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Timing is Everything on QSBS and Other Tax Deferral Techniques

Friday, November 5, 2021

2:10 p.m. – 3:10 p.m.

Speakers:

Cameron L. Hess

Allen Walburn

Conference Reference Materials

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Timing is Everything on QSBS and Other Tax Deferral Techniques

California Lawyers Association
Taxation Section Annual Meeting
San Diego, California

November 5, 2021

Allen B. Walburn, Esq.
Higgs Fletcher & Mack, LLP
San Diego, CA
walburna@higgslaw.com

Cameron L. Hess, Esq.
Wagner Kirkman Blaine
Klomparens & Youmans LLP
Mather ,CA
chess@wkblaw.com

Overview of IRC §1202:

Qualified Small Business Stock (“QSBS”)

What is the QSBS Gain Exclusion?

- Qualified Small Business Stock ("QSBS") code and regulations were promulgated in 1993 to encourage investment in emerging companies by excluding gain on sale of stock in qualified small businesses ("QSBs").

- Subject to the requirements under IRC §1202, a shareholder may exclude realized gain (0% Federal tax rate on the excluded gain) upon the sale of his or her stock; a corporation selling its assets is subject full taxation at corporate level even if it is a QSB (but shareholders may be eligible for QSBS exclusion on their gain on receipt of liquidating distributions).

- The amount of a shareholder's eligible gain with respect to stock of a particular corporation is the <u>greater</u> of**:**
  - $10 million (cumulative for all tax years), or
  - 10 times the adjusted basis of shares sold by the shareholder in a particular tax year

- The amount of a shareholder's eligible gain that may be excluded from tax depends on when the stock was acquired at original issue:
  - 50% of gain may be excluded if stock was acquired between 8/11/1993 and 2/17/2009
  - 75% of gain may be excluded if stock was acquired between 2/18/2009 and 9/27/2010
  - 100% of gain may be excluded if stock was acquired after 9/27/2010

After-Tax Proceeds: $10 Million Sale, Zero Basis*

*"Non-QSBS" scenario assumes that gains are subject to a long-term capital gains rate of 23.8%. "QSBS 50%" scenario assumes that $5.0 million of gain is excluded from Federal income tax, $5.0 million of gain is subject to an effective capital gains tax rate of 31.8% and that 7% of the excluded gain is an AMT preference item and subject to a 28% tax rate. "QSBS 75%" scenario assumes that $7.5 million of gain is excluded from Federal income tax, $2.5 million of gain is subject to an effective capital gains tax rate of 31.8% and that 7% of the excluded gain is an AMT preference item and subject to a 28% tax rate. "QSBS 100%" scenarios assumes that the entire gain is excluded for federal income tax purposes.

House Ways and Means Proposal (released 9/13/2021):

- For taxable dispositions of QSBS after September 13, 2021, a taxpayer's gain shall not be entitled to the 75% or 100% exclusion under IRC §§1202(a)(3) and (4) if:
  - The taxpayer's AGI in the year of disposition (without taking Section 1202 exclusion into account) equals or exceeds $400,000; <u>or</u>
  - The taxpayer is an estate or trust.

- Such limitations do not apply to any disposition made pursuant to a <u>written</u> binding contract which in effect on September 12, 2021, and not materially modified thereafter.

- Increases maximum long-term capital gains rate from 20% to 25% for capital gains recognized on or after September 13, 2021 (subject to a binding contract exception).

- For tax years beginning after December 31, 2021, individuals and trusts will be required to pay a 3% surtax on modified AGI in excess of $5,000,000 ($2,500,000 for MFS).

Key QSBS Requirements

- "Original issuance" of common or preferred domestic C corporation[1] stock directly to non-corporate shareholder in exchange for money, other property (not stock), or as compensation for services
- For a particular issuance of stock, the corporation must have $50 million or less of total gross assets[2] including amounts received by the corporation for the issuance (once $50M threshold exceeded, current and future stock issuances are not eligible even if gross assets later drop below $50M)
- Corporation must use at least 80% of the fair market of its assets in an active "qualified trade or business"
- The Internal Revenue Code defines the term "qualified trade or business" in the negative (i.e., what doesn't qualify)[3]
- Stock held for more than five years from date of issuance
- Business meets the active business requirements and is a C corporation during "substantially all" of the taxpayer's stock holding period ("substantially all" is not defined)

