Tax Strategies for the Sale of a Business

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A number of strategies can improve the tax consequences when a business is sold. These include: (1) basic installment sales, (2) special two-year installment sales, (3) Section 1202 qualified small business stock, (4) Section 1045 stock, (5) Section 1244 stock sales, (6) sales to incomplete gift non-grantor (ING) trusts, and (7) sales by charitable remainder trusts. If the business is a corporation, another important planning consideration is deciding whether to do a stock sale or an asset sale.

BASIC INSTALLMENT SALE
Perhaps the most basic tax planning strategy for the sale of a business is using an installment sale.1 The benefits of an installment sale include the following:

- The seller receives a predictable income stream.
- Income is spread out, so it remains in a lower income tax bracket.
- The net investment income tax is lower.
- It generates interest income for the seller.
- The financial burden on the buyer is reduced by dispersing the payments.

TWO-YEAR INSTALLMENT SALE
Taxpayers can create a timing mismatch between the realization of appreciation and the realization of capital gain by using a double sale strategy.

Example 1. Parent (P) sells Greenacre with a basis of $500,000 and a fair market value (FMV) of $1 million to a trust for P’s children (CT). P takes back a 10-year note calling for 10 annual principal payments of $100,000 and adequate stated interest. CT’s basis in Greenacre is $1 million, the amount of the note. In the first two years, CT makes payments of $100,000 to P and P recognizes $50,000 of gain on each payment. After making the second payment, CT sells Greenacre to an unrelated party for $1 million and recognizes no gain because CT’s basis is equal to the selling price. CT has cashed out the full $1 million value of Greenacre even though P has paid tax on only $100,000 of the gain. CT will continue to pay off the note during the next eight years and P will recognize the remaining gain only as the payments are received, creating a substantial timing advantage for the family.

Two qualifications should be noted. First, if P hasn’t received the full price on the first sale, CT must wait at least two years before making the second sale to avoid acceleration of gain recognition by P under Internal Revenue Code (IRC) Section 453(e). If marketable securities are sold, P’s gain is accelerated regardless of the time period between the two sales. In addition, the two-year grace period is suspended for any time during which the related person’s risk of loss is substantially diminished, for example, by holding a put option with respect to the property.2

SECTION 1202 GAIN EXCLUSION
Section 1202 provides a gain exclusion for qualified small business stock (QSBS) held for more than five years.3 For QSBS acquired from August 9, 1993, to February 17, 2009, the exclusion percentage is 50 percent; for QSBS acquired from February 18, 2009, to September 27, 2010, the exclusion percentage is 75 percent; and for QSBS acquired after September 27, 2010, the exclusion percentage is 100 percent.

Amount of gain exclusion
Although 100 percent of the gain from QSBS can now be excluded, the amount is capped at the greater of:

- $10 million ($5 million for a married taxpayer filing separately) reduced by the aggregate eligible gain taken into account by the taxpayer for prior tax years attributable to dispositions of stock issued by the corporation, or
- 10 times the aggregate adjusted bases of QSBS issued by such corporation and disposed of by the taxpayer during the tax year.4

QSBS requirements
To be considered QSBS, the stock must meet the following requirements:

- It must be the stock of a C corporation.
- The stock must have been issued originally after August 10, 1993.
- As of the date of issuance, and for substantially all of the taxpayer’s holding period, the corporation must be a qualified small business.
- The stock must be acquired by the taxpayer at its original issuance (directly or through an underwriter) in exchange for money or other property (not including stock), or as compensation for services provided to the corporation (other than services performed as an underwriter of the stock).5
**Active business requirement**
The corporation issuing the stock must be an active business during substantially all of the taxpayer's holding period. A corporation meets this requirement if during this period at least 80 percent (by value) of its assets are used in the active conduct of one or more active trades or businesses.

**Eligible corporation**
An eligible corporation is any domestic corporation other than: (1) a domestic international sales corporation (DISC) or former DISC, (2) a corporation with respect to which an election under Section 936 is in effect or that has a direct or indirect subsidiary with respect to which such an election is in effect, (3) a regulated investment company, real estate investment trust, real estate mortgage investment conduit, or financial asset securitization investment trust, or (4) a cooperative.

**Qualified small business**
The stock must be issued by a qualified small business. A corporation is a qualified small business if the aggregate value of its net assets never exceeded $50 million either between August 10, 1993, and the date the stock was issued or immediately after issuance (taking into account the amounts received in the issuance).

**Original issue requirement**
To qualify, stock must be acquired at its original issuance for money, other property, or services rendered to the corporation. A transferee is treated as receiving stock in the same manner as the transferor and holding the stock for the same period as the transferor if the stock is received by gift, at death, or in certain transfers from a partnership. The purpose of the original issuance requirement is to encourage taxpayers to invest new money into high-risk businesses.

**SECTION 1045 STOCK**
Taxpayers who have held QSBS for more than six months but can't qualify for Section 1202 gain exclusion may be able to defer some or all of the gain under Section 1045. If the taxpayer sells QSBS and purchases other QSBS within 60 days after the sale, the taxpayer can defer gain recognition on the old QSBS to the extent that the sale proceeds don't exceed the cost of the replacement stock. The deferred gain reduces the basis of the new stock.

