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Special Edition

DON'T GUESS AND MAKE A MESS WITH QSBS

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THE NEW STANDARD IN WEALTH MANAGEMENT

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Summary

Qualified small business stock, or QSBS, can be a powerful wealth planning tool. This communication explores the following:

- Opportunities to maximize the available QSBS exclusion
- Date of issuance requirements for stock to meet the definition of QSBS
- QSBS requirements for substantially all of a shareholder's holding period
- Potential QSBS pitfalls

Tax deferral can be great, but nothing beats tax-free. And one of the best tax-free gifts the federal government offers to business founders, executives, and investors is an exclusion from capital gains up to the greater of $10 million or 10 times basis for the sale of stock in a C corporation that meets the requirements for qualified small business stock (QSBS) under I.R.C. § 1202. If the QSBS was issued on or after September 28, 2010, before the company's gross assets exceeded $50 million, and held for at least five years, then zero federal tax would be owed upon a sale of that QSBS up to the greater of $10 million or 10 times basis—even if what started as a small business has grown in value to be worth billions of dollars. Moreover, each individual and nongrantor trust that receives QSBS via gift or inheritance will be independently entitled to an additional QSBS exclusion of the greater of $10 million or 10 times basis. In addition, the sale of QSBS often avoids income taxation at the state level because many states either have no state income tax or provide a similar QSBS exclusion for state income tax purposes.

Congress continues to support the QSBS tax incentive for entrepreneurs to start new businesses and for outside investors—such as angel investors and venture capitalists—to invest in those businesses because small businesses produce jobs, innovate, and help drive the economy. Per a report by the US Small Business Administration Office of Advocacy (Apr. 2022), small businesses with fewer than 500 employees have generated 12.9 million net new jobs over the past 25 years—compared to only 6.7 million net new jobs from large businesses. In other words, small businesses have accounted for 66 percent of employment growth over the past 25 years—that is, two out of every three jobs added to the economy. According to the legislative history for I.R.C. § 1202 (H.R. Rep. No. 103-111, at 831 (1993)), the exclusion provides "targeted relief for investors who risk their funds in new ventures [and] small businesses" and can "encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing." The QSBS exclusion also is a key tool for recruiting and rewarding employees.

The Evolution of the Section 1202 QSBS Exclusion

The QSBS tax benefit initially was enacted during the Clinton administration as part of the Omnibus Budget Reconciliation Act of 1993 to encourage small business investments. The original QSBS law excluded 50 percent of the capital gains from the sale of QSBS—not to exceed the greater of $10 million or 10 times the tax basis in the stock—based on a 28 percent rate, which was the capital gains rate that was in effect in 1993. In other words, the original QSBS tax benefit basically provided a more attractive 14 percent effective tax rate versus a 28 percent rate on the greater of $10 million or 10 times basis.

Although the greater of $10 million or 10 times basis threshold has not changed since 1993, the percentage of capital gains that can be excluded under that threshold was increased during the Obama administration. The exclusion percentage went from 50 percent to 75 percent for QSBS acquired between February 18, 2009, and September 27, 2010. It was increased again to 100 percent for QSBS acquired on or after September 28, 2010. The 100 percent exclusion percentage was then made “permanent”—that is, no automatic expiration date—under the Protecting Americans from Tax Hikes (PATH) Act of 2015.

There are two main reasons why the government expanded the QSBS benefit. First, after the highest capital gains tax rate was reduced to 15 percent from 2003 through 2012, the QSBS incentive for taking on the additional risk of starting or investing in a small business was somewhat minimal. In other words, the QSBS exclusion saved only 1 percent by imposing a 14 percent effective tax

Effective Tax Rates on QSBS Based on Issue Date

Issue Date	QSBS Exclusion Percentage	QSBS Effective Federal Tax Rate	QSBS Effective Federal AMT Rate	QSBS Effective NIIT Rate
8/11/93 – 2/17/09	50%	14%	14.98%	1.90%
2/18/09 – 9/27/2010	75%	7%	8.47%	0.95%
9/28/2010 – Present	100%	0%	0%	0%

Source: Internal Revenue Code of 1986, as amended.

rate—that is, 50 percent of the 28 percent rate set in 1993. The second reason is that during the so-called Great Recession with the market downturn in 2009, the federal government wanted to further incentivize investments in small businesses to help boost the country's economic recovery.

