400,000	400,000	
Amount of capital gain on sale of stock	$ 200,000	$ 200,000	
Amount reinvested in qualified small business stock within 60 days	$ 575,000	$ 0	
Taxable capital gain in year of stock sale	$ 25,000	$ 200,000	
Capital gains tax rate[1]	23.8%	23.8%	
Capital gains taxes in year of stock sale	$ 5,950	$ 47,600	$ 41,650
Adjusted cost basis of newly purchased stock:			
Purchase price of new stock	$ 575,000		
Less capital gain not taxed (rolled over)	(175,000)		
Adjusted cost basis of newly purchased stock	$ 400,000		

[1] Capital gain rate of 20% plus Medicare tax rate of 3.8%

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basis of the newly purchased stock is $400,000 ($600,000 – $200,000). The adjusted cost basis of $400,000 in this example is important because if the newly purchased stock is ever sold, the $400,000 adjusted cost basis will be used to determine the capital gain or loss on the sale. For example, if the newly purchased shares were sold for $500,000 in some future year, the capital gain on that sale would be $100,000 ($500,000 selling price, minus $400,000 adjusted cost basis).

There is a means by which the $200,000 rollover capital gain and any future capital gain rollovers can escape taxation entirely: the rollover process could continue until the death of the owner of the shares. Upon the owner's death, the stock could be inherited by the shareholder's beneficiary, who will receive a cost basis in the shares equal to the market price on the date of the shareholder's death. Thus, in the case of the death of a shareholder who properly rolled over capital gains, these capital gains from qualifying small business stock sales and purchases over a period of years would completely avoid capital gains taxation and the beneficiary would inherit the stock at the "stepped-up" basis (IRC section 1014[a]).

Example: partial rollover of capital gain. *Exhibit 2* shows a partial rollover of capital gains using the same basic assumptions as those in Exhibit 1; the only changed assumption is the purchase price on the newly acquired shares ($575,000 rather than $600,000). If the sales proceeds from the stock sale minus the purchase amount for the newly purchased shares were less than the $200,000 capital gain, then a portion of the gain must be recognized. For example, if the purchase price of the newly purchased shares was $575,000, then the $600,000 sales price minus the $575,000 purchase price would yield $25,000. Thus, a capital gain would have to be recognized up to the $25,000 amount; the rolled-over capital gain would be $175,000 ($200,000 – $25,000). In this case, the adjusted cost basis of the newly purchased shares would be $400,000 ($575,000 purchase price, minus $175,000 capital gain rolled over).

Comparing Exhibit 1 with Exhibit 2 reveals that the tax savings associated with the $175,000 rollover is only $41,650, rather than the $47,600 savings that results from rolling over the entire $200,000 capital gain. If the sale of the shares had occurred in 2012, the tax savings associated with the $175,000 rolled-over capital gain would have been only $26,250 (15% × $175,000), rather than the $41,650 shown in Exhibit 2.

The complex rule used in determining the amount of the capital gain that may be rolled over requires careful consideration. If the sales price of shares sold minus the purchase price of the newly purchased shares yields an amount that is equal to or greater than the capital gain on the sale, then the entire capital gain will be taxable. Therefore, once the taxpayer knows the proceeds from the sale and the capital gain on the sale, she must carefully choose the amount of stock that must be purchased within 60 days to maximize the tax savings associated with the rollover of capital gain.

Exclusion of Capital Gain

IRC section 1202 contains another potential tax-saving opportunity when the shareholder of qualified small business stock realizes a capital gain upon the sale of the shares. This tax-saving provision is available for noncorporate shareholders who have a capital gain from the sale or exchange of qualified small business stock owned for more than five years (IRC section 1202[a][1]). "Qualified small business stock" is defined the same way as in the IRC section 1045 capital gain rollover provision.

To qualify under IRC section 1202, however, a corporation that issued qualified small business stock must be a qualified small business—that is, a domestic C corporation that, at all times on or after August 10, 1993, and before the issuance of the qualified small business shares, had aggregate gross assets equal to or less than $50 million. In addition, the aggregate gross assets immediately after the issuance of the qualified small business shares must not exceed $50 million. All corporations that are members of the same parent-subsidiary controlled group are treated as one corporation with respect to the aggregate gross asset provision (IRC section 1202[d][1]).

