QSBS: The Quest for Quantum Exclusions (Queries, Qualms, and Qualifications)

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Quest for Quantum Exclusions

- Defining transfers “by gift,” “at death,” and other transfers (or non-transfers)
- “Stacking” & “packing” (multiplying & leveraging) the Per-Issuer Limitation
- QSBS with pre-existing businesses (sole proprietorships, S corporations, and partnerships, etc.)
- Common ways to inadvertently lose QSBS status
- QSBS and carried interest
- Reporting QSBS installment sales
- Charitable planning with QSBS and the basis adjustment at death
Transfers “By Gift,” “At Death,” and Others

Defining Transfers “By Gift” and “At Death”:

- Income Tax Definition, Not Transfer Tax

- Transfers “By Gift”:
  - Recognized for income tax purposes but is not a taxable sale or exchange
  - Results in a different taxpayer as transferee
  - Transferee’s basis is determined under section 1015

- Transfers “At Death”:
  - Recognized for income tax purposes but is not a taxable sale or exchange
  - Results in a different taxpayer as transferee
  - Transferee’s basis is determined under section 1014

Transfers Related to Partnerships

- Transfer of QSBS from a partnership to a partner is a permissible transfer

- Contribution of QSBS by a partner to a partnership is NOT a permissible transfer

- Gratuitous transfer of interest in a partnership that holds QSBS
  - Section 1202: “held by the taxpayer” at the time of acquisition and “at all times thereafter before disposition.”
  - Section 1045 regulations: transfer by gift or at death, transferee treated as having held partnership interest during the period the transferring partner held it.

- Transfers related to wholly-owned (disregarded) entities
## Movement of QSBS Shares: Transfers “By Gift”

<table>
<thead>
<tr>
<th>Description of Transfer</th>
<th>Status Retained?</th>
<th>Additional Per-Issuer?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift to individual</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Contribution to non-grantor trust</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Contribution to incomplete gift non-grantor trust (i.e., DING or NING)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Distribution from non-grantor trust to a beneficiary</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Distribution from grantor trust to a beneficiary (other than grantor)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Splitting pot trust into separate trusts for separate beneficiaries</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Termination of grantor trust status</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Transfer on exercise of a general or limited power of appointment</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Expiration of GRAT term to non-grantor trust or individual (not grantor)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Gift to spouse who is filing separately</td>
<td>Yes</td>
<td><strong>No</strong></td>
</tr>
<tr>
<td>Gift to spouse who is filing jointly</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Transfer incident to a divorce</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Contribution to CRT</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Contribution to non-grantor CLT</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Description of Transfer</td>
<td>Status Retained?</td>
<td>Additional Per-Issuer?</td>
</tr>
<tr>
<td>---------------------------------------------------------------------------</td>
<td>------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>Contribution to revocable trust</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Taxable gift to IDGT</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Contribution to GRAT</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Transfer to grantor from GRAT in satisfaction of annuity payment</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Expiration of GRAT term to a grantor trust</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Sale to IDGT in exchange for installment note</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Transfer to grantor in satisfaction of installment note debt held by grantor</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Contribution to grantor CLT</td>
<td>Yes</td>
<td>No</td>
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</table>
## Movement of QSBS Shares: Entity-Related Transfers

<table>
<thead>
<tr>
<th>Description of Transfer</th>
<th>QSBS Treatment</th>
<th>Status Retained?</th>
<th>Additional Per-Issuer?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution to FLP</td>
<td>Disqualifying</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Distribution from FLP to partner</td>
<td>Permitted</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Contribution to disregarded entity</td>
<td>Ignored</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Gift of interest in FLP to individual or non-grantor trust</td>
<td>Unknown</td>
<td>Unknown</td>
<td>Unknown</td>
</tr>
<tr>
<td>Gift of FLP interest to GRAT or IDGT</td>
<td>Ignored</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Sale of FLP interest to IDGT in exchange for promissory note</td>
<td>Ignored</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Contribution to S corporation</td>
<td>Disqualifying</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Distribution from S corporation</td>
<td>Disqualifying</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Gift of interest in S corporation</td>
<td>Unknown</td>
<td>Unknown</td>
<td>Unknown</td>
</tr>
<tr>
<td>Gift of S corporation to GRAT or IDGT</td>
<td>Ignored</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Termination of GRAT with FLP interest passing to grantor trust</td>
<td>Ignored</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Conversion of disregarded LLC to partnership</td>
<td>Disqualifying</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Conversion of partnership or S corporation to C corporation</td>
<td>Disqualifying</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
## Movement of QSBS Shares: Other Transfers

<table>
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<th>QSBS Treatment</th>
<th>Status Retained?</th>
<th>Additional Per-Issuer?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Termination of grantor trust status</td>
<td>By gift</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Termination of grantor trust status with debt in excess of basis</td>
<td>By gift &amp; Disqualifying</td>
<td>Yes &amp; No</td>
<td>Yes &amp; No</td>
</tr>
<tr>
<td>Conversion of non-grantor trust to grantor trust</td>
<td>Ignored</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Conversion of non-grantor trust to grantor trust with debt in excess of basis</td>
<td>Ignored</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Bequest of QSBS</td>
<td>By death</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Transfer to survivor from joint account</td>
<td>By death</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Distribution from revocable trust upon death of grantor</td>
<td>By death</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Getting Both Per-Issuer Limitations

- Prescribes the maximum gain that can be excluded (or partially excluded) each taxable year.

- Each taxable year shall not exceed the GREATER of:
  - $10 million reduced by aggregate eligible gain taken for prior taxable years ($10 Million Per Taxpayer Limitation); or
  - 10 times the aggregate adjusted basis of QSBS sold by the taxpayer in the taxable year (10 Times Basis Limitation).