The QSBS benefit became an even more powerful tax incentive after the highest capital gains tax rate was increased to 23.8 percent in 2013—including the additional 3.8 percent net investment income tax that became effective in 2013 pursuant to the Patient Protection and Affordable Care Act of 2010, as amended by the Health Care and Education Reconciliation Act of 2010 (colloquially known as Obamacare). Moreover, the 100 percent QSBS exclusion also avoids a portion of the gains from being included as an addback for alternative minimum tax purposes.

Despite the potential economic benefits resulting from the creation of—and investment in—small businesses, the House of Representatives attempted to reduce the 100 percent QSBS benefit back to the original 50 percent limitation under different versions of the proposed Build Back Better Act in 2021. The nonpartisan Joint Committee on Taxation estimated that the QSBS tax expenditure would cost $1.8 billion in 2021, and the aggregate reduction of the QSBS benefit over a 10-year period would have provided the government with flexibility to offset other new spending proposals in the Build Back Better Act as part of the budget reconciliation process—which would have allowed the Senate to pass the bill by a simple majority of 51 votes or 50 votes with the vice president serving as a tie breaker. The new 50 percent exclusion would have applied to individual taxpayers with adjusted gross income of $400,000 or more and all nongrantor trusts and estates regardless of adjusted gross income. Moreover, the proposed Build Back Better Act threatened to apply to sales and exchanges of QSBS on or after September 13, 2021, even if the shareholder had acquired the QSBS before that date in reliance on the laws in effect at that time.

It would seem patently unfair that the government could change the tax rules after the fact on taxpayers who had already acquired QSBS—especially founders, investors, and employees who were willing to take on the additional risk associated with small businesses specifically because they thought they would be entitled to the QSBS tax benefits that the law appeared to promise at that time. But unlike the constitutional limitation on retroactive—that is, ex post facto—criminal law changes, retroactive tax law changes are constitutional. For example, the Supreme Court in United States v. Carlton, 512 U.S. 26 (1984), unanimously upheld the retroactive repeal of a tax deduction and even stated, "Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code." Fortunately for founders, executives, and investors with QSBS, the Build Back Better Act was not enacted because of insufficient support in the Senate in 2021, and similar proposed QSBS limitations have not been included in any legislation since that date.

C Corporation and the $50 Million Requirement

To qualify for the QSBS exclusion, the business entity must be a domestic C corporation for tax purposes and the company's gross assets must not exceed $50 million at any time through the time of the stock issuance—including cash received in exchange for the issued stock. For the gross assets test, the value generally includes cash plus the adjusted basis of the company's assets—not the fair market value—and does not include self-created intangible value such as goodwill.

Even though there could be potential QSBS exclusion benefits from a future sale of a C corporation, founders starting a new business should not necessarily let the tax tail wag the planning dog by immediately creating a C corporation. A major disadvantage with a C corporation is that there is a double layer of taxation including a 21 percent tax at the corporate level, which was reduced from 35 percent by the Tax Cuts and Jobs Act of 2017. There also is a second layer of tax for C corporations at the shareholder level up to a 23.8 percent federal tax rate—including the 3.8 percent net investment income tax—on qualified dividends distributed from the company. For many founders starting a business, there could be significant ongoing tax advantages to using a different type of limited liability entity—such as an LLC taxed as a partnership under subchapter K—that allows for passthrough taxation and only one layer of taxation at the owner level.

Fortunately, it may be possible for a business to start out as something other than a C corporation and then convert to a C corporation at a later date for QSBS planning purposes. For instance, an LLC taxed as a partnership could check the box under Treasury Regulation section 301.7701-3 to be a C corporation, which is treated as a deemed transfer of all the LLC's assets in a section 351 transfer in exchange for stock and a deemed liquidation of the LLC. So long as the fair market value of the appreciated assets—not the historical tax basis—do not exceed $50 million at the time of conversion, the future appreciation after the conversion could qualify for the QSBS exclusion equal to the greater of $10 million or 10 times basis. As an example, if the fair market value at the time of the LLC conversion was $49.5 million and the founder owning 99 percent of the business had close to a zero basis for tax purposes, then the founder's first $49 million from a future sale would be subject to a tax on capital gains, and then the founder would benefit from a $490 million QSBS exclusion—equal to 10 times basis—for any gain above the first $49 million.