Not eligible for the 1202 exemption: DISCs or former DISCs, corporations (including subsidiaries) that have a §936 election in effect regulated investment companies, REITs, REMICs, cooperatives, S corporations, and foreign corporations. IRC
§1202(d)(1) IRC §1202(d)(2) and §1202(e)(4)
2. Gross assets defined as the amount of cash and aggregate adjusted bases of other assets held by the corporation. Contributed property basis is determined by FMV at time of contribution. IRC §1202(d)(2)
3. "Qualified Trade or Business" means any trade or business other than—**(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

Subsidiaries

- Parent corporation and all of its >50%-owned corporate subsidiaries (based on voting power or FMV) are aggregated in calculating $50M threshold.
- For purposes of 80% active business requirement (§1202(e)), stock and debt held by parent corporation in >50%-owned corporate subsidiaries are disregarded; parent is deemed to own its pro-rata share of each subsidiary's assets and activities.
- How does a corporation's interest in a partnership count toward $50M test and 80% active business requirement?
    - Pro-rata based on partnership interest percentage?
    - Include 100% of partnership's gross (or net) assets and activities or only a pro-rata portion?
    - No direct authority (cf. Treas. Reg. §1.368-1(d)(4)(iii) regarding similar issues in context of §368 reorganizations).

QSBS: Pitfalls and Opportunities

Pitfalls

- Forming as a S corporation
- Original issuance ≠ issuance of options or convertible debt
- Beware of stock transfers that nullify "original issuance" (e.g., transfers to partnerships)
- Large cash injections
  - Gross asset test
  - 80% Active business asset requirement
- Failure to meet 5 year holding period
- Significant stock redemptions
- Taxable income of C corporation taxed at 21% fed. rate + state income taxes; shareholder level tax on dividends paid out of "earnings and profits"
- No QSBS gain exclusion for California income tax purposes

Opportunities

- LLC to C Corp conversion
- S corporation contributes its business assets and liabilities to a C corporation in exchange for C corp. stock
- Acquiring stock before gross assets exceed $50 million
- Gain deferral under IRC 1045
- Basis + QSBS sales over multi-year period
- Gifting QSBS
- Gain excluded under §1202 is not subject to 3.8% NIIT under §1411

Formation of Entity

C Corp versus Pass Through

S to C Corporation Conversion: Founder Perspective

- Many founders like the single layer of taxation that an S corporation provides.
- In order for stock to be considered Qualified Small Business Stock, it must be originally issued by a C corporation.
- If an S corporation converts into a C corporation, stock issued while the corporation was an S corporation will not qualify for the QSBS exclusion.
- If the corporation issues additional stock as a C corporation, that stock will qualify as QSBS provided that the other QSBS requirements are satisfied.
- Tax legislation passed in 2017 reduced the top federal tax rate for C corporations to 21%, reducing the tax penalty relative to S corps and other pass-through entities.

LLC to C Corporation Conversion: Founder Perspective

- The founder can qualify for the QSBS exclusion if she forms her company as a LLC taxed as a partnership and later converts the LLC into a C corporation.

- The C corporation stock will be considered “issued” as of the date of the conversion, but the basis in the stock for QSBS gain exclusion purposes will be the fair market value of the LLC interests at the time of conversion, as opposed to the basis of the LLC interests[1].

- FMV of the LLC interest held by an LLC member is greater than $1 million at time of conversion, then the maximum QSBS gain exclusion of that member can be increased significantly by virtue of the “10 times” basis provision[2]. However, the built-in gain at the time of conversion is not eligible for exclusion under Section 1202.

1. Assumes a tax-free incorporation pursuant to IRC §351 with QSBS basis determined pursuant to IRC §1202(i).
2. IRC 1202(b)(1)(B).

