

#36: Qualified Small Business Stock

IRC section 1202 allows non-corporate taxpayers to exclude 50%, 75%, or 100% of any gain from the sale or exchange of qualified small business stock (QSBS) held for more than five years. The exclusion percentage is—

- 50% if the QSBS was acquired before February 18, 2009,
- 75% if the QSBS was acquired after February 17, 2009, and before September 28, 2010, and
- 100% if the QSBS was/is acquired after September 27, 2010.

QSBS Requirements

QSBS stock is stock that meets the following requirements—

- The stock was issued after August 10, 1993¹⁶⁸
- The issuer of the stock was a “qualified small business” when the stock was issued.¹⁶⁹
A qualified small business is—
 - a domestic C corporation;
 - with assets totaling \$50 million or less at all times after August 10, 1993 and before the date of issuance;
 - that agrees to submit reports to the IRS verifying compliance with the \$50 million requirement.¹⁷⁰
- The taxpayer acquired the stock at original issuance in exchange for money or property other than stock or as compensation for services to the corporation (other than as underwriter of the stock).¹⁷¹ Certain conversions of stock¹⁷² or tax-free transfers may also qualify.¹⁷³
- The corporation meets an active business requirement on the stock issuance date and during substantially all of the taxpayer’s holding period for the stock.¹⁷⁴
 - Active business requirement—at least 80% of the value of the corporation’s assets are used in the active conduct of one or more qualified trades or businesses and such corporation is an eligible corporation.¹⁷⁵
 - Qualified trade or business requirement—a qualified trade or business is any business other than—
 - Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset

¹⁶⁸ IRC § 1202(c)(1).

¹⁶⁹ IRC § 1202(c)(1)(A).

¹⁷⁰ IRC § 1202(d)(1).

¹⁷¹ IRC § 1202(c)(1)(B).

¹⁷² IRC § 1202(f).

¹⁷³ IRC § 1202(h).

¹⁷⁴ IRC § 1202(c)(2)(A).

¹⁷⁵ IRC § 1202(e)(1).

- of such trade or business is the reputation or skill of one or more of its employees,
 - Any banking, insurance, financing, leasing, investing or similar business,
 - Any farming business,
 - Any business involving the production or extraction of products subject to percentage depletion, and
 - Any business of operating a hotel, motel, restaurant or similar business.¹⁷⁶
- Eligible corporation—an eligible corporation is any domestic corporation other than—
 - A DISC or former DISC, a REIT, a REMIC, a regulated investment company, a cooperative or a corporation with respect to which an IRC § 936 election is in effect (relating to the Puerto Rico and Possession Tax Credit).

Pass-Through Entities

If a pass-through entity owns QSBS, gain on the disposition of the stock passes through to the entity's owners. The \$10 million gain limitation is applied separately for each partner, shareholder or beneficiary. To qualify for QSBS treatment, the stock must be QSBS in the hands of the entity and the taxpayer must have held an interest in the entity on the date the stock was acquired and at all times thereafter before the disposition of the stock.¹⁷⁷

Anti-Avoidance Rules

The purpose of IRC § 1202 was to encourage investment in small business corporations. Thus, anti-avoidance rules were necessary to prevent corporations from redeeming existing stock and reissuing it under § 1202.

IRC § 1202(c)(3)(A) provides that stock acquired by a taxpayer is not QSBS if, at any time during the four-year period beginning two years before the issuance of such stock, the corporation issuing the stock purchased (directly or indirectly) any of its stock from the taxpayer or from a related person (within the meaning of § 267(b) or § 707(b)).

IRC § 1202(c)(3)(B) provides that stock issued by a corporation is not QSBS if, during the two-year period beginning one year before the issuance of such stock, the corporation made any purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of its stock as of the beginning of the two-year period.

There are two exceptions to these rules. First, a corporation can redeem de minimis amounts of stock. Under this exception, stock acquired from the taxpayer or a related person exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds \$10,000 and more than two

¹⁷⁶ IRC § 1202(e)(3).

