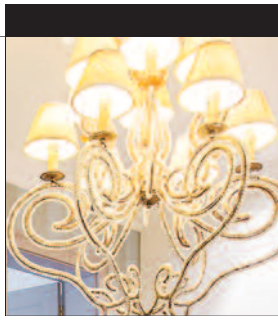

Maximize Qualified Small Business Stock Exclusion

Owners of closely held C corporations can reap significant tax savings by making use of the QSBS exclusion in their estate plans.

BENETTA P. JENSON AND STUART J. KOHN

The law informally known as the Tax Cuts and Jobs Act of 2017 (TCJA) breathed new life into the use of C corporations. The TCJA lowered the corporate income tax rate to a flat 21% (down from a top rate of 35%) and repealed the corporate alternative minimum tax. In addition, these new provisions are "permanent"—they do not sunset, as other provisions of the TCJA are scheduled to. As a result, the C corporation is a more attractive business vehicle than it used to be, particularly for businesses such as start-ups that do not expect to make substantial distributions to shareholders.

With the use of the C corporation structure comes an additional tax benefit—the potential availability of the qualified small business stock (QSBS) exclusion. The QSBS exclusion from capital gain was enacted in 1993 to spur investment in small business. Use of the exclusion has gained increased attention over the last 15 years or so among entrepreneurs, business owners, and investors in start-ups (such as venture capital and private equity funds and family offices interested in direct investments). During this period, the percentage of the QSBS exclusion increased and the differential between the effective capital gains tax rate for non-QSBS and QSBS widened. The fact that the QSBS exclusion became a permanent tax benefit in 2015 means that there are now significant estate planning opportunities associated with it. To understand the breadth of these opportunities, it is important to understand the requirements to qualify for QSBS status and the exclusion, tax benefits and considerations, and planning around QSBS.

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Overview of the QSBS exclusion

Section 1202 provides an incentive for taxpayers to invest in many types of small businesses by providing that some or all of the gains resulting from the sale of qualified small business stock can be realized tax-free.[1] Noncorporate taxpayers who acquire QSBS at original issuance and hold the stock for at least five years may be able to take advantage of this preferential tax treatment. Depending on the date of acquisition, the taxpayer may be eligible to exclude up to 100% of the gains, including an exclusion from the alternative minimum tax and the 3.8% Medicare surtax (i.e., net investment income tax).

Requirements

Under Section 1202, an individual shareholder generally is eligible for a full or partial exclusion on the gain from a sale or exchange of QSBS that *has been held for more than five*

years.[2] In order to qualify as QSBS, stock must be both of the following:

1. Issued by a *"qualified small business"* after 8/10/1993.[3]
2. *Acquired by the taxpayer at original issuance*, either purchased or received as compensation for services rendered.[4]

(Emphases added.) Both the business and the taxpayer must meet detailed requirements to qualify for the preferential tax treatment under Section 1202.

Definition of "qualified small business." A "qualified small business" (QSB) is a corporation that meets all of the following requirements:

1. *C corporation*. A domestic corporation organized as a C corporation for substantially all of the taxpayer's holding period for such stock.[5]
2. *Gross assets not more than $50 million*. The aggregate gross assets of the corporation (or any predecessor) do not exceed $50 million at or before the issuance of the taxpayer's stock.[6] Subject to certain exceptions, the gross assets test generally is based on tax basis, not fair market value.[7]
3. *Active trade or business*. During substantially all of the taxpayer's holding period for the stock, *at least 80% (by value) of the corporation's assets* have been used in the *active conduct of one or more qualified businesses*. (This determination of whether a business is an active trade or business is referred to below as the "active business assets test").[8]

80% of assets. The following rules apply for the 80%-of-assets requirement.

Subsidiaries:

1. For purposes of the 80%-of-assets requirement, stock and debt in a subsidiary corporation are disregarded and the parent corporation is deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities.[9]
2. A corporation is considered a subsidiary if the parent owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock of the corporation.[10]
3. The parent corporation will fail the active-business-assets test for any period during which more than 10% of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations that are not subsidiaries (as defined in item 2, above), other than assets described under the "working capital" exception (described below).[11]

Working capital exception:

1. Pursuant to the "working capital" exception, any assets held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or held for investment and are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business, will be treated as used in the active conduct of a qualified trade or business.[12]
2. However, for periods after the corporation has been in exis-