**Example 2.** T buys ABC stock for $1 million in 2020. ABC is a QSBS. In 2023, T sells the stock for $7 million. Section 1202 doesn't apply because T doesn't satisfy the five-year holding period requirement. Within 60 days after the sale, T purchases XYZ stock, also QSBS, for $4 million. T realizes a $6-million gain on the sale of the ABC stock ($7 million - $1 million). T recognizes $3 million of the gain ($7 million realized on sale of ABC stock - $4 million cost of new QSBS). T must reduce the basis of the XYZ stock by $3 million ($6 million realized gain - $3 million gain recognized). This gives T a basis of $1 million in the XYZ stock ($4 million cost basis - $3 million deferred gain).

Section 1045 deferral can be used in combination with Section 1202.

**Example 3.** In 2017, T buys stock in XYZ, a QSBS, for $1 million. In 2021, T sells the stock for $14 million. T can exclude $10 million from gain under Section 1202. T also can defer the remaining $3 million of gain by doing a Section 1045 rollover.

**SECTION 1244 STOCK**
Section 1244 allows individuals and partnerships to convert losses on the sale of a small business from a capital loss to an ordinary loss. The maximum amount that can be treated as an ordinary loss generally is $50,000 but increases to $100,000 for married taxpayers filing jointly. Losses more than these amounts are capital losses.

**Example 4.** In 2020, T contributed $160,000 to the corporation and took back stock qualifying as Section 1244 stock. The business performed poorly and T sold the stock to an unrelated party for $40,000 in 2023. T has a $120,000 tax loss on the sale ($160,000 - $40,000). T files a joint return with a spouse S. Assuming they have adequate taxable income, T and S can claim a $120,000 ordinary loss under Section 1244 in 2023.

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**INCOMPLETE GIFT NON-GRANTOR TRUST**
Taxpayers in high-income tax states with highly appreciated assets should consider transferring assets to a trust in a state that doesn't tax trust income.

**Example 5.** T, a resident of a state taxing long-term capital gains at 7 percent, owns stock with a basis of $100,000 and FMV of $1.1 million. If T transferred the stock to a trust in a state that didn't tax capital gains, T could save $70,000 on state capital gains tax (0.07 × $1 million gain).

**Mechanics of the strategy**
To accomplish the desired results, the transaction generally must be structured to meet all the following requirements:
The trust must be created in an appropriate state.

The income from the trust must not be taxable by the grantor’s home state.

The trust must allow discretionary distributions to the settlor without making the trust a grantor trust.

Transfers to the trust generally should be structured as incomplete gifts for federal gift tax purposes without making the trust a grantor trust.

**Appropriate trust situs**
The ING trust must be set up in a state that (1) doesn’t tax trust income, (2) has a domestic asset protection trust statute, and (3) allows the settlor to retain a lifetime and testamentary special power of appointment. Nevada is one of the most popular states for ING trusts. Other states that work include Alaska, Delaware, Ohio, South Dakota, and Wyoming.  

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**Trust not subject to tax in the settlor’s home state**
Locating the trust in a state that doesn’t tax trust income doesn’t help if the trust income is taxed in the settlor’s home state. Some states treat trusts as resident trusts if the grantor was a state resident when the trust became irrevocable, regardless of where the trust is located. Other states treat out-of-state trusts as resident trusts if the trust is administered in the state, has in-state trustees, or has in-state beneficiaries.

**Discretionary distributions to the settlor**
The trustee generally should be given the power to make discretionary distributions to the settlor so that the settlor can receive the trust income. However, this must be accomplished without making the trust a grantor trust. Otherwise, the trust income would be taxed in the grantor’s home state.

**Incomplete gift**
Gifts to the trust are made incomplete for tax purposes by giving the donor both a lifetime and a testamentary special power of appointment.

**Charitable Remainder Trust**
Contributing property to a charitable remainder trust (CRT) and having the CRT sell it can be very useful for a taxpayer who wants to sell a business with a large capital gain. No gain is recognized when the CRT sells the property because the CRT is a tax-exempt entity. Thus, the full FMV of the property can be reinvested and not just the after-tax proceeds.

The gain realized by the trust on the sale is taxed to the grantor, but only as the annuity or unitrust payments are received, providing substantial tax deferral. This enables the seller to spread gain recognition over several years. Moreover, the donor receives gift-- and income--tax charitable deductions for the present value of the remainder interest and the lead interest isn’t subject to gift tax because the donor still owns it. A possible downside is that the present value of the charity’s remainder interest must be at least 10 percent of the value of the assets transferred to the trust.

It should be noted, however, that unless Section 7520 rates increase significantly, this strategy generally should be used only if the business owner has strong charitable intent. The higher the Section 7520 rate, the larger the annuity payments will be. Given the current 4.6--percent rate, a seller generally could accumulate significantly more wealth by selling the property and reinvesting the proceeds than by contributing it to a CRT and having the CRT sell it.

Consider the following examples.