Although more complicated than an LLC partnership conversion for QSBS purposes, it also may be possible to have an S corporation establish one or more new subsidiary C corporations and contribute assets in a section 351 transfer to take advantage of the QSBS exclusion.

Qualified Trade or Business and the 80 Percent Requirement

Even with a C corporation that does not have more than $50 million in gross assets, not every trade or business will be eligible for QSBS treatment. Other than a special exception for working capital for the first couple years of a business, at least 80 percent of the company's assets must be used in the active conduct of a qualifying trade or business. Although there is no specific definition for what does qualify, I.R.C. § 1202 specifically lists numerous exceptions for what does not qualify, including "(A) 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 of such trade or business is the reputation or skill of 1 or more of its employees, (B) any banking, insurance, financing, leasing, investing, or similar business, (C) any farming business (including the business of raising or harvesting trees), (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and (E) any business of operating a hotel, motel, restaurant, or similar business."

Given the lack of a clear definition for what type of trade or business qualifies under I.R.C. § 1202, a private letter ruling could be helpful in certain circumstances to address the uncertainty. Beginning in January 2024, however, under Rev. Proc. 2024-3, 2024-1 IRB 143, the IRS stated that it would temporarily stop issuing private letter rulings on whether a corporation meets the "active business" requirement for QSBS purposes. Despite all the listed exclusions under section 1202, there have been numerous private letter rulings issued by the IRS that have approved QSBS treatment for businesses such as a temporary staffing business (I.R.S. Priv. Ltr. Rul. 202352009 (Dec. 29, 2023)), an enterprise cloud application services software company (I.R.S. Priv. Ltr. Rul. 202319013 (Feb. 14, 2023)), the manufacture of products prescribed by health care providers (I.R.S. Priv. Ltr. Rul. 202125004 (Mar. 29, 2021)), and a business that contracts with insurance companies and wholesalers (I.R.S. Priv. Ltr. Rul. 202114002 (Jan. 13, 2021)). See also I.R.S. Priv. Ltr. Ruls. 202221006 (Mar. 3, 2022), 202144026 (Aug. 10, 2021), and 201436001 (May 22, 2014). Even though private letter rulings provide an indication of how the IRS might address a certain matter, note that private letter rulings may not be relied upon by taxpayers other than the specific taxpayer who was issued the ruling. And while the IRS has issued many favorable private letter rulings related to QSBS, the IRS did release Chief Counsel Advice 202204007 (Nov. 4, 2021), which found that an online services company's business of facilitating the leasing of real estate—which could have been Airbnb, Vrbo, or a similar company—did not qualify for QSBS treatment because it was a brokerage service under I.R.C. § 6045, even though it was not one under I.R.C. § 199A.

Original Issuance and the Exception for Gifts and Inheritance

To qualify for the QSBS exclusion, the shareholder cannot be a C corporation, but it may be an individual, partnership, S corporation, or trust. That shareholder must acquire the stock in exchange for money or other property (not including stock) or as compensation for services provided to the corporation (other than as an underwriter). In other words, stock purchased from an existing shareholder or on a secondary market does not qualify for the QSBS exclusion.

A major exception to the original issuance rule is that a shareholder—including an individual or nongrantor trust—that receives a gift or inheritance of QSBS will qualify for the shareholder’s own additional QSBS exclusion. The recipient also will be treated as having the same basis and holding period as the donor for QSBS purposes.