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1 This assumes that a Section 1045 rollover election (discussed below) has not been made.
2 Section 1202(a)(1). This assumes that the taxpayer does not hold any offsetting short positions as described in Section 1202(j).
3 Section 1202(c)(1).
4 *Id.* Certain qualified nonrecognition transfers will allow the transferee to retain the same benefits. The specific transfers are outlined in Section 1202(h), but include death, by gift, and certain transfers out of partnerships.
5 Sections 1202(d)(1) and 1202(c)(2)(A).
6 *Id.*
7 Section 1202(d)(2).
8 Sections 1202(c)(2)(A) and 1202(e). See also Steven B. Gorin, Part II.Q.7.j.ii. Limitation on Assets a Qualified Small Business May Hold, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (printed 6/29/2016), available by emailing the author at sgorin@thompsoncoburn.com.
9 Section 1202(e)(5)(A).
10 Section 1202(e)(5)(C).
11 Section 1202(e)(5)(B).
12 Section 1202(e)(6).
13 *Id.*
14 Section 1202(e)(7).
15 *Id.*
16 Section 1202(e)(8).
17 Section 1202(e)(1).
18 Section 1202(e)(3).
19 Ltr. Rul. 201436001.
20 *Id.*
21 *Id.*
22 Section 1202(c)(1)(B).
23 Section 1202(f).
24 Sections 1202(h)(1) and 1202(h)(2)(A) and (B).

tence for at least two years, no more than 50% of the assets of the corporation may qualify as used in the active conduct of a qualified trade or business by reason of this "working capital" exception.[13]

Real property:

1. A corporation also fails the active-business-assets test for any period during which more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business.[14]
2. For this purpose, the ownership of, dealing in, or renting of real property is not treated as the active conduct of a qualified trade or business.[15]

Computer software:

For purposes of the active business assets test, rights to computer software that produce active business computer software royalties (within the meaning of Section 543(d)(1)) are treated as an asset used in the active conduct of a trade or business.[16]

Active trade or business. For purposes of Section 1202, a qualified business is an active trade or business, excluding the following categories:[17]

1. Health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage.
2. Banking, insurance, financing, leasing, investing, or similar business.
3. Farming.
4. Mining or natural resource production or extraction.
5. Operating a hotel, restaurant, or similar business.[18]

Implied "service test." Section 1202 and the regulations promulgated thereunder provide limited guidance on what is a qualified "active trade or business," other than excluding the categories of businesses detailed above.

However, it appears that there is a "service test." If the business provides a service, then it likely is *not* a trade or business that qualifies as a qualified small business.[19] In Ltr. Rul. 201436001, the IRS explains that "the thrust of [Section] 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners)."[20]

But if the business offers value to customers using the company's physical assets (rather than offering services in the form of individual expertise), then the business might qualify as an active trade or business under Section 1202(e)(3). For example, the company at issue in Ltr. Rul. 201436001 provided products and services primarily in connection with the pharmaceutical industry, so the taxpayer was requesting a ruling on whether the business of the company was a qualified trade or business as defined in Section 1202(e)(3) notwithstanding the proximity of its business activities to the field of health.

Specifically, the company worked with clients to help commercialize experimental drugs. Because the company's activities involved the deployment of specific manufacturing assets and intellectual property assets of the company to create value for customers (rather than offering services in the form of individual expertise), the IRS ruled that the company was not performing services in the health industry within the meaning of Section 1202(e)(3).[21]

Acquisition by the taxpayer. As mentioned above, in order to qualify as QSBS, the stock must have been acquired by the taxpayer at the stock's original issue either in exchange for money or other property (not including stock) or as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).[22]

Exceptions. There are exceptions to this original issuance requirement. If stock is acquired by the taxpayer in the following ways, then the stock will qualify as QSBS if the other QSBS requirements also are met:

- *Acquired through conversion*. If any stock in the corporation is acquired solely through the conversion of other stock in the corporation which is QSBS in the hands of the taxpayer, then stock so acquired is treated as QSBS in the hands of the taxpayer and is treated as having been held during the period during which the converted stock was held.[23]
- *Acquired by gift or inheritance*. If any stock in the corporation is received as a transfer by gift or at death, the transferee is treated as having acquired the stock in the same manner as the transferor and having held the stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under these rules) by the transferor.[24]
- *Acquired from a partnership*. If any stock in the corporation is received as a transfer from a partnership and the pass-through entity requirements of Section 1202(g) (without regard to the five-year holding period requirement) are met, the transferee is treated as having acquired the stock in the same manner as the transferor and having held the stock during any continuous period immediately preceding the transfer during which it was

EXHIBIT 1
Excludable Gain and Effective Tax Rates on QSBS

Acquisition Date	Amount of Gain Excluded	Effective Rate	Effective AMT Rate
8/11/1993 to 2/17/2009	50%	15.90%	16.88%
2/18/2009 to 9/27/2010	75%	7.95%	9.42%
9/28/2010 or later	100%	0%	0%

EXHIBIT 2
Tom's Tax Liability

Acquisition Date	Amount of Gain Excluded	Applicable U.S. Tax Rate	U.S. Tax Due	If Tom is Subject to AMT, Total U.S. Tax Due
8/11/1993 to 2/17/2009	50% x $10,000,000 = $5,000,000	28% + 3.8%	$1,590,000	$1,688,000
2/18/2009 to 9/27/2010	75% x $10,000,000 = $7,500,000	28% + 3.8%	$795,000	$942,000
9/28/2010 or later	100% x $10,000,000 = $10,000,000	0%	$0	$0

held (or treated as held under these rules) by the transferor.[25]