If the common stock sold is qualified small business stock issued by a qualified small business, then the capital gain from the sale of the stock can be reduced by a specified percentage if the stock has been held for more than five years (IRC section 1202[a]). The percentage of the exclusion is determined by the time period during which the shares were acquired, in accordance with the following schedule:

- Shares acquired after August 10, 1993, but before February 18, 2009, have a 50% exclusion percentage.
- Shares acquired after February 17, 2009, but before September 28, 2010, have a 75% exclusion percentage.
- Shares acquired after September 27, 2010, but before January 1, 2012, have a 100% exclusion percentage. (If the 100% exclusion is not extended or modified beyond December 31, 2011, it will automatically revert back to the 50% exclusion.)

To qualify under IRC section 1202, however, a corporation that issued qualified small business stock must be a qualified small business.

Although capital gains on the sale of stock are typically taxed at a maximum tax rate of 15% in 2012 (and at 20% starting in 2013), the portion of the gains not excluded in the case of an IRC section 1202 capital gain is taxed at a higher 28% tax rate under IRC section 1(h)(4)(A)(ii). In addition, 7% of the excluded gain is considered a preference item for alternative minimum tax (AMT) purposes when the exclusion percentage is 50% or 75%. The AMT on 7% of the capital gain was eliminated for the 100% exclusion (IRC section 57[a][7] and IRC section 1202[a][4][C]). Depending upon the taxpayer's particular circumstances, preference items have the potential of being taxed at a 26% or 28% rate for AMT purposes (IRC 55[b][1][A]).

If a shareholder has an eligible gain for the taxable year from sales of stock

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issued by any qualified small business, the aggregate amount of such gain for which the exclusion is applicable may not exceed the greater of 1) $10 million, reduced by the aggregate amount of eligible gain taken into account in prior years; or 2) 10 times the aggregate adjusted basis of qualified small business stock issued by the qualified small business and sold by the shareholder during the taxable year (IRC section 1202[b]).

Example: advantages of the capital gain exclusion. This example makes the same assumptions as the example above, with one modification and one addition. In order to examine the impact of the 50%, 75%, and 100% exclusions on tax savings, this example makes three alternative assumptions about when the shareholder purchased the 40,000 shares that were sold. The one additional assumption is that the shareholder has owned the shares for more than five years before the sale of the stock.

The 50% exclusion is applicable for qualified small business shares purchased from August 11, 1993, through February 17, 2009, and held for more than five years. If the shareholder purchased the 40,000 shares on February 17, 2009, he would have to wait until February 18, 2014—one day more than five years later—to sell the shares in order to qualify for the 50% capital gains exclusion. The 75% exclusion is only applicable to situations where the shareholder purchased the shares from February 18, 2009, through September 27, 2010, and will have owned the shares for more than five years (that is, at least until February 19, 2014). The 100% exclusion is applicable for shares purchased from September 28, 2010, through December 31, 2011 (unless further extended), and owned by the same shareholder for more than five years (that is, at least until September 29, 2015). As discussed above, the highest tax savings from IRC section 1202 are the 75% and 100% exclusions that are not attainable until a future date.

Exhibit 3 examines the situation in which the stock was sold at a gain of $200,000 (40,000 shares × [$15 –$10]), and the tax savings associated with the IRC section 1202 capital gain exclusion are calculated for each of the 50%, 75%, and 100% exclusion alternatives. The tax savings and the tax savings as a percentage of capital gain for each of the three alternatives are shown in Exhibit 3.

Exhibit 3 reveals that the tax savings associated with the 50% exclusion, using the tax rates starting in 2013, are minimal. Without considering the AMT, the tax savings is 7.9% of the capital gain. Although not shown in Exhibit 3, the 50% exclusion tax savings are even less when the AMT is considered (6.99% at the lower 26% AMT rate; 6.92% at the higher 28% AMT rate). The tax savings is only 1% of the capital

EXHIBIT 3
Federal Income Tax Advantages of IRC Section 1202 Capital Gain Exclusion

	Tax Rates Starting in 2013 Capital Gain of $200,000		
	50% Exclusion	75% Exclusion	100% Exclusion
Amount of capital gain on sale of qualified small business stock	$ 200,000	$ 200,000	$ 200,000
Less gain excluded from gross income	(100,000)	(150,000)	(200,000)
Amount of capital gain included in gross income	$ 100,000	$ 50,000	$ 0
Tax effect of capital gain exclusion:			
Amount of capital gain excluded	$ 100,000	$ 150,000	$ 200,000
Normal capital gains tax rate	23.8%	23.8%	23.8%
Taxes saved as a result of exclusion	$ 23,800	$ 35,700	$ 47,600
Amount of capital gain not excluded	$ (100,000)	$ (50,000)	$ 0
Excess tax rate for IRC section 1202 capital gain not excluded (31.8%–23.8%)[1]	8%	8%	8%
Extra tax on section 1202 capital gain not excluded	$ (8,000)	$ (4,000)	$ 0
Net capital gains tax savings from exclusion	$ 15,800	$ 31,700	$ 47,600
Net tax savings as a percentage of total capital gain	7.9%	15.85%	23.8%

