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Sell Stock at a Big Gain But Pay No Tax?

By Robert W. Wood

This sounds like an infomercial. No one likes paying taxes, and if you are thinking about selling stock, you might think that it is inevitable that you'll pay state and federal taxes on your gain. Sure, if you play your cards right, you might end up with long term capital gain, taxed at a lower rate than ordinary income. But in California, there is no break on tax rates when it comes to paying your state taxes. Ordinary income and capital gain rates in the Golden State are taxed the same, up to the top rate of 13.3%.

On the other hand, with the IRS, long term capital gain matters. In 2023, you won't pay any capital gain tax if your total taxable income is $44,625 or less. The tax rate jumps to 15 percent on capital gains if your income is $44,626 to $492,300. Above income of $492,300, the rate climbs to 20 percent. And don't forget about the 3.8% net investment income tax that was added by the Affordable Care Act. For federal purposes, you need to add that to your 15% or 20% capital gain tax.

At upper incomes, that makes your total federal tax on your gain 23.8%. That's much better than 37%, but is there a better path? If you qualify, the answer is yes, and the benefits can be astounding. If the stock qualifies as qualified small business stock (QSBS), you might pay zero federal tax. That's right, if you hold stock qualifying as QSBS for at least five years before selling, some or all your gain can be *excluded* from gross income, so you don't have to pay federal income tax.

If you meet all the tests, it can mean no federal tax on up to $10 million in gain. Any remaining gain above this—say if your stock sale produced $13 million of gain—is taxed as a capital gain, but at 28 percent, not 20 percent. The upper limit on the exclusion is the *greater* of $10 million or 10 times the taxpayer's adjusted basis in the stock.

If you are selling QSBS but have not held it for five years, there is *another* QSBS benefit. You can *defer* the gain by rolling it over into a *new* investment in QSBS. Rollover treatment is available if you held the original stock for more than six months; and if you make an election on your tax return. The rollover works only if you invest in new QSBS within 60 days of your sale. At a later date, you could sell your *second* QSBS and exclude 100 percent of your gain (up to the cap) if you meet the five year holding period requirement at that time.

Founder Lawsuits

Before we talk about what stock qualifies as QSBS, it might be worth thinking about lawsuits by founders who claim they were frozen out of companies and had their equity converted or sold at an unfair price. QSBS issues can come up there too. Some of this may depend on the settlement agreement and how the case was framed in the pleadings. In some cases, the original stock issuance records may not be perfect.

The goal may be for the founder to dispose of his shares at settlement, or to be paid more for the shares on settling the suit, even if his shares were disposed of previously for a bargain price. In some cases, the rollover provisions are easier to satisfy than the exclusion provisions, which require a five-year holding period.

QSBS Requirements

Section 1202 of the tax code contains the QSBS rules. QSBS is defined as stock of a domestic C corporation originally issued after August 10, 1993, if several requirements are met. When the stock is issued, the corporation must be a qualified small business. The stock must be acquired at *original issue* in exchange for money or other property (not including stock), or as compensation. Stock purchased from *other* shareholders does not qualify. The company must be an active trade or business and must be a C corporation with gross assets of less than $50 million at all times after August 10, 1993.

Active Trade or Business

At least 80 percent by value of the company's assets must be used in the conduct of a qualified trade or business. A qualified trade or business is any business except: (i) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees; (ii) any banking, insurance, financing, leasing, investing, or similar business; (iii) any farming business; (iv) any business involving the production or extraction of products if a character with respect to which a deduction is allowable under sections 613 or 613A; and (v) any business of operating a hotel, motel, restaurant, or similar business.

Exclusion or Rollover

The exclusion provisions of section 1202 and the rollover provisions of section 1045 have much in common. Yet the requirements of each section can pose different challenges. To take advantage of section 1202, a shareholder must hold the QSBS for at least five years. Where the five-year requirement for the exclusion is not satisfied, a seller might turn to a section 1045 rollover.

To qualify for section 1045 rollover, a shareholder must only hold the stock for six months before acquiring new QSBS. Both section 1202 and section 1045 require that QSBS be acquired at original issuance in exchange for property or services. For a rollover, you have 60 days to purchase replacement QSBS. In addition, section 1045 provides that you must establish that the issuer of the replacement QSBS is operating an active business.

Mixing and Matching

The QSBS rules have some confusing dates and percentage amounts. For QSBS acquired after February 9, 2009, and before September 28, 2010, the gain exclusion is 75 percent. For stock acquired after September 27, 2010, the gain exclusion is 100 percent. However, a taxpayer cannot exclude more than the greater of: (i) $10 million (reduced by the aggregate amount of eligible gain taken into account with respect to that corporation); or (ii) 10 times the aggregate adjusted basis of QSBS issued by such corporation and disposed of during the taxable year.

For purposes of determining the total amount of eligible gain, all dispositions of QSBS by the taxpayer from all

corporations are aggregated. However, any reduction to the $10 million limitation is applied on a corporation-by-corporation basis and only to the extent the taxpayer has disposed of QSBS in that corporation in a prior taxable year.

State Income Tax

The federal tax benefits of QSBS are huge, but one should think about state taxes too. Some states have parallel laws, some do not, and some put their own spin on the issues. For example, for many years, California had its own brand of QSBS that only worked if the business was quite California-centric in sales, payroll, and assets. The California brand of QSBS rules was so exacting that claiming it became known as virtually a guaranteed audit from the Franchise Tax Board.

That meant there were many California QSBS contests in the wake of the audits that almost invariably ended with the California Franchise Tax Board telling the taxpayer that he or she did not qualify. Eventually, California did away with its version of QSBS entirely, and it now has no QSBS counterpart. Many sellers in California with their feet firmly planted pay the California tax and stay put.

But not everyone. Indeed, regardless of whether stock is QSBS, a looming sale that will produce big gains often prompts California (and other high tax state residents) to move before they sell. This is not unique to stock sales, and not unique to any location. But moves like New York to Florida (or closer by, New York to New Hampshire), or from California to Nevada before a sale (or for that matter before settling a big lawsuit) are among the most common.

The no-tax states of Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, and Wyoming seem most popular with tax emigres, but most states are materially better than California and New York. Washington state used to be more popular as a destination than today. One reason is that even though Washington does not have a general state income tax), it now levies a state capital gains tax on certain high earners. The Washington Supreme Court recently upheld its constitutionality. Of course, most moves are not solely about taxes, but taxes may play a role, and that is particularly true before a major income event.

Conclusions

A sale of stock (especially by founders and early employees) may represent the biggest single lump-sum payment of a taxpayer's lifetime. A large tax bill may go along with a large amount of income. The QSBS provisions in sections 1202 and 1045 can provide a break on these taxes.

However, taking advantage of the QSBS provisions can require care and planning. If the proceeds are coming from a lawsuit, that is especially true. Careful planning is also needed if the taxpayer hopes to take advantage of the section 1045 rollover. Given the short 60-day timeframe available to purchase replacement QSBS, you want to be ready before the proceeds are received and the 60-day clock starts to run.

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