1. Gain on QSBS held by a partnership, S corporation, or mutual fund is excludable if the entity held the stock for the requisite five-year period[26] and if the partner or shareholder to whom the gain passes through held an interest in the entity when the entity acquired the stock and at all times thereafter.[27]
2. The same exclusion limitations (the greater of $10 million or ten times basis rule) apply at the individual taxpayer level. The gain will be determined taking into account the taxpayer's share in the basis in the pass-through entity.[28] Any increase in the ownership of the entity after the date of acquisition of the QSBS will not be included in the calculation of excludable gain upon the sale of the QSBS.[29]
3. A partnership generally may distribute QSBS to its partners as long as the partner held his or her partnership interest when the stock was acquired. However, if QSBS is transferred to a partnership, which generally may be done in a nontaxable manner, and the partnership subsequently disposes of the QSBS, no part of the QSBS gain is excludable.

- *Section 351 formation or Section 368 reorganization.* In the case of a Section 351[30] formation or a Section 368 reorganization, if QSBS is exchanged for other stock which would not qualify as QSBS but for the provisions of Section 1202(h)(4), the other stock will be treated as QSBS acquired on the date on which the exchanged stock was acquired.[31] However, unless the stock is issued by a corporation which at the time of the transfer is a QSB, the Section 1202 exclusion will apply only to gain from the sale or exchange of stock treated as QSBS by reason of the preceding sentence only to the extent of the gain which would have been recognized at the time of the transfer described in the preceding sentence if Section 351 or 368 had not applied at such time.[32]

Waiting period in the case of certain redemptions. Stock acquired by a taxpayer will not be treated as QSBS if, at any time during the four-year period beginning on the date two years before the issuance of the stock, the corporation issuing the stock purchased (directly or indirectly) any of its stock from the tax-

25 Sections 1202(h)(1) and 1202(h)(2)(C).
26 Section 1202(g)(2)(A).
27 Section 1202(g)(2)(B).
28 Section 1202(g)(1)(B).
29 Section 1202(g)(3).
30 With respect to a Section 351 organization, Section 1202(h) will apply only if, immediately after the transaction, the corporation issuing the stock owns directly or indirectly stock representing control (within the meaning of Section 368(c)) of the corporation whose stock was exchanged. Section 1202(h)(4)(D).
31 Section 1202(h)(4).
32 Section 1202(h)(4)(B).
33 Section 1202(c)(3)(A).
34 Reg. 1.1202-2(a)(2).
35 Section 1202(c)(3)(B).
36 Reg 1.1202-2(a)(2).
37 Section 1202(b)(3)(A).
38 Section 1202(b)(1).
39 Sections 1202(a)(1), 1202(a)(3), and 1202(a)(4).
40 Sections 1(h)(4)(A)(ii) and 1(h)(7). These sections apply to both ordinary income tax and AMT.
41 Sections 1202(a)(4) and 57(a)(7).
42 The rates assume a $10 million stock position with a $0 basis, only U.S. taxes (including the 3.8% Medicare surtax), a minimum gain exclusion of $10 million, and the five-year holding period requirement is met. Effective AMT rate is shown for illustrative purposes. Whether a taxpayer will be subject to AMT will depend on the taxpayer's particular situation. The taxpayer should consult with his or her tax advisor to determine whether the taxpayer would be subject to the AMT tax.

payer or from a person related to the taxpayer (within the meaning of Section 267(b) or 707(b)).[33] The corresponding Treasury regulations, however, provide for a de minimis exception to this rule: The redemption restriction will apply only if the aggregate amount paid for the stock exceeds $10,000 and more than 2% of the stock held by the taxpayer and related persons is acquired.[34]

In addition, stock will not be treated as QSBS if, during the two-year period beginning on the date one year before the issuance of the stock, the corporation made one or more 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 that two-year period.[35] Again, the corresponding regulations provide for a de minimis exception.[36]

Five-year holding period. The rules relating to when the five-year holding period begins depends on the type of interest and how the stock was acquired. Some of those rules are as follows:

- *Options*. For stock acquired through the exercise of an option (e.g., a compensatory option), the company must pass the "qualified small business" test, and the individual's five-year holding period begins on exercise, not grant.
- *Restricted shares*. For stock acquired through the vesting of restricted shares or units, the company must pass the "qualified small business" test, and the individual's five-year holding period begins on vesting, not grant.
- *Section 83(b) election on unvested restricted stock*. If an employee made a Section 83(b) election on unvested restricted stock, the employee should be treated as receiving stock as of the Section 83(b) election date for purposes of both the "qualified small business" test for the company and the individual's five-year holding period.

