Avoiding Income Tax on the Sale of Stock
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If it is true that, “for everything there is a season, and a time for every matter under heaven,” then the enactment of the Tax Cuts and Jobs Act (“TCJA”) brought about a season in which taxpayers should take the time to consider doing business through a C corporation. In the context of closely held businesses, C corporations have traditionally been thought of as inferior to “pass-through” entities due to the “double tax” incurred by C corporation shareholders. The TCJA, however, created a significant discrepancy between the highest C corporation tax rate (21%) and the highest tax rate potentially applicable to income from a pass-through entity (as high as 40.8%). Accordingly, although a pass-through entity often continues to be the appropriate choice of entity, it is no longer an obvious choice.

The primary consideration that continues to weigh against doing business through a C corporation is the possibility of its earnings being taxed at both the corporate-level and shareholder-level. In considering this cost, however, business owners should be aware of certain provisions under the tax law that can avoid, or at least mitigate, the effect of that double tax by allowing shareholders of a C corporation to avoid (or defer) gain on the sale of their C corporation stock. This article briefly addresses two such rules: sections 1202 and 1045.

Exclusion of Gain on the Sale of Qualified Small Business Stock - Section 1202
Section 1202 allows individual taxpayers to exclude from gross income up to 100% of the gain on the sale or exchange of qualified small business stock (“QSBS”) held for more than five years if certain conditions are met. Section 1202 is particularly powerful because it provides one of the rare instances in which the tax law allows a taxpayer both to receive cash without any limitation on its use and to exclude the corresponding gain. Before turning to some of the details of this rule, it should be noted that President Biden’s “Build Back Better” legislation would have significantly curtailed the benefits of section 1202, but (at least as of now) these limitations remain only proposed changes.

Under section 1202, a shareholder may potentially exclude gain limited to the greater of (i) $10 million (reduced by the aggregate amount of gain excluded in prior taxable years with respect to the corporation) or (ii) 10 times the adjusted basis of the QSBS of the corporation sold during the taxable year. At a high level, the general requirements for treating stock as QSBS are as follows:

- **C corporation requirement.** The stock must be stock of a C corporation.
- **Issuance date requirement.** The stock must be stock issued after the date of the enactment of the Revenue Reconciliation Act of 1993, but to receive the 100% exclusion, the stock must be issued after September 27, 2010.
- **Qualified small business requirement.** As of the date of the stock issuance, the corporation must be a qualified small business, which very generally requires that the corporation have gross assets with a value not in excess of $50 million. It is important to note, however, that the corporation’s assets can subsequently grow and exceed this $50 million threshold.
- **Original issuance requirement.** The stock generally must be acquired by the taxpayer at its original issuance (i) in exchange for money or other property (other than stock) or (ii) as compensation for services provided to the corporation.

- **Active business requirement.** During substantially all of the taxpayer's holding period with respect to the stock, the corporation must (i) be a C corporation, (ii) be an "eligible corporation," and (iii) use 80% of its assets in one or more "qualified trades or businesses." Most C corporations will be eligible corporations, and a qualified trade or business generally includes any business other than a set of specifically excluded businesses (e.g., most professional service providers cannot qualify).
- **Limited redemption requirement.** Certain redemptions by the corporation of its stock may prevent its stock from being treated as QSBS.

Deferral of Gain on the Sale of Qualified Small Business Stock – Section 1045

Section 1045 is an elective provision that also applies to QSBS. In contrast with section 1202, however, a taxpayer (other than a corporation) may apply section 1045 after holding the QSBS for more than six months (rather than the five years required by section 1202). In general, section 1045 allows individual taxpayers to make an election to recognize gain on the sale of QSBS only to the extent the proceeds exceed the cost of other QSBS ("replacement QSBS") that the taxpayer purchases within 60 days of the initial sale. For example, if an individual sells QSBS that he has held for more than six months and reinvests all of the proceeds in replacement QSBS within 60 days, the individual can elect to not recognize any gain.

Although the holding period requirements under section 1045 are less onerous than those under section 1202, section 1045 may often only result in a deferral of the gain from the sale of QSBS (rather than the complete exclusion provided by section 1202). In this regard, a taxpayer that elects not to recognize gain under section 1045 must reduce his stock basis in the replacement QSBS by the amount of the gain not recognized. Accordingly, that unrecognized gain becomes embedded in the replacement QSBS and that gain is potentially subject to tax when the taxpayer disposes of the replacement QSBS (unless he can also apply an exception to that subsequent disposition).

Conclusion

Both section 1202 and section 1045 contain a number of other detailed rules that business owners need to carefully consider with their tax advisors. But in the appropriate case, the wise application of these rules, coupled with the 21% corporate tax rate, can allow business owners to keep significantly more of the profit from all of their toil under the sun.