insights

SHUMAKER
Shumaker, Loop & Kendrick, LLP

A Newsletter from Shumaker, Loop & Kendrick, LLP | June 2016

New Tax Law Allows Some to Avoid Paying Tax on the Sale of Their Business

At the end of last year, the President signed into law the ability of some investors to not pay tax on the sale of "qualified small business stock" ("QSBS") acquired after September 27, 2010 and held for more than five years. Under the new law (which permanently extends this special treatment that had been allowed on a temporary, annual basis since 2010), the gain from such sales (subject to numerous technical qualifications and limitations) is excluded from taxable income and, therefore, is not subject to federal and, for most states, state income taxes, the alternative minimum tax, or the 3.8% tax (sometimes referred to as the Obamacare tax) on capital gains and other net investment income.

by Warren P. Kean

The amount of gain that is excluded from tax is capped at the *greater* of $10 million or 10 times one's investment.

The amount of gain that is excluded from tax is capped at the *greater* of $10 million or 10 times one's investment.

For example, a person who invests $100,000 in a qualified small business after September 27, 2010, holds that investment for over five years, and meets the other eligibility requirements will not be subject to tax on gain of up to $10 million, and a person who invests $1.5 million will not be subject to tax on gain of up to $15 million.

Not all investors are entitled to this tax break. Only individuals (directly or indirectly through flow-through entities, such as limited liability companies ("LLCs") classified as partnerships for federal tax purposes), estates and trusts are eligible (i.e., not C corporations), and those eligible investors generally must purchase the QSBS directly from the issuing corporation and not from any other person (except transfers upon death, by gift or distributions from LLCs and other entities classified as partnerships for federal tax purposes).

Only C corporations (including LLCs that elect to be classified as C corporations for federal tax purposes)

may issue QSBS. Investments in partnerships, LLCs and other entities classified as partnerships, and S corporations do not qualify, except to the extent those flow-through entities own QSBS in other companies. Moreover, only businesses that are deemed to be both "active" and, at the time of the issuance of the stock, "small" are eligible to issue QSBS.

The list of businesses that are not deemed to be "active" and, therefore, do not qualify to issue QSBS include professional-service, arts and entertainment businesses; insurance, financing, leasing, banking and investment companies; hospitality (hotels, restaurants, etc.) businesses; farms; and businesses entitled to depletion deductions (such as mining, oil and gas, and other mineral extraction businesses). Also excluded are those active businesses that immediately after the investment have a gross asset value of more than $50 million and, therefore, are not considered "small" for this purpose.

LLCs and other entities classified as partnerships for federal tax purposes are not completely left out from securing this tax break for their owners. Those entities may convert into C corporations (usually a fairly easy process) to have their future appreciation escape tax (i.e., only the owners' built-in gain at the time of conversion will be subject to tax when they later sell their QSBS), up to the above-described caps.

Hence, owners of existing companies that are LLCs or other entities classified as partnerships for federal tax purposes may be better suited to realize this tax break than existing C corporations that issued all or substantially all of their stock before September 27, 2010. However, those investors will want to weigh the benefits of maintaining flow-through status (e.g., one-level of tax on business earnings that are distributed to its owners, the ability to sell assets or the company itself at lower capital gains rates while allowing the purchaser of those assets or the company to receive a tax basis in those assets equal to the amount the purchaser directly or indirectly pays for them, and the ability to use company losses to reduce, subject to several limitations, the owners' taxable income from other sources) against the benefits of not having the future appreciation in their interest in the company subject to tax.

The ability to sell an asset for *cash* and not have to pay tax on the gain realized on the sale is extraordinary. This tax break was deliberately enacted by Congress to encourage investment in "active," "small" businesses. Every business owner who either has an investment in a small business (including a business that may otherwise not qualify but has a segment or division that may qualify) or is considering starting or investing in a small business should consider whether that business qualifies (or through restructuring or reorganization could qualify) for this tax break and, if it does, assess whether the ability to avoid tax on the sale of their investment outweighs the numerous, complex and, in some cases, unsettled compliance requirements and limitations and competing considerations of flow-through taxation.

For additional information, contact Warren Kean at wkean@slk-law.com ***or 1-800-797-9646, ext. 2906.***