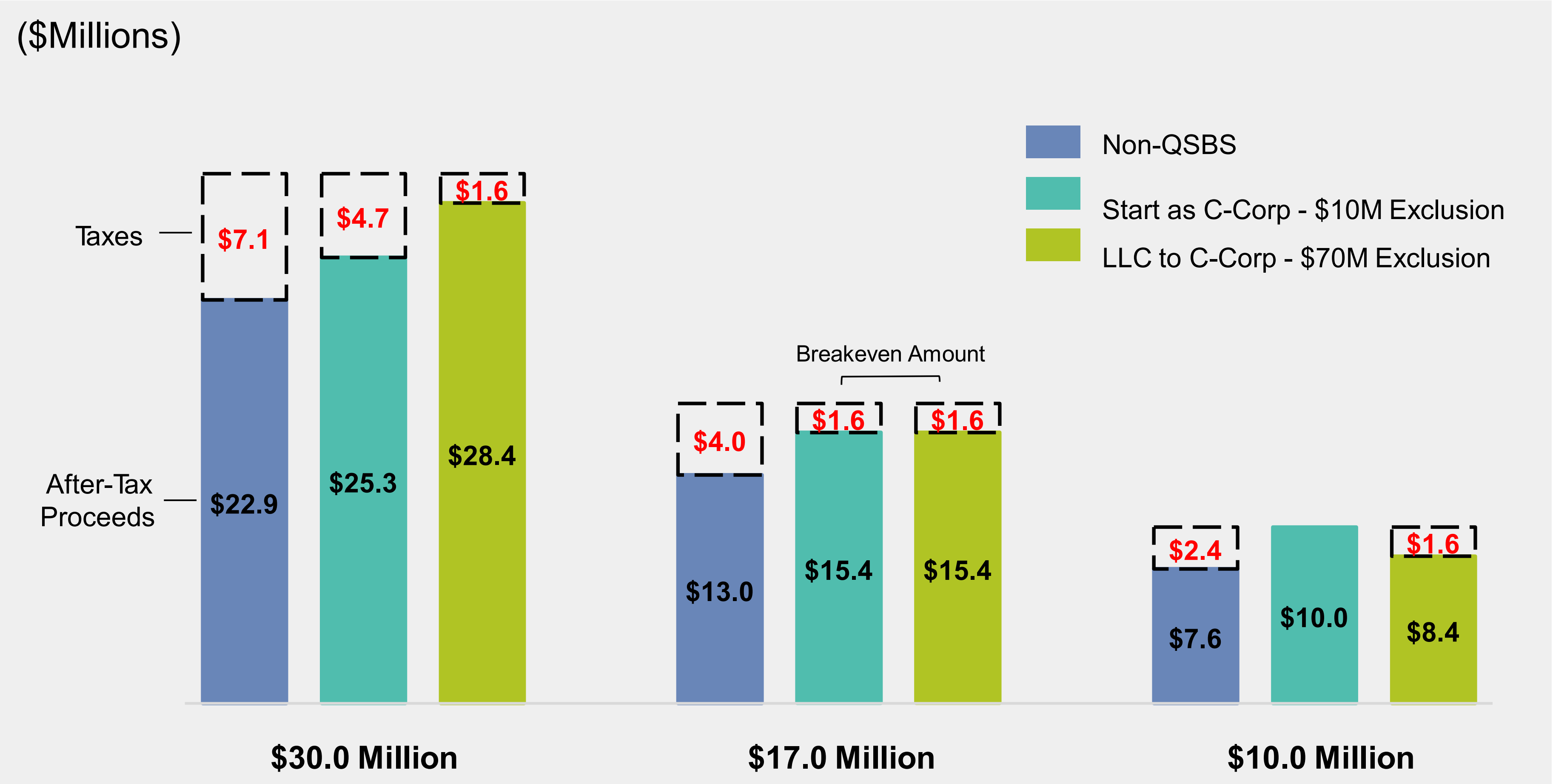
Sample Case Fact Pattern: Conversion of LLC into C Corporation

- Founder Ashley Yoo establishes an LLC with her partner in late 2010. Ashley's interest had a basis of $100,000 at formation.
- In early 2012, Ashley and her partner convert the LLC into a C corporation. As of the date of the conversion, the fair market value of Ashley's interest was $7.0 million.
- In 2017, Ashley and her partner sell the C corporation. Ashley's share of the sale proceeds is $30 million.

Question:

How much gain will Ashley be permitted to exclude?
What about the built-in gain?