U.S. taxation

The maximum gain from the sale of QSBS that may be excluded in a tax year for a particular issuer is limited to the *greater* of:

1. $10 million ($5 million for a married taxpayer filing separately[37]) less the sum of any gains already taken by the taxpayer for that specific issuer in previous tax years[38]; or
2. Ten times the taxpayer's adjusted cost basis of QSBS of the subject issuer disposed of during the tax year.[39]

Under Section 1202, the portion of a taxpayer's gain on the sale of QSBS that may be excluded, up to the above-described limits, depends on when the stock was acquired, provided that the five-year holding period is met. Listed below are some general rules on the taxation of gains on QSBS:

- Gains above the excludable amount, within the per issuer eligible gain limitation, are subject to the flat capital gains tax rate of 28%,[40] plus the 3.8% Medicare surtax applicable to unearned income.
- For shares acquired after 9/28/2010, the excluded gain is not subject to the AMT. For shares acquired before then, 7% of the excluded gain is treated as a "preference item" (i.e., it is added back to a taxpayer's income in computing his or her AMT) and, thus, is subject to AMT.[41] During periods when there was not a 100% exclusion, the AMT treatment and higher long-term capital gains rate can erode some of the benefit of the QSBS exclusion.
- Gains, if any, in excess of the $10 million eligible gain limitation will be taxed at the current long-term capital gains (LTCG) tax rate of 20%, plus the 3.8% Medicare surtax applicable to unearned income.

The chart in Exhibit 1 shows the amount of gain that is excluded and the effective tax rates on QSBS.[42]

Example. Tom Investor is married (files jointly) and has taxable income this year (aside from stock sales) of $500,000. Tom also sold stock this year in We Are Tech, Inc., realizing a long-term capital gain of $10 million. If Tom's stock in We Are Tech, Inc. does not qualify for the Section 1202 QSBS exclusion, Tom would owe U.S. tax of $2.38 million ((20% capital gains +3.8% Medicare surtax) x $10 million gain). If, however, Tom's stock in We Are Tech, Inc. does qualify for the QSBS exclusion, Tom would owe U.S. tax as shown in Exhibit 2.

Treatment of certain short positions. If an offsetting short position is entered into with regard to any QSBS position, Section 1202 will not apply to any gain from the sale

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EXHIBIT 3
State Tax Treatment of QSBS as of 4/15/2018

State	Personal Income Tax	Starting Point for Income Tax Liability	Capital Gains/Losses Recognized	QSBS Applicability (State Level)	QSBS Statute (if any)
AK	No	N/A	N/A	N/A	
AL	Yes	Gross income	Yes	Yes	
AR	Yes	Gross income	Yes	Yes	Ark. Code Ann. § 26-51-815 (West)
AZ	Yes	Federal adjusted gross income	Yes	Yes	
CA	Yes	Gross income	Yes	No	West's Ann.Cal.Rev. & T.Code § 18152
CO	Yes	Federal taxable income	Yes	Yes	
CT	Yes	Federal adjusted gross income	Yes	Yes	
DC	Yes	Federal gross income	Yes	Yes, with modification	D.C. Code Ann. § 47-1817.07 (West)
DE	Yes	Federal adjusted gross income	Yes	Yes	
FL	No	N/A	N/A	N/A	
GA	Yes	Federal adjusted gross income	Yes	Yes	
HI	Yes	Federal adjusted gross income	Yes	Yes, with modification	Haw. Rev. Stat. §235-2.45(e)
IA	Yes	Federal adjusted gross income	Yes	Yes	
ID	Yes	Federal adjusted gross income	Yes	Yes	
IL	Yes	Federal adjusted gross income	Yes	Yes	
IN	Yes	Federal adjusted gross income	Yes	Yes	
KS	Yes	Federal adjusted gross income	Yes	Yes	
KY	Yes	Federal adjusted gross income	Yes	Yes	
LA	Yes	Federal adjusted gross income	Yes	Yes	
MA	Yes	Federal gross income	Yes	Yes, with modification	Mass. Gen. Laws Ann. ch. 62, § 4 (West)
MD	Yes	Federal adjusted gross income	Yes	Yes	
ME	Yes	Federal adjusted gross income	Yes	Yes	
MI	Yes	Federal adjusted gross income	Yes	Yes	
MN	Yes	Federal taxable income	Yes	Yes	
MO	Yes	Federal adjusted gross income	Yes	Yes	
MS	Yes	Gross income	Yes (sale of stock in MS corps. not taxable)	No	Miss. Code Ann. § 27-7-9 (2016)
MT	Yes	Federal adjusted gross income	Yes	Yes	
NC	Yes	Federal adjusted gross income	Yes	Yes	
ND	Yes	Federal taxable income	Yes	Yes	
NE	Yes	Federal adjusted gross income	Yes	Yes	
NH	Yes	Gross income from interest and dividends	No	N/A	
NJ	Yes	Gross income	Yes	Yes, with add-back provision	N.J. Stat. Ann. § 54:8A-36 (West)
NM	Yes	Federal adjusted gross income	Yes	Yes	
NV	No	N/A	N/A	N/A	
NY	Yes	Federal adjusted gross income	Yes	Yes	N.Y. Tax Law § 612 (McKinney)
OH	Yes	Federal adjusted gross income	Yes	Yes	
OK	Yes	Federal adjusted gross income	Yes	Yes	
OR	Yes	Federal adjusted gross income	Yes	Yes	
PA	Yes	Gross income	Yes	No	PA PIT Guide Ch. 12
RI	Yes	Federal adjusted gross income	Yes	Yes	
SC	Yes	Federal taxable income	Yes	Yes	
SD	No	N/A	N/A	N/A	
TN	Yes	Taxable dividends and interest income	No	N/A	
TX	No	N/A	N/A	N/A	
UT	Yes	Federal adjusted gross income	Yes	Yes	
VA	Yes	Federal adjusted gross income	Yes	Yes	
VT	Yes	Federal taxable income	Yes	Yes	
WA	No	N/A	N/A	N/A	
WI**	Yes	Federal adjusted gross income	Yes	No	
WV	Yes	Federal adjusted gross income	Yes	Yes	
WY	No	N/A	N/A	N/A	