As a hypothetical example from a trust and estate planning perspective, a QSBS shareholder with four kids could use the 2024 $13.61 million lifetime exemption amount to set up four nongrantor trusts with $3.4 million of QSBS without paying any gift taxes—colloquially referred to as “stacking.” Each one of those four trusts would get its own QSBS exclusion up to the greater of $10 million or 10 times basis. In other words, the value of the QSBS in each trust could roughly triple to $10 million, and each trust would be able to exclude the entire capital gain from the sale of the QSBS. Not only would the original shareholder get a $10 million QSBS exclusion, but the four nongrantor trusts set up by the shareholder for the four children would get an additional aggregate $40 million QSBS exclusion. Moreover, even if the shareholder is a resident of a state that does not provide a state income tax exclusion for QSBS, those four nongrantor trusts could be set up in a state that provides the benefit of zero state taxes in addition to the federal QSBS benefits. The table below shows the tax savings potential in this example.

When creating multiple nongrantor trusts for loved ones, it is imperative that the trust agreements are carefully drafted to prevent any grantor trust triggers under subpart E of subchapter J. While intentionally defective grantor trusts (IDGTs) generally are the bread and butter of estate planning for wealthy families, it is important to avoid creating an unintentionally defective grantor trust (UDGT) if the purpose is to create a nongrantor trust to obtain an additional QSBS exclusion. Furthermore, each separate nongrantor trust should be different enough to steer clear of the multiple trust rule under I.R.C. § 643(f). If two or more trusts have substantially the same grantors and beneficiaries, and the principal purpose is avoidance of tax, then those trusts will be treated as one trust for income tax purposes—meaning only one QSBS exclusion. Moreover, the IRS announced in Rev. Proc. 2021-3, 2021-1 IRB 1, that it would not issue any private letter rulings to approve any proposed planning related to multiple trusts under I.R.C. § 643(f).

Five-Year Holding Period and Qualified Rollovers

To qualify for the QSBS exclusion, the QSBS must have been held for at least five years. For purposes of the five-year holding period, shareholders—including individuals and nongrantor trusts—that received QSBS as a gift or inheritance will keep the same holding period as the original shareholder. As an example, if a founder has held QSBS for five years and then gifts QSBS shares to a nongrantor trust for the benefit of a child, that nongrantor trust will have met the five-year holding period requirement and will qualify for its own greater of $10 million or 10 times basis exclusion.

If a shareholder is selling QSBS before the end of the five-year holding period, all is not lost. That shareholder can continue the existing holding period by purchasing replacement QSBS under I.R.C. § 1045 within 60 days. For example, if a shareholder held the original QSBS for only four years at the time of sale, that shareholder could go ahead and purchase new shares that qualify as QSBS and only would need to hold those new shares for one more year to take advantage of the tax-free QSBS benefits. As another option, a shareholder could even create the shareholder's own brand-new C corporation with a plan for a trade or business that would qualify for QSBS treatment and then continue the existing holding period with the new QSBS. I.R.C. § 1202(e)(6) even provides a special rule for working capital during a corporation's first two years before it is required to be used in active conduct of a business.

Example of QSBS "Stacking" with Nongrantor Trusts

	Basis	Capital Gain on Sale	QSBS Exclusion	Federal Tax	State Tax (at 13.3%)	Total Tax Savings
Shareholder and No Nongrantor Trusts	$100	$50M	$10M	$9.52M	$5.32M	$2.38M
Shareholder and Four Nongrantor Trusts for Children	$100	$50M	$50M	$0	$1.33M	$17.22M

Hypothetical example assumes the shares meet the requirements for QSBS, each of the shareholders are subject to the highest federal income tax rates on capital gains of 20 percent plus the 3.8 percent net investment income tax, and the original shareholder is a resident of California subject to a 13.3 percent state income tax.

Common Pitfalls with Redemptions and Family Partnerships

Redemptions—that is, a purchase by the C corporation of its own stock—are a common major pitfall that a company may want to avoid since it could cause shareholders to lose their QSBS exclusion benefits. A shareholder's stock will no longer be treated as QSBS if (1) at any time during the four-year period beginning on the date two years before the issuance of such stock, the corporation purchased (directly or indirectly) more than a de minimis amount of its stock from the shareholder or person related to the shareholder or (2) during the two-year period beginning on the date one year before the issuance of such stock, the corporation made one or more purchases of more than a de minimis amount of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all its stock as of the beginning of such two-year period. An amount would be more than de minimis if the aggregate amount paid exceeded $10K and the corporation purchased more than 2 percent of the stock held by the shareholder or a related person.

