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Capital Gains

Michael J. Knight, of Knight Rolleri Sheppard CPAs, examines requirements for taking advantage of tax code Section 1202's exclusion and deferral for gains on the sale of a qualifying small business. He focuses on the need to navigate the rules of other code sections in order to fully realize benefits available under Section 1202.

Editor's note: This article was updated Dec. 24 to include additional information regarding Section 338 elections.

Scylla, Charybdis and Tax Planning: Non-Featured Code Sections in Section 1202 Avoidance and Deferral of Gain

BY MICHAEL J. KNIGHT

Like Scylla and Charybdis, the twin monsters guarding the entrance of the straights of Messina, near Sicily, the twin goals of income and estate tax gain avoidance and deferral on the sale of a business represent danger for the tax professional unfamiliar with the treacherous currents of the tax code.

Successfully navigating complex tax codes is as daunting as Homer's Odyssey. Like Odysseus, all of a certified public accountant's guile with the non-featured Internal Revenue Code sections outside Section 1202 must be used to avoid the doom of a failed transaction.

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Twin Benefits, Surprise Dangers

Most CPAs are familiar with like-kind exchanges and code Section 1031, whose basic premise is to allow deferral of gain. Only upon death when property can get a stepped-up basis can deferral of income tax gain become permanent avoidance. But finally, serial entrepreneurs can feel like Donald Trump deferring gains on the sale of their assets and their companies, and they can trump Trump, getting tax avoidance while alive!

Code Section 1202 provides the twin benefits of tax avoidance (the $10 million exemption)[1] and tax deferral (the rollover feature if proceeds are invested in an active trade or business).[2] With the proper planning, income and estate tax are avoided!

We can only wish this code section is made permanent as Section 1031 has been. However, these two features, avoidance and deferral, like the twin monsters guarding the straights of Messina, contain surprise dangers.

For tax avoidance, the dangers include:

[1] Exemption is the greater of $10 million or 10 times the taxpayer's basis in the stock. Section 1202(b)(1)(A) and (B). Exemption is 50 percent, 75 percent or 100 percent depending on the acquisition date. Pub. L. No. 111-312, 2010.

[2] Certain businesses are excluded from exemption and deferral benefits. Section 1202(e)(3).

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Hidden Code Considerations

There are multiple code sections that can come into play when structuring a transaction involving Section 1202's preferences for qualified small business sales, including:

- **Section 351.** Before entering a binding contract, a nonqualifying entity can incorporate in order to take advantage of Section 1202.
- **Section 1045.** Rollover provisions are key to deferrals available under Section 1202.
- **Section 338.** A Section 338(h)(10) election can bring buyer and seller together on terms, but can also raise questions.

- Does your business qualify as an active trade or business, as defined in Section 1202?
- Has it been held for the requisite five years?
- Is it a C corporation?
- Is the shareholder an individual, partnership, S corporation or trust?

For tax deferral, dangers include:

- Have you invested or are you invested in a qualifying active trade or business, as defined in Section 1202?
- Have you adhered to the 60-day rollover limitation?
- Have you properly adjusted your basis in the new business, if a rollover?

Tax Avoidance Strategy

If the tax professional is truly guiding the seller to the maximum result, all other aspects of a transaction must be analyzed or Odysseus's successful return to Ithaca will never be realized. Thus the following non-featured code sections in 1202 may come into play.

Question: If I am a Schedule C filer, partnership or S corporation, may I avail myself of Section 1202 benefits?

Answer: Yes, but know the pitfalls.

Question: If I am doing estate planning, may I still achieve Section 1202 benefits?

Answer: Yes, but know the pitfalls.

Question: If I want a stock sale, but the buyer wants an asset sale, may I still use Section 1202 benefits?

Answer: Yes, but know the pitfalls and a private letter ruling may be needed.

So let us use an example of a single member limited liability company or S corporation owner who wants to sell his business for $30 million. To accomplish tax avoidance, the first question is, is it a business that qualifies under Section 1202? The answer is yes, subject to the qualifiers referenced in footnote 2.

But being a non-C corporation business how can I qualify? As the title implies, this is one of the non-featured code sections not mentioned in Section 1202. Instead, we utilize code Section 351 for a tax-free incorporation, which most of us are familiar with. However, a monster lurks in this new seemingly safe move.