**For taxable years beginning on or after January 1, 2014, Wisconsin conforms to the Internal Revenue Code in effect on January 1, 2014. For taxable years beginning after January 1, 2014, Wisconsin does not adopt Section 13113 of P.L. 103-66, which created Section 1202 of the Internal Revenue Code effective for small business stock issued after August 10, 1993.

or exchange of the QSBS, unless both of the following requirements are satisfied:

1. QSBS has been held for more than five years as of the first day on which there was such a short position.
2. The taxpayer elects to recognize gain as if the QSBS has been sold on such first day for its fair market value.[43]

"Offsetting short positions" are defined as:

- Short sales of substantially identical property (e.g., short against the box transactions).
- Acquiring an option to sell (put) substantially identical property at a fixed price.
- Any other transaction entered into that substantially reduces the risk of loss from holding such QSBS position as provided in regulations (no regulations have been published to date).[44]

Shorting a QSBS position to disqualify Section 1202 treatment may be appropriate in certain circumstances. For example, it may be appropriate to short a QSBS position if offsetting loss realizations result in tax-effective diversification.

State taxation

The state income taxation of QSBS generally falls into the following five categories:

1. States with no individual income tax, and therefore no QSBS exclusion.
2. States with an individual income tax but no capital gains tax, and therefore no QSBS exclusion.
3. States which, in effect, take into account the Section 1202 QSBS exclusion because the starting point for the determination of individual income tax liability is adjusted gross income or taxable income for U.S. income tax purposes.
4. States that start with gross income, but then have their own QSBS exclusion statutes.
5. States that start with gross income but do not have an applicable QSBS statute.

A chart of applicable QSBS treatment in each of the 50 states and District of Columbia is provided in Exhibit 3.

Other QSBS considerations

A variety of other factors should be considered with respect to QSBS.

Rolling QSBS to another issuer. If a taxpayer holds stock that qualifies as QSBS but the taxpayer has not held it for the five-year holding period to qualify for the QSBS gain exclusion, the taxpayer (other than a C corporation) may sell his or her QSBS and roll the proceeds into another QSBS issuer without recognizing a gain under Section 1045, if the taxpayer has held the QSBS for more than six months. This is similar in concept to a Section 1031 exchange.

Per Section 1045, the taxpayer has 60 days from the date of the sale of the QSBS to roll the sale proceeds into another issuer.[45] In general, to effectively defer the taxation of gains, *all* of the proceeds from the sale of the original QSBS must be rolled over in the new QSBS issuer. If any cash is "taken off the table" after the initial sale, that amount would be subject to applicable capital gains tax. The basis of the new QSBS is the purchase price less unrecognized gain from the sale of the original QSBS, and the holding period from the original QSBS is counted towards the holding period of the new QSBS.

Converting entities to qualify for the QSBS exclusion. Only some types of entity conversions qualify for the exclusion.

Can an S corporation be converted to a C corporation to qualify for the QSBS exclusion? No.

As discussed above, only stock in a C corporation will be QSBS for purposes of the Section 1202 exclusion. If a corporation has elected to be treated as an S corporation and that election is later terminated, the stock held immediately after the termination of the S election will not be QSBS because it is not original issuance by a qualified small business—one requirement of which is C corporation status.

Can an LLC be converted to a C corporation to qualify for the QSBS exclusion? Yes.

Suppose a company has been organized as an LLC from inception. If the company otherwise meets the requirements of QSBS, it can convert from the LLC to a C corporation and then qualify for QSBS treatment.

Depending on the date of acquisition, the taxpayer may be eligible to exclude up to 100% of the gains.