**Rules of Construction:**
- Calculated each taxable year;
- $10 Million Per Taxpayer reduced by previous eligible gain from prior years; and
- 10 Times Basis Limitation is NOT reduced by previous year (only the current year counts).

**Ordering QSBS Sales:**
- Utilize multiple taxable years
- Sell 100% Exclusion Percentage QSBS before 75% and 50% QSBS
- Sell lowest basis QSBS first to utilize the $10 Million Per Taxpayer Limitation
- Consider selling multiple lots to maximize the “aggregate” cost basis for the 10 Times Basis Limitation
- Take advantage of “stacking” (multiplying) the Per Issuer Limitation to other taxpayers
“Stacking” the Per-Issuer Limitation

- Stacking (Multiplying) the $10 Million Per Taxpayer Limitation with “by gift” transfers
  - Individual
  - Non-Grantor Trust
  - Incomplete Gift Non-Grantor Trust
  - Pot trust to separate trusts for each beneficiary
  - Trust distribution to beneficiary

- Creating New $10 Million Per Taxpayer Limitation with section 1045 rollover
  - Replacement QSBS No. 1
  - Replacement QSBS No. 2
  - Replacement QSBS No. 3

Per-Issuer Limitation is based upon the stock “issued by such corporation.”
“Packing” the Per-Issuer Limitation

- Packing (Maximizing) the 10 Times Basis Limitation with contributions of property

\[ \text{\$40 Mil. Built-In Gain} \times 10 = \text{\$500 Million Per-Issuer Limitation} \]

- Packing the 10 Times Basis Limitation with non-eligible gain

10 Times Basis Limitation Defined

“10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.”

NOT defined in terms of QSBS eligible gain (5-year holding period) of the taxable year.

Exercise option to purchase $4 million for $1 million QSBS ($3 million of ordinary income) + (Non-Eligible Gain) Sell option-acquired QSBS stock for nominal gain + (Eligible Gain) Sell $0 basis QSBS held for more than 5 years for $40 million of gain = $40 Million Per-Issuer Limitation
QSBS and Pre-Existing Businesses

**The “Flush” Language**

“In the case of any stock which would be described in the preceding sentence (but for this sentence), the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223.” §§ 1202(a)(3) and 1202(a)(4).

**Contributing Controlling Shareholders**

(Corporation)

(Property Purchased in 1990)

1990 holding period

("In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation, such stock shall be treated as having been acquired by the taxpayer on the date of such exchange.” § 1202(i)(1)(A).

**Legislative History**

- Flush language only applies for section 1045 rollover purposes.
- “The provision is not intended to change the acquisition date determined under Section 1202(i)(1)(A) for certain stock exchanged for property.”
Partnership Division and C Corporation Conversion

Anti-Abuse Consideration

“The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including regulations to prevent the avoidance of the purposes of this section through split-ups, shell corporations, partnerships, or otherwise.”
Original Issuance (i.e., C corporation) requirement likely prevents S corporation from issuing QSBS even if QSBS “substantially all” requirement is met.

C corporation that temporarily converts to an S corporation may still be able to claim QSBS status because QSBS “substantially all” requirement is still a possibility.

Parent-subsidiary limitation of Aggregate Gross Asset Requirement (i.e., $50 million) may limit ability of pre-existing business to create non-Q-Sub QSB.

One option is a tax-free division under section 355.
Losing QSBS Status

**Disqualifying Corporate Redemptions/Purchases:**

- Any purchase from taxpayer (or related person)
  - Disqualifies all stock held by the taxpayer.

- Significant purchase (>5% aggregate stock of corporation)
  - Disqualifies all stock of the corporation.

**Aggregate Gross Asset Requirement**

Original Issuance

-2 years

Disqualifies all stock held by the taxpayer.

+2 years

Original Issuance

-1 year

Disqualifies all stock of the corporation.

+1 year

Stock Issuance

FMV

AGA

QSBS

QSBS

QSBS?

Not QSBS

$50 Mil.
Section 1202 benefits with a pass-thru entity:

- Limited by the interest “held by the taxpayer on the date on which such pass-thru entity acquired such stock,” and
- May not exceed that amount that would have been excludable “by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired.”

**Revenue Procedure 94-27:**
- Capital interest is based on proceeds received upon complete liquidation. Profits interest is an interest other than a capital interest.
- If person receives a profits interest for providing services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the receive of the interest is not a taxable event for the partner or the partnership.

**Revenue Procedure 2001-43**
- “Where a partnership grants an interest in the partnership that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date of grant,” provided
  - Partnership and service provider treat service provider as the owner of the partnership interest from the date of its grant and service provider takes into account the distributive share of partnership income for the entire period the service provider has the interest.
  - On the date of grant of the interest or when it becomes substantially vested, neither the partnership nor any partner deducts any amount for the fair market value of the interest.

**2007 Partnership Section 1045 Treasury Regulations:**
Deferral of gain is limited by the **Nonrecognition Limitation**, defined as:

- Partnership realized gain from the sale of QSBS, multiplied by
- Eligible partner’s “smallest percentage in partnership capital” determined “at the time of acquisition” of the original QSBS.
Charitable Planning and the Basis Adjustment at Death

Consider for Charity & Basis Adjustment

- Very low adjusted tax basis
- 50% or 75% Exclusion Percentage
- Significant unrealized Non-Section 1202 Gain
- Less than 5 year holding period stock

If stock had been acquired for appreciated property in tax free transaction …

Non-Section 1202 Gain

$4 Mil. Built-In Gain

$1 Mil. (Basis)

Per-Issuer Limitation $50 Mil. (10 x Basis)

50% Exclusion Percentage

$100 Mil. (FMV)

Non-Section 1202 Gain

Excluded Section 1202 Gain

$5 Mil. (Basis)
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