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Biden Retroactively Doubles Capital Gain Tax But Keeps $10M Benefit

Tax hikes are coming—in fact, they are already in force, assuming they are passed as proposed. The “it’s already effective” rule is designed to prevent selling to get in under the wire. Whether that strategy will work depends on how good your crystal ball is. Make no mistake, these tax hikes pack a punch. The Biden administration’s so-called "Green Book" has nothing to do with the environment, and everything to do with tax hikes. The General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals are not mere tweaks to the tax code. Right now, there is a top 37 percent tax rate. You don’t hit that rate until (as a married couple) you have over $628,300 in taxable income. The Biden proposal would raise the top marginal rate to 39.6 percent beginning December 31, 2021, for couples with over $509,300 in taxable income. The capital gain hikes are more ambitious. Instead of top rates of 20% plus the 3.8% Obamacare tax, you lose out entirely on capital gain rates if you make more than $1 million. You will now pay 39.6% *plus* the 3.8% Obamacare tax, for a whopping 43.4%. And here’s the kicker: that capital gain tax hike is already in effect, *retroactively* to the date Biden first announced his proposal to Congress on April 28, 2021.

Is there any good news in this? The qualified small business stock provision that has been the darling of the tech industry for decades is slated to be quietly left alone. You can get up to $10M tax free that way, or in some cases conceivably even more if you are able to creatively leverage the limit with family. But be careful, that can backfire too. Among other requirements, the QSBS $10M allowance is only for selling certain stock in a C corporation. You can read about the qualifications for getting the $10M tax free or tax deferred. Of course, choice of entity for small and not-so-small businesses involves lots of tradeoffs, and not all businesses are the same. The traditional choices are corporations, partnerships and limited liability companies (LLCs), but you have to think ahead.

A few decades ago, when an individual outgrew a proprietorship, a corporation was almost always the logical choice. In more recent decades, LLCs became the new norm. They are generally taxed as partnerships. That means partners (or using the terminology of LLCs, 'members') pay taxes on the business income themselves at their *own* tax rates. Flow-through tax treatment is still favored. In fact, entities like partnerships, LLCs, and S corporations got a big boost from Trump's Tax Cuts and Jobs Act, Provision 11011 Section 199A. But so did corporations when the corporate tax rate was slashed from 35% to 21%, also by Trump. Biden wants the corporate rate hiked to 28%, but it might settle in between. Even at 28%, the C corporation rate is lower than the rate the owners of an S corporation or LLC will pay on their pass-through income.

But the rub is in the two levels of tax to which C corporations and their shareholders are subject. After all, income from a C corporation is taxed twice. The corporation pays tax on its net income. Then, shareholders also pay tax on dividend distributions they receive. In contrast, income from an S corporation is taxed once at the shareholder level. Starting in 2018, the tax law radically cut the corporate tax rate paid by C corporations from 35% to 21%. That means C corporation status is much better, right? Well, compare that 21% rate to how an S corporation is taxed. Individual tax rates were also cut. The top rate dropped from 39.6% to 37%. Then there's the pass-through deduction. If you qualify, it can reduce the top effective tax rate from 37% to 29.6%. For many, the idea of a 29.6% tax rate sounds pretty good, even compared to the 21% C corporation tax rate.

With a C corporation, one must consider the shareholder level taxes too. Dividends are generally taxed at 15% or 20%, depending on income levels. Considering the corporate tax and the shareholder tax, unless you leave all income in the corporation, you end up paying more in taxes with a C corporation, even at the 21% corporate rate. What can be a $10M issue? And that brings us to the magical Qualified Small Business Stock (QSBS) benefit that Biden is keeping in place. It only applies to C corporation stock.

For the small companies that qualify—generally up to $50 million in assets—shareholders who have held their stock for 5 years may be able to exclude their gain from federal tax. The shareholder limit is usually $10 million, and $10 million tax free would be nice! If you sell QSBS but have not held it for 5 years, there is another QSBS benefit. You can defer the gain by rolling it over into a new investment in QSBS. All in all, the QSBS rules can allow founders and other shareholders huge tax free or tax deferred benefits.

S corporation stock does not qualify as QSBS, and an S corporation can have no more than 100 shareholders, only U.S. citizens and resident aliens as shareholders. The shareholders must generally be individuals (and certain limited types of trusts), and the corporation must generally have a calendar year. If there are multiple classes of stock, only differences in voting rights are allowed. For most small businesses, these criteria are easy to meet. If the owners are more comfortable with the corporate form than an LLC, an S corporation can be a good choice. However, the accounting rules for S corporations are more complicated. Moreover, converting from C to S can be nuanced. An S corporation can face corporate tax if it was previously a C corporation and elected S status within the last 5 years (the built-in gain tax).

Choosing which type of business entity and then playing out the tax choices clearly involves some tough decisions. It is even harder to plan when the tax laws seems always to be changing. However, the presence of the qualified small business stock rules as what might be a permanent feature of the tax law make C corporations worth another look, even if the 21% tax rate seems likely to go up. If you are a high-income earner and a founder, QSBS benefits may be hard to ignore.

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