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Much Higher Capital Gain Rates Are Already In Effect, Any Good News?

By Robert W. Wood

The Biden administration's so-called "Green Book" has nothing to do with the environment, and everything to do with taxes, or tax hikes actually. The "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" might be green in color, but it is about raising money in ways that are hardly mere tweaks to the tax code. Right now, the top federal income tax rate is 37 percent. You don't hit that rate until (as a married couple) you have over $628,300 in taxable income.

The proposal would raise the top marginal rate to 39.6 percent beginning December 31, 2021, for couples with over $509,300 in taxable income. There are parallel hikes for single persons too. However, the capital gain hikes are way more ambitious. Instead of the current top rates of 20% plus the 3.8% Obamacare tax (for a 23.8% total), you will 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%. How is that for a preferential capital gain rate! And here's the kicker: this capital gain tax hike is already in effect, retroactively to the date President Biden first announced his proposal to Congress on April 28. Yes, this tax increase is already in force, assuming of course that it is passed as proposed.

The "it's already effective" rule is designed to prevent selling assets to get in under the wire. Whether that strategy will work depends on how good your crystal ball is. It's causing tax advisers and their clients lots of angst. Make no mistake, these tax hikes pack a punch. Is there any good news in this? Well, the qualified small business stock provision that has been the darling of the tech industry for decades is slated to be left alone.

What is qualified small business stock? If you sell stock that qualifies, you can get up to $10 million tax free. Indeed, in some cases conceivably even more if you are able to creatively leverage the $10 million limit with family. But be careful, some family transfers can backfire and disqualify shares. Keep in mind that QSBS benefits apply only for federal tax law. Many states conform and give you a state tax break too.

How about California? You guessed it, your stock sale in the golden state will be fully taxable. And adding insult to injury, California taxes capital gain and ordinary income at the same rate, up to 13.3%. If you make more than a million dollars, there is a proposal to raise that rate by 1% to 3.5% depending on your income. It's no wonder that many Californians are eyeing Nevada, Texas, Washington, Wyoming, etc. Anywhere, actually.

For federal tax purposes, the QSBS $10M allowance is only for selling certain stock in a C corporation. The company must also have gross assets of less than $50 million. The selling taxpayer must have acquired the stock directly from the issuing corporation at original issuance. The stock can be acquired by the taxpayer in exchange for property, or it can also be awarded as compensation by the issuing corporation.

However, stock purchased from other shareholders (that is, not acquired at original issuance) generally cannot be QSBS. There are lots of other rules too, including an active business rule. There are even rules that particular types of businesses don't qualify, so there is some line-drawing. Even so, plenty of founders want to start C corporations precisely because of QSBS benefits later if they sell.

What if you have losses when the business starts, isn't an LLC better, so the founders can get the losses during the early years? Perhaps, and if you are careful, you can later convert to a C corporation without spoiling the QSBS benefit. 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).

A few decades ago, when an individual outgrew a proprietorship, a corporation was usually the logical choice. In more recent decades, LLCs became the norm, 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. Partnerships, LLCs, and S corporations got a big boost from Trump's Tax Cuts and Jobs Act with its 20% pass-through deduction.

But so did corporations when the tax rate was slashed from 35% to 21%. Biden wants the corporate rate hiked to 28%, but it might settle in between 21% and 28%. 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 shareholders are subject. 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. In 2018, the top rate for individuals 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%.

A 21% C corporation rate sounds best but consider shareholder taxes too. Dividends are generally taxed at 15% or 20%, so unless you leave all the income in the corporation, you end up paying more in taxes with a C corporation, even at the 21% corporate rate. A liquidation or sale of the business is particularly painful, with double taxes, unless you sell stock and qualify for QSBS.

Yes, the magical QSBS benefit that Biden is keeping in place still may favor C corporations. For the companies that qualify, shareholders who have held their stock for 5 years may be able to exclude their gain from federal tax. 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.

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 qualified small business stock rules 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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