¹⁷⁷ IRC § 1202(g).

percent of the stock owned by the taxpayer and related persons is acquired.¹⁷⁸ Second, there is an exception for redemptions due to termination of services, death, disability or mental incompetency and divorce.¹⁷⁹

Amount of Excludable Gain

The total gain that can be excluded is generally limited to \$10 million per taxpayer, or \$5 million for married taxpayers filing separately. If the spouses file jointly, they share a single \$10 million exclusion amount. In the case of pass-through entities, the \$10 million gain limitation is applied separately for each partner, shareholder or beneficiary.

Tax Planning

Planning to maximize the benefits of the QSBS exclusion involves the following questions—

- (1) Does stock lose its QSBS status if it is gifted or bequeathed?
- (2) Can a trust claim an exclusion amount on the sale of QSBS?
- (3) Does stock lose its QSBS status if it is transferred to an incomplete gift non-grantor (ING) trust?
- (4) Can an individual claim a \$10 million exemption amount for himself or herself and create an irrevocable trust to claim a second \$10 million exclusion amount?
- (5) If an individual transfers QSBS stock to two or more trusts, will IRC § 643(f) apply, treating the trusts as a single trust and barring more than one \$10 million exclusion amount?
- (6) Can a pass-through entity be incorporated to enable its owners to take advantage of IRC § 1202?
- (7) Can the required business activities be conducted through a subsidiary?
- (8) Can gain be rolled over into a replacement QSBS?

Gift or Bequest of QSBS

IRC § 1202(h)(2)(A) provides that if stock is received by gift or bequest, the transferee is treated as having acquired the stock in the same manner as the transferor and having held such stock during the period held by the transferor. This means that, assuming that the stock would meet all the requirements for QSBS treatment if it was sold by the donor, it will also qualify for QSBS treatment if sold by the donee.

Trusts and QSBS

Unfortunately, Congress didn't address trusts in the statute or in its legislative history, nor did the IRS mention them in its regulations. IRC § 1202(g) provides that if a pass-through entity holds QSBS, the exclusion on a sale of the stock passes through to the entity's owners in proportion to their ownership percentages. This section lists only partnerships, S corporations, regulated investment companies and common trust funds as pass-through entities, however. Thus, because a

¹⁷⁸ Reg. § 1.1202-2(a)(2).

¹⁷⁹ Reg. § 1.1202-2(d).

trust is a non-corporate taxpayer and isn't included as a pass-through entity, there is a strong argument that a trust could claim a QSBS exclusion at the entity level. Note that if a trust is a simple trust its income would pass through in much the same way as it would in a partnership or S corporation, but this wouldn't be the case for a complex trust.

ING Trust

ING trusts have become the favorite strategy for avoiding state income tax. As the name indicates, transfers to an ING trust are incomplete gifts. This raises the question of whether an incomplete gift qualifies for the special gift rule under IRC § 1202(h)(2)(A) explained above. There is no guidance on whether IRC § 1202(h)(2)(A) applies only to completed gifts or also includes incomplete gifts. A plausible argument could be made that the gift exception should also apply to ING trusts—

- The statute doesn't say that the gift must be complete for gift tax purposes.
- It would be treated as a gift for state property law purposes.
- It would shift income tax exposure from the grantor to the trust.
- It would be treated as a gift for income tax purposes.
- Because IRC § 1202 is an income tax provision and not a gift tax provision, whether there was a completed gift for gift tax purposes would seem to be irrelevant.
- The rationale for the special gift/bequest rule under IRC § 1202(h) is that the listed transfers are income tax-free. A gratuitous transfer to a trust would ordinarily be tax-free regardless of whether it was a completed gift for federal gift tax purposes.

Exclusion Amount for Both a Trust and an Individual

For taxpayers with large holdings of stock, the exclusion amount could be doubled if an individual and a trust could transfer stock to a trust and both the individual and the trust could claim a \$10 million exclusion. There appear to be no treasury regulations, private letter rulings or cases on the question of whether an individual can claim an exclusion amount for himself or herself and a second exclusion amount for a trust. A phone conference with Chief Counsel confirmed that there is no law on this issue. The IRS considered drafting regulations on the subject but decided not to. This was apparently because such regulations would be complex and time consuming and there was far less interest in § 1202 when the exclusion was only 50%.