[1] 31.8% equals the 3.8% Medicare tax plus the 28% capital gains tax on gain not excluded.

23.8% equals the 3.8% Medicare tax plus the 20% capital gains tax on gain not subject to IRC section 1202.

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gain when the AMT is ignored and the 2012 tax rates are used to calculate the tax savings; when the AMT is considered, the tax savings percentage drops to .09% for the lower 26% AMT tax rate and to .02% for the higher 28% AMT tax rate.

The tax savings percentages are much more attractive for the 75% and 100% exclusions, which will become available in the next few years. In the case of the 75% exclusion (using the tax rates starting in 2013), the tax savings percentage is 15.85% of the capital gain (Exhibit 3). Although not shown in Exhibit 3, the tax savings for the 75% exclusion, as a percentage of the capital gain, is 14.49% at the lower 26% AMT rate and 14.38% at the higher 28% AMT rate. In the case of the 100% exclusion (using the tax rates starting in 2013), the tax savings is 23.8% of the capital gain (Exhibit 3). There is no tax preference amount associated with the 100% exclusion; thus, there is no AMT for the 100% exclusion. A sensitivity analysis revealed that, for each of the exclusion percentages, the tax savings as a percentage of the capital gain remained unchanged as the capital gain amount changed.

These two rather obscure provisions of the IRC are often overlooked when applying the rules for capital gains taxation.

Joint Application

There is nothing in the IRC that prevents a taxpayer from rolling over the capital gain using IRC section 1045 and then, if there is a taxable portion that was not rolled over, applying IRC section 1202 to that portion. Of course, this joint application is only possible if the capital gain involved qualified small business stock issued by a qualified small business and if the other conditions required by both IRC sections 1045 and 1202 are met.

In such a joint application of IRC sections 1045 and 1202, the portion of the gain rolled over under IRC section 1045 would be deducted from the purchase price of the newly purchased stock to arrive at the adjusted cost basis of the stock. Next, the portion of the capital gain that was not deferred would be eligible for exclusion from capital gains tax under IRC section 1202. The amount of the gain excluded from taxation under IRC section 1202 would only be related to the stock that was sold and would have no effect on the adjusted basis of the newly acquired stock. Of course, those shareholders fortunate enough to qualify for the 100% capital gain exclusion should not even consider using the rollover capital gain provisions of IRC section 1045.

An Obscure Opportunity

It is essential to mention several caveats related to the tax provisions and examples described above. The tax rates used here are based on the tax rates that are expected to be in effect starting in 2013 and those that are currently in effect in 2012. If the stockholder is in a lower federal income tax bracket and subject to the lower capital gains rate, however, the tax savings could be less.

The focus here is on the salient tax provisions related to IRC sections 1045 and 1202. As is true with all generalized tax advice, however, taxpayers should consult with their advisors before taking action. Only a tax professional who understands a taxpayer's precise situation and has a comprehensive understanding of the relevant tax provisions is in a position to make the correct decision concerning the issues discussed above.

These two rather obscure provisions of the IRC are often overlooked when applying the rules for capital gains taxation. Both of these provisions represent opportunities to reduce the capital gain tax due on the sale of qualified small business stock. These savings will increase significantly in 2013 because of the scheduled increase in the capital gains tax rate and the new Medicare tax on investment income. The tax savings associated with IRC section 1202 are scheduled to increase significantly in the next few years as well; stockholders who will have held the qualified small business shares for more than five years will be able to realize the tax savings associated with the 75% and 100% capital gains exclusion.

Taxpayers can also jointly use both IRC provisions to maximize the capital gains tax savings. Any remaining taxable capital gains after applying the rollover provisions of IRC section 1045 may be partially reduced by using the capital gain exclusion provisions of IRC section 1202. A taxpayer's overall objective is to minimize the capital gain tax, and CPAs can advise an individual of the right steps to take. ❑

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