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Income Insights: Rolling Over Qualified Small Business Gains

Income Insights is a series designed to quickly describe important income tax concepts for advisors and their clients.

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Rolling Over Qualified Small Business Gains

Section 1045 of the Internal Revenue Code (IRC) was enacted to incentivize taxpayers to invest in small businesses. It allows the rollover of capital gains earned from selling qualified small business (QSB) stock if these two requirements are met: the taxpayer owned the stock for over 6 months *and* reinvested the proceeds in other another QSB within 60 days of the date of sale.

For purposes of Section 1045, a QSB is a business that meets these criteria:

- The company must be taxed as a domestic C corporation.
- For stock issued prior to July 4, 2025, the company's aggregate gross assets must not exceed $50 million before and immediately after the stock issuance.
- For stock issued on or after July 4, 2025, the company's aggregate gross assets must not exceed $75 million (to be adjusted annually for inflation) before and immediately after the stock issuance.
- The company must be engaged in a qualifying trade or business, and 80% of the company's assets must be used in actively conducting one or more qualifying trades or businesses.

Per the IRC, a qualifying trade or business does *not* include businesses primarily engaged in performing services in certain fields, including health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business in which the principal asset is the reputation or skill of one or more of its employees. The definition of a qualifying trade or business also excludes any banking, insurance, financing, leasing, investing, or farming businesses and any hotel, motel, or restaurant.

In order to obtain the Section 1045's rollover benefit, taxpayers must make an election on or before the due date (including extensions) for filing their income tax return for the tax year in which their QSB stock was sold.

While Section 1045 bears many similarities to Section 1202, a key difference is that Section 1045 provides a tax *deferral* while Section 1202 provides a tax *exclusion*. Section 1045 may also provide a benefit to QSB shareholders who don't meet the requirements to benefit—either fully or partially—from Section 1202. For example, a QSB shareholder who hasn't held the stock for the holding period that Section 1202 requires might be able to benefit from a Section 1045 deferral—and may even be able to use the 1045 deferral to extend his holding period long enough to ultimately qualify for Section 1202's gain exclusion.

Alternatively, a QSB shareholder whose gain exceeds her Section 1202 per-issuer gain limitation might benefit from the Section 1045 deferral for all or a portion of her excess gains.

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