IRC § 1202(g) states that in the case of pass-through entities (partnerships, S corporations, regulated investment companies or common trust funds) the \$10 million gain limitation is applied separately for each partner, shareholder or beneficiary. In other words, the relevant taxpayers for applying the \$10 million limitation are individuals rather than the pass-through entities. This would prevent a taxpayer from creating multiple partnerships or S corporations, RICs or common trust funds to obtain more than one \$10 million exclusion amount. No matter how many of such entities the taxpayer created, she would be entitled to only one exemption amount. As explained above, however, § 1202(g) doesn't include trusts as a pass-through entity.

An argument could be made that there is substantial authority for claiming a second exclusion. Reg. § 1.6662-4(d)(3)(ii) lists the types of authority that can be used to establish a reasonable basis for a position or substantial authority. These include, for example, the Tax Code, regulations, cases, revenue rulings, etc. Under our facts, there is no applicable law other than the Tax Code. Reg. §

1.6662-4(d)(3)(ii) indicates, however, that the Tax Code may be sufficient by itself to establish substantial authority. It provides in relevant part as follows—

There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

The conclusion that a \$10 million exclusion amount should be available for both an individual and a trust created by the individual would seem to be a well-reasoned construction of IRC § 1202. First, the exclusion is said to apply to any non-corporate taxpayer and the individual and an irrevocable, non-grantor trust are separate taxpayers. Further, if Congress had intended for the exclusion amount to flow through to the trust beneficiaries it could have included trusts as pass-through entities under IRC § 1202(g). Nevertheless, caution is advised in using this strategy.

Multiple Trusts and IRC § 643(f)

IRC § 643(f) provides that two or more trusts shall be treated as one trust if—

- such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and
- a principal purpose of such trusts is the avoidance of income tax.

Thus, it appears that this section wouldn't cause trusts to be aggregated if they have different primary beneficiaries and different dispositive provisions. Trusts should also be treated as separate if there are important non-tax reasons for creating more than one trust.¹⁸⁰

Incorporating a Pass-Through Business

An LLC, partnership or S corporation can be converted to a C corporation and qualify for the § 1202 exclusion, but § 1202 only applies to post incorporation gain. Moreover, the stock must be held for five years after the incorporation. The IRS treats an LLC that elects to be taxed as a C corporation like any other C corporation for purposes of § 1202(a). In Revenue Procedure, 84-111, the IRS provided guidance on how to convert a partnership to a C corporation to take advantage of IRC

¹⁸⁰ Prop. Reg. § 1.199A-6 suggests that for purposes of the 20% deduction on passthrough income under IRC § 199A, IRS might try to completely disregard trusts even if they have different lead beneficiaries, different grantors or very different terms. This section reads as follows.

(v) Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount. Trusts formed or funded with a significant purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A. See also §1.643(f)-1 of the regulations.

Note that this provision is inconsistent with Prop. Reg. § 1.643(f)-1 in two ways. First, it makes a significant purpose of avoiding applicable threshold amounts the sole criteria for denying a tax benefit rather than requiring both a tax avoidance purpose and trust similarities. Second, it completely disregards trusts instead of aggregating them.

§ 1202.¹⁸¹ Note that a C corporation conversion is more favorable now that the C corporation tax rate has been lowered to 21%.

Conducting Business Activities Through a Subsidiary

IRC § 1202(e)(5) provides that the required business activities can be conducted through subsidiaries. If there is a disregarded entity between the holding company and the subsidiaries, the disregarded entity is ignored and the holding company is treated as conducting the business activities of the subsidiaries directly to the extent of its ownership interest in the subsidiaries (provided it owns more than 50%).

Rolling Over Gain into a Replacement QSBS

IRC § 1045 allows taxpayers who have held QSBS for at least six months to roll over gain into replacement QSBS if the replacement QSBS is purchased within 60 days of the sale of the QSBS. Gain is recognized only to the extent that the amount of the sale proceeds exceeds the cost of any QSBS purchased during the replacement period and any portion of such cost already used to shelter gain under § 1045 with other reinvestments.

¹⁸¹ 1984-2 C.B. 88.