**Example 6.** T owns XYZ stock with a basis of $100,000 and FMV of $1.1 million. T sells the stock in July 2023, recognizing a gain of $1 million. Assume that T is in a 30--percent combined federal and state income tax bracket for long--term capital gains and a 50--percent bracket for ordinary income. The after--tax proceeds from the sale are $800,000. T reinvests this $800,000 at a 7--percent after--tax rate of return. After 20 years, the sale proceeds grow to $3,095,748.

**Example 7.** Now suppose that instead of selling the stock, T contributes it to a 20--year charitable remainder annuity trust (CRAT) in July 2023 when the most favorable Section 7520 rate is 4.6 percent. T sets the value of the charity’s remainder interest at the minimum 10--percent value allowed under the tax code and retains the right to receive an annuity of $76,768 per year. Assume that all annuity payments come from the CRAT’s capital gains, both from the sale of the XYZ stock and from later reinvestments of the sale proceeds. Given T’s 30--percent capital gains rate, T’s annuity payments are $53,738 after tax (0.7 × $76,768). Again, assuming a 7--percent after--tax rate of return, the payment stream grows to $2,203,016 after 20 years. T also has the future value of a charitable income tax deduction. The value of the charitable remainder interest in the CRAT is set equal to the minimum 10--percent value required under IRC Section 664(d)(1)(D). Given T’s 50--percent federal and state bracket for ordinary income, the charitable deduction saves T $55,000 [0.5 × (0.1 × $1,100,000)] in the year the CRAT is created. Assuming the same 7--percent after--tax growth rate, this $55,000 grows to $212,833 after 20 years. This makes T’s total future value from the XYZ stock at the end of 20 years $2,415,849 ($2,203,016 + $212,833), substantially less than the $3,095,748 T would have in the sale and reinvestment scenario.
The current 4.6-percent Section 7520 rate is simply too low to make a stock sale by a CRAT produce more wealth than reinvestment of the sale proceeds in other assets under these facts. What if the Section 7520 rate increases though?

Under the general fact pattern described above, the breakeven Section 7520 rate is slightly less than 8 percent. With an 8-percent Section 7520 rate, the maximum yearly annuity payment that can be made without violating the 10-percent minimum remainder value requirement is $100,834. This makes the after-tax annuity payments to T $70,584 (0.7 × $100,834). The future value of $70,584 annual payments appreciated at 7 percent for 20 years is $2,893,626. Adding the $212,833 future value of the charitable deduction increases the total value of the CRAT alternative to $3,106,459 ($2,893,626 + $212,833). This is just slightly more than the $3,095,748 future value in the sell and reinvest scenario described above. If we assume a 10-percent Section 7520 rate, the total wealth in the CRAT alternative after 20 years is $3,336,123 ($3,336,123 + $212,833), substantially more than the $3,095,748 in the sell and reinvest scenario. If Section 7520 rates increase substantially in the future, the charitable remainder trust strategy might be desirable even if the taxpayer has no charitable intent.

**STOCK SALE VS. ASSET SALE**

The seller of a corporation generally prefers to sell stock and the buyer prefers to buy assets. Stock sales are attractive to the seller because of eligibility for installment reporting of the gain and, in most cases, the ability to report the entire gain as a capital gain rather than reporting depreciation and other recapture items as ordinary income. Moreover, an asset sale has important disadvantages for a seller: (1) the seller has to deal with assets the buyer doesn’t want; (2) if the seller is a C corporation or an S corporation with built-in gains, an asset sale might result in double taxation; and (3) the seller may be unable to transfer contracts and other agreements to the buyer that would automatically transfer in a stock sale.

But an asset sale also might have important advantages for a seller.

An asset sale makes it easier for a seller to retain intangible assets such as copyrights, patents, trademarks, or a line of business. Also, the seller generally won’t have to provide as many warranties or guarantees to the buyer because the corporate assets of the seller wouldn’t carry over to the buyer.

Asset purchases are also attractive for buyers. Favorable tax attributes of the seller might not carry over to the buyer like they would with a stock sale. Moreover, the buyer would have to bargain separately for other favorable attributes of the seller such as copyrights, patents, and trademarks.

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**ENDNOTES**

1. IRC Section 453.
2. The term “related person” includes the same persons and entities described in the attribution rules of IRC § 318 and the related party rules of IRC § 267(b). Thus, it includes the original seller’s spouse, siblings, lineal descendants, and ancestors. It also includes certain partnerships, trusts, estates, and corporations.
3. IRC Section 1202(a).
4. IRC Section 1202(b)(1).
5. IRC Section 1202(c)(1).
6. IRC Section 1202(c)(2).
7. IRC Section 1202(e)(1).
8. IRC Section 1202(e)(4).
9. IRC Section 1202(d)(1).
10. IRC Section 1202(c)(1)(B).
11. IRC Section 1202(h)(1) and 1202(h)(2).
12. The term qualified small business stock has the same meaning for purposes of Section 1045 that it has for purposes of Section 1202.
13. IRC Section 1244(a).
14. IRC Section 1244(b).
15. IRC Section 1244(c)(3)(A).
16. Tennessee and a few other states also may qualify.
17. IRC Section 664(d)(1)(D).