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Generations Summer 2021 - Planning and Pitfalls with Qualified Small Business Stock

Since 1993, Section 1202 of the Internal Revenue Code has provided taxpayers the opportunity to exclude gain from the sale of "qualified small business stock" (QSBS). The provisions of Section 1202 have fluctuated over time due to congressional tinkering and shifting economic climates, but the benefits of Section 1202 may be more valuable now than ever before. Section 1202 is designed to incentivize investment in small businesses, and the returns for investors can be extraordinary.

QSBS is stock in a "qualified small business" (QSB). A QSB is a domestic C corporation with aggregate gross assets of $50 million or less (i) at all times leading up to the issuance of the QSBS and (ii) immediately after the issuance. The value of a QSB can exceed the $50 million threshold down the road (e.g., at the time of an initial public offering), while its early-stage shareholders can still qualify for QSBS treatment on a sale of their shares. In order to qualify for QSBS treatment, a shareholder must acquire the stock at its original issuance from the QSB (or an underwriter) in exchange for cash, property (other than stock) or services. The QSB must also satisfy an active business requirement, and some types of businesses (health, law, engineering, banking, financing and others) are excluded from qualifying.

If a shareholder sells QSBS after satisfying a five-year holding period, the gain from the sale is 100% excluded from tax (i.e., completely tax-free) up to the greater of (i) $10 million per taxpayer (per issuer) or (ii) ten times the taxpayer's adjusted basis in the stock. The "per taxpayer" limitation creates a tax planning incentive to make gifts so that each donee can take advantage of a separate Section 1202 exclusion. This technique is known as "stacking." The most common example of stacking is where a QSBS shareholder makes gifts of QSBS to one or more non-grantor trusts, permitting each trust to claim its own exemption. With capital gain tax rates on high-income taxpayers in the cross-hairs of tax reform proposals, there has been a recent uptick in this stacking strategy.

Family offices are not strangers to QSBS investments. However, it is critical to note that Section 1202 contains special rules that apply to ownership of QSBS by pass-through entities (i.e., partnerships and S corporations). These special pass-through rules can often limit planning options. Some of the rules are unclear, and the IRS has yet to issue definitive guidance to alleviate concerns. Since most family offices are structured as partnerships for tax purposes, these special rules can be traps for the unwary for family offices.

Section 1202(c)(1) provides the general rule that the taxpayer must acquire QSBS directly from the QSB at initial issuance. Thus, if an investor contributes QSBS to a partnership, that stock loses QSBS status because the partnership did not acquire the stock directly from the QSB. Even if the partnership immediately distributes the stock back to the shareholder, there is no guidance to suggest that the stock would "regain" QSBS status. This is extremely important to remember in a scenario where family members are contributing assets to a family office structure.

A taxpayer could, however, contribute QSBS to a single-member LLC without losing QSBS status, because the IRS does not respect a single-member LLC as an entity separate from its owner (assuming that the LLC does not elect to be taxed as a

corporation). That said, if the LLC admits a second member at any time, the QSBS immediately loses its status as a disregarded entity because the LLC becomes a partnership.

Stock held by a partnership may qualify as QSBS if the partnership acquired the stock at original issuance from the QSB. If a partner owns an interest in a partnership that sells QSBS and meets all of the requirements to exclude the gain, the partner can generally treat his or her share of the gain as if the partner had sold QSBS individually, and can use his or her own Section 1202 exclusion to shelter the gain from tax. However, Section 1202(g) requires that the partnership own the interest in the partnership when the partnership acquired the QSBS and at all times thereafter leading up to the disposition of the QSBS by the partnership. Thus, a partner cannot qualify for QSBS benefits by joining a partnership or increasing his or her interest in the partnership after the partnership acquires the QSBS.

This rule can create significant issues in the estate planning context. The general rule under Section 1202 is that if a taxpayer transfers QSBS to a different taxpayer, the recipient does not qualify for QSBS benefits. There are three exceptions: transfers of the QSBS (i) by gift, (ii) at death or (iii) by a distribution from a partnership to a partner. If a transferee acquires QSBS in one of these transactions, the transferee can step into the shoes of the transferor, and the stock retains QSBS status in the hands of the transferee. Thus, a partnership can distribute QSBS to a partner and the partner can retain QSBS benefits, but if a partner contributes QSBS to a partnership, the QSBS benefit disappears.

These rules also restrict one's ability to makes gifts of QSBS held through a partnership. Suppose a partner wishes to gift his or her interest in a partnership that owns QSBS. Gifting QSBS is one of the three exceptions, but the gift of an interest in a partnership holding QSBS seems to fall outside the exception. The logical workaround is to have the partnership distribute the QSBS to the partner and then have the partner make a gift of the QSBS, but for practical reasons, that might not always be an option.

Absent further guidance, the best practice is to be careful about gifting interests in pass-through entities that own QSBS unless the gift is made to an entity that is not treated as a taxpayer separate from the transferor, such as a grantor trust or a single-member LLC. That type of gifting, however, will not permit stacking of the Section 1202 exclusion, as discussed earlier. At a more general level, taxpayers should remain highly diligent when owning and transferring QSBS (or interests in pass-through entities that own QSBS). While Section 1202 can produce tremendous tax benefits, one could easily lose those benefits by undertaking relatively common gifting strategies in the family office context.

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