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How to Minimize Taxes When Selling your Company's Stock

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Tax planning is essential when a small business owner contemplates a future sale of stock in the business. If the owner hasn't prepared ahead of the sale, taxes may take a big bite out of the profit.

For some owners, taking advantage of the qualified small business stock (QSBS) tax exclusion in IRC Section 1202 can significantly reduce the tax bill.

IRC Section 1202 provides an exclusion from income for any gain from the sale or exchange of QSBS acquired after the statute's effective date and held for more than five years. The stock must be originally issued after August 10, 1993, to qualify for the exclusion.

The amount of gain that is excludible from income depends on when the QSBS was initially issued. The gain exclusion is:

- 50% for QSBS issued after August 10, 1993, and before February 17, 2009.
- 75% for QSBS issued between February 18, 2009, and September 28, 2010.
- 100% for QSBS issued after September 27, 2010.

The 28% maximum capital gains rate applies to the taxable portion of the sale of the stock. The excludable portion of the gain on sale or exchange of QSBS is exempt from the alternative minimum tax (AMT) inclusion requirements and exempt from the 3.8% net investment income tax.

The gain eligible for exclusion is limited to the greater of $10 million for each qualified business or ten times the taxpayer's cost basis of the stock disposed of during the year. However, the gain realized on the sale of QSBS may also be eligible for rollover treatment if the taxpayer purchases other qualified stock (Section 1045 stock).

"Seller Be Aware": 9 Critical Factors for QSBS or Section 1202 Sales

In considering the sale or exchange of QSBS and the applicability of Section 1202, a prospective seller should keep several factors in mind:

1. The stock involved must be the stock of a domestic C corporation.

2. There are limitations on the amount of eligible gain that can be excluded.

3. The business must be a qualified small business and satisfy the active business test to qualify for QSBS treatment.

4. The case for employing Section 1202 may be even more compelling if QSBS proceeds are reinvested in Qualified Opportunity Zone (QOZ) stock. A QOZ is an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment.

5. The taxable portion of the gain forgoes the 15 or 20% capital gains rate and is subject to a maximum rate of 28% on capital gains.

6. Section 1202 is available on a per-issuer, per-taxpayer basis. If the ownership of QSBS includes other family members or non-grantor trusts, the total exclusion can be maximized.

7. Not all states follow the Section 1202 gain exclusion rules.
8. Section 1202 is not applicable for businesses involved in providing professional services (health, law, engineering, architecture, accounting, consulting, financial services, or brokerage services) or any business where the principal asset of the company is the reputation or skill of one or more employees.
9. Since QSBS qualifications can be complex, business owners contemplating the use of Section 1202 should work closely with their tax advisors.

Acting now could grow and protect the ultimate net proceeds in the face of potential changes

Early planning can increase a business owner's potential Section 1202 gain exclusion and grow wealth through significant tax savings. Selling company stock can be complicated and can have downstream impacts on your financial plan. With the reduction of the corporate tax rate from 35% to 21% under the 2017 tax legislation and the potential for an increase in the corporate tax rate under a new administration, it's an ideal time to review the advantages of QSBS treatment and Section 1202.

For more information about strategies and ways to plan ahead, contact your relationship manager, or contact our Business Advisory Services team through key.com/businessadvisory.

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