Tax-free reorganization. In limited situations, if an LLC converts to a C corporation through a tax-free reorganization (a Section 368 reorganization), the taxpayer's LLC interests may be treated as "stock" and meet the definition of QSBS and the taxpayer may be able to tack the holding period to the time the LLC interests were originally issued.[46]

For example, in Ltr. Rul. 201636003, following tax-free reorganizations under which an LLC, *taxed as a corporation*, converted to a corporation for state law purposes and changed

[43] Section 1202(j)(1).
[44] Section 1202(j)(2).
[45] Section 1045(a)(1).
[46] Ltr. Rul. 201636003.

its name, the IRS ruled that the taxpayer's LLC interests were "stock" for purposes of QSBS qualification.

According to the letter ruling, "Section 1202(h) provides that in the case of a transaction described in § 351 or a reorganization described in § 368, if qualified small business stock is exchanged for other stock which would not qualify as qualified small business stock but for this subparagraph, such other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired." Section 368(a)(1)(F) provides that the term "reorganization" includes "a mere change in identity, form, or place of organization of one corporation, however effected…."

The Service ruled that, "[w]hile ownership of a corporation is normally tied to stock ownership, and under state law LLC owners hold a member interest and not formal stock, the term 'stock' for federal tax purposes is not restricted to cases where formal stock certificates have been issued. Rather, it has been consistent Service position that for federal tax purposes stock ownership is a matter of economic substance (i.e., the right to which the owner has in management, profits, and ultimate assets of a corporation). The presence or absence of pieces of paper called 'stock' representing that ownership was immaterial."

Taxable conversion. If the conversion is from an LLC taxed as a partnership to a C corporation, then it seems that the original issuance of the new C corporation shares would start the clock on the holding period. But on the upside, the taxpayer's C corporation shares now may have a higher adjusted cost basis. If the C corporation shares meet the other requirements of QSBS, then the taxpayer may have the benefit of a higher gains exclusion because the exclusion is the *greater of* $10 million or ten times the taxpayer's adjusted cost basis in the QSBS. The benefit of an exclusion equal to ten times adjusted cost basis may outweigh the benefit of a tax-free reorganization, which may provide the taxpayer with the ability to tack the holding period but limit the exclusion to $10 million.

Example. On 1/1/2015, Tom Investor and Tammy Techy organized We Are Tech, LLC, with a contribution of $2 million cash from each of Tom and Tammy in exchange for a 50% interest in the LLC each. We Are Tech, LLC was organized as a limited liability company taxed as a partnership for U.S. income tax purposes.

Shorting a QSBS position to disqualify Section 1202 treatment may be appropriate in certain circumstances.

During 2015, We Are Tech, LLC purchased a building for $2 million cash (with no debt) and created certain intellectual property (IP) assets. By the end of 2015, the self-created IP had a fair market value of $2 million. We Are Tech, LLC sustained a $1 million loss in 2015.

At the end of Year 1, Tom and Tammy's capital accounts were as shown in Exhibit 4.

On 1/1/2016, We Are Tech, LLC incorporated as We Are Tech, Inc., a C corporation that would qualify as a QSB, and would be treated for U.S. income tax purposes as transferring all of its assets to We Are Tech, Inc., in exchange for all of the stock in We Are Tech, Inc., and then distributing the stock to Tom and Tammy in liquidation of We Are Tech, LLC. No gain or loss was recognized on the incorporation pursuant to Section 351. At the time of the incorporation, the fair market value of the assets was $5 million.

Upon incorporation, Tom and Tammy's basis in their respective We Are Tech, Inc. stock was as follows:

- Tom—stock basis (per Section 358(a)): $1.5 million; stock basis (per Section 1202(i)): $2.5 million.
- Tammy—stock basis (per Section 358(a)): $1.5 million; stock basis (per Section 1202(i)): $2.5 million.

On 1/1/2017, Tom sold all of his stock in We Are Tech, Inc., for $10 million,[47] an $8.5 million long-term capital gain ($10 million - $1.5 million stock basis). As a result, if Tom decided not to reinvest his sale proceeds, Tom would owe U.S. tax of $2.023 million ((20% + 3.8%) x $8.5 million).

Suppose instead, within 60 days of 1/1/2017, Tom were to have bought stock in Tech Savvy, Inc., a QSB, for $8 million, and were to elect rollover treatment pursuant to Section 1045. Despite the rollover, Tom immediately recognized the previously deferred $1 million gain, which is the difference between his stock basis per Section 1202(i) ($2.5 million) and stock basis per Section 358(a) ($1.5 million). Tom also recognized $2 million long-term capital gain pursuant to Section 1045(a), for a total recognized long-term capital gain of $3 million, as shown in Exhibit 5.

Because the $1 million previously unrecognized gain was not qualified gain, it would be taxed at the 20%

[47] This hypothetical and the corresponding analysis assumes that Tom's sale of We Are Tech, Inc. stock had both a business purpose and economic substance and that the step-transaction doctrine would not apply to recharacterize the January 2017 incorporation as a taxable sale and not as a Section 351 nonrecognition transaction.