As I learned when a client was told by a Big Four accounting firm that there was no way his partnership was able to achieve a tax-free transaction with Medtronic Inc., and I used a Section 351 transaction to accomplish it.

The key, as told to me by the Internal Revenue Service Section 351 counsel, was that there was no binding contract, a rule espoused by *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025, (1976). As long as there was no binding contract the partnership was free to incorporate and then use the provisions of Section 368 to accomplish the tax-free transaction. There would be no danger in the step transaction doctrine or form over substance to derail the deal.

Providing the business has been held for five years, then the first three hurdles in the tax avoidance list—a qualified small business, five-year holding and C corporation status—have been cleared. But what about the fourth?

The transaction described above was about a partnership or S corporation qualifying as a C corporation. But what if we threw in an estate planning curveball to deal with on the fourth requirement, so that a trust becomes an eligible shareholder? I dealt with that monster by considering an irrevocably defective grantor trust. The end result is the grantor retains his or her revocable basis status as to the income, but gets irrevocable estate tax avoidance.

So is it possible that using the estate tax exemption of a husband and a wife, one can save up to $7.5 million in estate taxes? The answer is yes, yes and yes.

Let us see how: My valuation knowledge tells me that when gifting a minority interest to an irrevocable trust, the valuator can consider marketability, liquidity and minority discounts. Let us assume marketability is 15 percent and minority is 20 percent. Ignoring that in this situation, a liquidity event is imminent, an adviser may tend to reduce the marketability discount and possibly just use the minority discount.

But let us assume the full 35 percent discount to show how an estate in a 50 percent bracket can save $7.5 million. Assume the joint estate tax exemption is $10 million. With a 35 percent discount, the value of the gift removed from the estate is $15,384,615 ($10 million/65 percent). Because the sale is imminent, there are no income tax savings. But at a 50 percent estate tax rate, the taxpayer has saved $7,692,000 in estate taxes! And the trust is an eligible shareholder!

Tax Deferral Strategy

Now to the rollover technique under Section 1202. The above tax avoidance steps permanently save $10 million in gains. What about the other $20 million? The rollover provisions under Sections 1202 and 1045 are the way out.

Assume all the facts above, that is:

- It is a qualified small business.
- There are eligible shareholders.
- The business is a C corporation.
- The stock has been held for five years.

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If the shareholders meet the 60-day rollover rule, the taxpayer can defer $20 million in gain. So in summary, almost $17 million in tax savings can be achieved as follows:

- Income tax savings on $30 million of gain ($30 million x 30 percent = $9 million).

- Estate tax savings of $7.7 million, for a total of $16.7 million.

Are we finished? Not yet. Section 1202 helped us avoid the twin monsters of income and estate taxes. The final and possibly most important monster lurks in the waters of the Messina. How do we get the buyer and seller to agree to all of this?

I find the hardest part of putting a deal together is getting the seller and buyer on the same page. The seller wants capital gains via a stock sale and the buyer wants a step up in basis via an asset sale. With the transaction occurring through a C corporation, those mutually competing goals are hard to accomplish.

Section 338(h)(10)

Let me introduce the most important non-featured code section not in Section 1202, Section 338. Most of us are generally aware that with a Section 338 election, a buyer can get a step up in basis, but the cost is paying tax on the gain. The seller of course gets his capital gain, but at a cost. You can bet the buyer will negotiate a reduction in sales price. There is no such thing in life as a free Trump!

But what if we used a Section 338(h)(10) election? Doesn't that shift the gain to the seller? But is there a gain if the seller then avails himself or herself of Section 1202 and the tax avoidance and deferral features of the code section?

The lurking monster is the following: Do we meet the rule that the seller must be a non-corporate seller? Since Section 338 elections are all about a ''phantom'' asset transaction, in the end isn't it really the individual owner still deemed the seller of the stock even though the phantom asset sale is allowed?

As with the Section 351 comments above, I checked with the IRS counsel who heads up Section 1202, regarding whether a Section 338 (h)(10) transaction stays within the boundaries of Section 1202 and the stock sale rules. He affirmed that because a 338 transaction is in essence a stock transaction allowed to be treated as an asset sale (the phantom asset sale), it would in all likelihood comport with Section 1202 rules.

Conclusion

Most people call the 77,000 pages of the I.R.C. a monster. Knowing how to navigate between the monsters Scylla and Charybdis will leave tax professionals' clients smiling.