Another major pitfall to avoid would be the contribution of QSBS to a partnership, such as a family limited partnership. While such planning structures often provide families with significant benefits from an investment and estate planning perspective, the contribution of QSBS to a partnership would disqualify the stock from QSBS treatment under I.R.C. § 1202.

Hypothetical Example

In January 2016, Founder Fred formed a domestic C corporation and started a small business with $100,000 to manufacture medical equipment for hospitals. In June 2017, Investor Ivan invested an additional $300,000 to help the business grow more quickly. As the business rapidly expanded and needed access to more capital, Venture Capital Firm agreed to invest $3 million in the business in January 2018. Then, in June 2019, Employee Ellen exercised $200,000 in stock options that were granted by company back in January 2016. Finally, on December 31, 2023, the company was sold for $60 million in cash.

Founder Fred, Investor Ivan, and Venture Capital Firm each received their stock after September 27, 2010, and have met the five-year holding requirement, so they each are entitled to a 100 percent exclusion of capital gains tax up to the greater of $10 million or 10 times basis. As a result, Founder Fred will be able to exclude $10 million of capital gains, which reduces his federal tax bill from $5.7 million to $3.3 million—saving $2.4 million in taxes. Had Founder Fred made gifts to loved ones—or to nongrantor trusts for the benefit of loved ones—each one of those shareholders also would have qualified for separate QSBS exclusions up

to $10 million. Investor Ivan will be able to exclude the entire amount of his $7.5 million gain, which saves him $1.8 million in taxes. Because Venture Capital Firm had a basis of $3 million in QSBS, it will be able to exclude the entire $24 million of capital gain under the 10 times basis rule, thus saving $5.7 million in taxes.

Unfortunately for Employee Ellen, she did not exercise her options until June 1, 2019, so she did not meet the five-year holding period for QSBS as of the date of sale on December 31, 2023. However, as discussed earlier, she does have the option of rolling over her proceeds into a new QSBS investment for an additional six months to meet the five-year holding period—which could even include investing in a C corporation that she created herself as a new business qualifying for QSBS treatment. The chart below summarizes the results for each of the shareholders.

Example of QSBS Exclusions for Founders, Executives and Investors

	Date Stock Acquired	Initial Investment	Ownership in 2023	Gain (After $60M Purchase)	Tax With No QSBS Exclusion	Tax With QSBS Exclusion	Federal Tax Savings
Founder Fred	1/1/2016	$100,000	40%	$23.9M	$5.7M	$3.3M	$2.4M
Investor Ivan	6/1/2017	$300,000	13%	$7.5M	$1.8M	$0	$1.8M
Venture Capital Firm	1/1/2018	$3M	45%	$24.0M	$5.7M	$0	$5.7M
Employee Ellen	6/1/2019 (Options Exercised)	$200,000	2%	$1.0M	$238,000	$238,000	$0

Hypothetical example assumes the shares meet the requirements for QSBS, each of the shareholders are subject to the highest federal income tax rates on capital gains of 20 percent plus the 3.8 percent net investment income tax, and the original shareholder is a resident of California subject to a 13.3 percent state income tax.

Conclusion

To take advantage of the QSBS exclusion and optimize the tax benefits for current and future generations, business founders, executives, and investors should work closely with their attorneys, accountants, and wealth managers to address the technical requirements and potential planning opportunities. Proactive tax, trust, and estate planning with QSBS can help shareholders maximize the income, gift, estate, and generation-skipping transfer tax benefits for families over multiple generations. Although there is no special election that needs to be made for shares to qualify as QSBS at the time of issuance or the time of sale, shareholders must report the sale of QSBS correctly on their income tax returns to take advantage of the QSBS tax benefits. Because of the strict requirements for QSBS eligibility, it is important for both shareholders and the issuing company to maintain accurate records of purchase dates and amounts, track when the company’s gross assets exceed $50 million after the purchase of shares, and confirm that at least 80 percent of the company’s assets are used in the active conduct of a qualifying trade or business.

Evercore Wealth Management

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