[48] Sections 1202(h)(1), and 1202(h)(2)(A) and (B).

[49] Paul S. Lee, "Planning in the ATRA-Math: The Best Income and Estate Planning Ideas Today" (9/8/2016).

[50] *Id.*

long-term capital gains rate. The other $2 million recognized also was not qualified gain and is subject to the 20% capital gains tax rate. Total U.S. tax due as a result of Tom's sale of his We Are Tech, Inc. stock was $238,000 + $476,000 = $714,000.

On 1/2/2021, Tom sells all of his stock in Tech Savvy, Inc., for $25 million, and decides to retire and not to reinvest in another QSB. His realized and recognized gain are calculated as follows:

- Proceeds from sale of Tech Savvy, Inc. stock: $25 million.
- Less: adjusted stock basis: ($2.5 million).
- Realized gain: $22.5 million.
- Applicable Section 1202 gain exclusion: $25 million (10 x basis of $2.5 million).
- Recognized gain: $0.

By using the gain rollover provisions of Section 1045 and the gain exclusion of Section 1202, Tom would pay a total U.S. tax on his $23 million gain ($25 million - $2 million initial investment) of $714,000, which is an effective tax rate of 3.1% ($714,000 ÷ $23 million).

If, instead, Tom used all the proceeds from the sale of We Are Tech, Inc. stock to purchase Tech Savvy, Inc., Tom would recognize only $1 million total long-term capital gain (the difference between the $2.5 million stock basis per Section 1202(i) and the $1.5 million stock basis per Section 358), which results in $238,000 of total tax [(20% + 3.8%) x $1 million]. The effective tax rate is 1.03% on his $23 million total gain ($238,000 ÷ $23 million).

EXHIBIT 4
Tom and Tammy's Capital Accounts

Member	End of Prior Year Basis	Contributions in 2015	Income (Loss) in 2015	12/31/2015 Basis
Tom Investor	$0	$2 million	($500,000)	$1.5 million
Tammy Techy	$0	$2 million	($500,000)	$1.5 million

EXHIBIT 5
Computation of Tom's Gain

Proceeds from sale of We Are Tech, Inc. stock	$10,000,000
Less: Adjusted basis per Section 1202(i)	($2,500,000)
Realized gain (loss)	$7,500,000
Purchase of stock in Tech Savvy, Inc.	$8,000,000
Gain recognized pursuant to Section 1045(a) (difference between sale proceeds and purchase price of replacement QSBS)	$2,000,000
Unrealized gain	$5,500,000
Adjusted basis in stock in Tech Savvy, Inc. (per Section 1045(b)(3))	$2,500,000

Estate planning opportunities and basis considerations

As mentioned above, a holder who acquired QSBS by gift or at death is treated as having acquired the stock in the same qualifying manner as the transferor (relevant for the "acquired at original issuance" requirement) and tacks the transferor's holding period (relevant for the five-year holding period requirement).[48]

If the transfer is by lifetime gift, the donee receives the QSBS with the donor's basis per Section 1015. If, on the other hand, the transfer is at death, the QSBS receives a step-up in basis under Section 1014, but appreciation after the date of death would continue to be eligible for gain exclusion under Section 1202.[49] Because of the gain exclusion and gain rollover aspects of QSBS, taxpayers may therefore wish to consider inter vivos transfers of these assets to remove them from the taxpayer's gross estate to the extent that the value of the QSBS exceeds the taxpayer's transfer tax exclusions (both U.S. transfer tax exclusions and state transfer tax exclusions, if applicable). The reason is that the taxpayer's heirs may not benefit as much from a step-up in basis because the gain exclusion features of QSBS, and QSBS status can be retained and transferred through donative transfers to donees.[50] This presents planning opportunities using inter vivos gift trusts.

Grantor trusts. Section 1202 and the Treasury Regulations promulgated thereunder are silent as to whether stock retains its character as QSBS if it is transferred to an irrevocable grantor trust and whether the grantor trust can tack onto the transferor's holding period. But presumably, the transfer is a donative transfer so it seems that the answer is yes—the grantor trust should be treated as having acquired the stock in the same manner as the transferor and can tack onto the transferor's holding period.

Grantor retained annuity trust (GRAT). What if the transfer is to fund a GRAT? Again, the transfer is a donative transfer so it seems that the GRAT should be treated as having acquired the stock in the same manner as the transferor and can tack onto the transferor's holding period.

Sale to an irrevocable grantor trust. What if the transfer is pursuant to a sale to an irrevocable grantor trust? While the Code and corresponding Treasury Regulations do not specifically answer the question, presumably, because the sale is ignored for income tax purposes and losing grantor trust status (whether due to death or otherwise) is akin to a donative transfer at that time, QSBS status should pass to the grantor trust in an installment sale transaction.[51] However, there are varying opinions on what the effect is on the QSBS when the trust loses grantor trust status.

A taxpayer who makes a lot of QSBS investments should retain an integrated team of advisors who understand the rules well.

Non-grantor trusts and stacking $10 million gain exclusions. Now assume that an individual acquires QSBS and subsequently makes a gift of QSBS to one or more irrevocable trusts that are separate taxpayers (non-grantor trusts). The question arises whether a non-grantor irrevocable trust may claim its own $10 million QSBS gain exclusion, separate from the grantor's $10 million gain exclusion.

The answer is seemingly yes:

- As described above, per Section 1202(h)(2), the transferee of QSBS obtained by gift or bequest is treated as having acquired the stock in the same manner as the transferor and can tack the transferor's holding period.
- The same result should apply if the gift originally was made to an irrevocable trust structured as a grantor trust for income tax purposes, but the grantor trust status was terminated prior to the sale of the QSBS.
- If the goal is to maximize the $10 million QSBS gain exclusions, can a grantor make gifts to separate non-grantor irrevocable trusts for the benefit of different beneficiaries versus making a gift to a single pot trust, in order to maximize the number of separate taxpayers able to claim the $10 million gain exclusion? Tax advisors may differ on whether a grantor can stack multiple $10 million gain exclusions by making gifts to separate non-grantor trusts.

While stacking multiple exclusions using non-grantor trusts is powerful, practitioners should model the benefits of grantor trust treatment over a taxpayer's lifetime and compare the results against the benefits of multiple exclusions using non-grantor trusts over the same time period in order to determine which technique may better meet the taxpayer's overall wealth transfer objectives.

Planning pitfalls. Professionals implementing some common estate planning techniques may unwittingly cause the loss of the client's ability to take advantage of the QSBS exclusion. The most common pitfalls relate to transfers of QSBS that do not qualify as gifts or transfers on death that are exceptions to the original issuance requirements detailed above. Shares that are gifted to trusts maintain their status as QSBS as described above. In addition, shares that are sold to an irrevocable grantor trust arguably should retain their character as QSBS.

Shares of QSBS that are contributed to a family limited partnership or limited liability company as part of an FLP/FLLC transfer tax planning transaction will not, however, retain their character as QSBS. The FLP/LLC did not receive the shares on original issuance from the QSB. This is but one example of why practitioners should have a working knowledge of Section 1202 when engaging in advanced estate planning for entrepreneurs and investors.

Practical pointers

As illustrated above, the QSBS exclusion can be a very powerful tax benefit to many entrepreneurs. However, to take advantage of the exclusion, the taxpayer must be armed with the necessary information and documentation to show that his or her shares are in fact QSBS and that he or she has held the stock for the requisite holding period. To that end, the following are practical pointers that should make it easier for clients to claim the QSBS exclusion.[52]

Document the purchase. Keep good records of the purchase of QSBS, including the following items:

- Date QSBS is purchased.
- Amount paid.
- Proof of payment (e.g., copy of the account statement reflecting that the funds left the account to pay for the stock).
- Copy of the share certificate.

51 *Id.*

52 See Johnston, "Qualified Small Business Stock Is an Often Overlooked Tax Windfall," blog.wealthfront.com (2/17/2016).

Request certification of the QSBS. If an investment eventually could qualify for QSBS treatment, request that the company certify to the following:

- The company is a domestic C corporation.
- The company has $50 million or less in assets immediately after the purchase of original issuance shares.
- At least 80% of the company's assets are used in the active conduct of a qualifying active trade or business.
- It is ideal to request certification of this information prior to the purchase, or if not, immediately thereafter. The company may not be able to provide this information if years have passed since the purchase.

Track the holding period. Keep track of the purchase of QSBS and know when the five-year holding period is up. The taxpayer may wish to hold off on selling the QSBS until the five-year holding period is up to benefit from the exclusion. If the QSBS is not held for the five-year holding period but has been held for more than six months, then under Section 1045 the taxpayer could sell the QSBS and the sale proceeds could be rolled over into another QSBS issuer without recognizing gain.

Build the appropriate advisory team. A taxpayer who makes a lot of QSBS investments should retain an integrated team of advisors who understand the rules well (i.e., accountant, estate planning attorney, and corporate or corporate tax attorney).

Conclusion

The QSBS exclusion has been a valuable tax benefit to entrepreneurs, business owners, and investors in start-ups for many years. The exclusion has survived temporary status, managed to increase in benefit in 2010, and has now not only survived the 2017 tax reform, but should flourish with the increased use of C corporations resulting from lower corporate income tax rates. It is therefore imperative that estate planners be familiar with the provisions of Section 1202, if for no other reason than to not unintentionally cost a client the opportunity to take the exclusion. At the same time, it is essential that planners are, or become, comfortable enough with the requirements of the QSBS exclusion to take full advantage of the benefits of the QSBS exclusion when and where appropriate. ■

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