After-Tax Proceeds: LLC to C-Corp Conversion



*"Non-QSBS" scenario assumes that the gain is fully subject to a long-term capital gains rate of 23.8%. "Start as a C-Corp" scenario assumes that the first $10.0 million are excluded from Federal income taxation. Gains over $10.0 million are subject to a long-term capital gains rate of 23.8%. "LLC to C-Corp" scenario assumes that the first $6.9 million of gain is subject to a long-term capital gains rate of 23.8%, the next $70.0 million of gain is excluded from Federal income taxation. Any additional gain is subject to a long-term capital gains rate of 23.8%.

Original Issuance

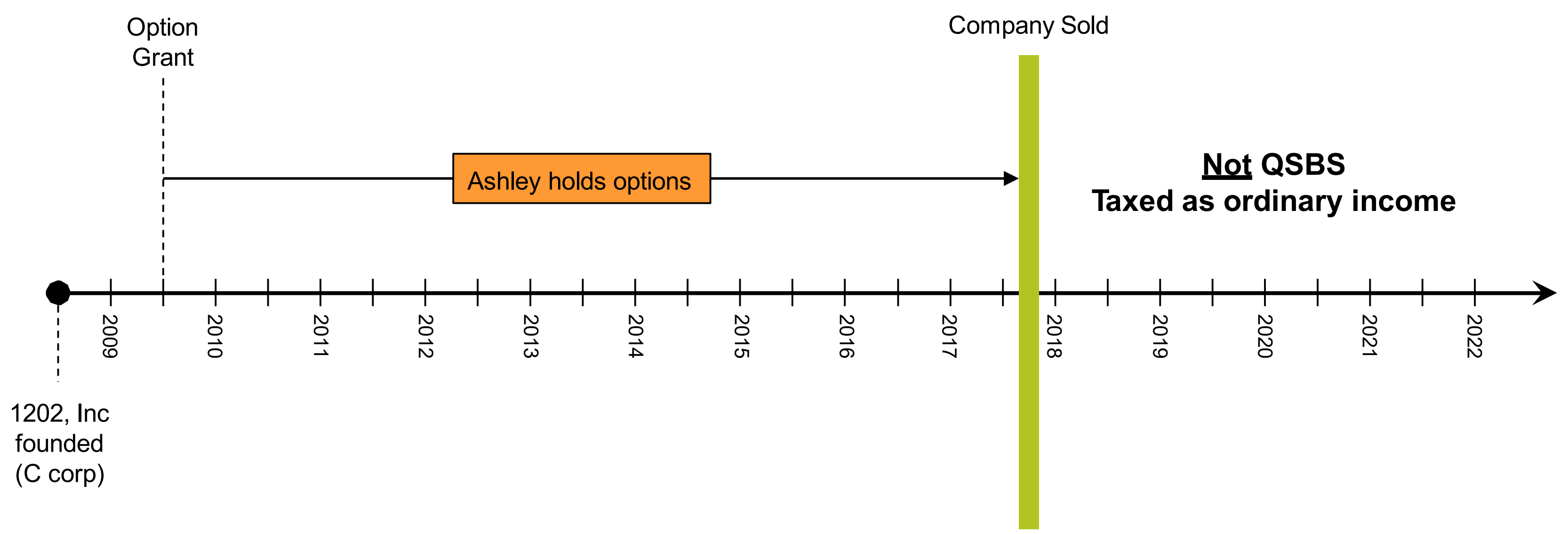
Different Flavors of "Original Issuance"

Type	QSBS Qualification Test	QSBS Holding Period Test
Stock Options	Upon date of exercise[1]	5 years from the date of exercise
Restricted Stock	Upon 83(b) election[2] or vesting date	5 years from the date of 83(b) election or vesting date
Restricted Stock Units (RSUs)	Upon later of stock issuance date or vesting date	5 years from the later of stock issuance date or date of vesting
Convertible Preferred Stock	Upon date of preferred investment[3]	5 years from the date of preferred investment
Convertible Debt	Upon date of conversion[4]	5 years from the date of conversion

1. In the case of unvested options, the company can allow early exercise of unvested options and taxpayer must also make an 83(b) election within 30 days of exercise for holding period to start on exercise date rather than stock vesting date. Note that an 83(b) election for exercise of unvested incentive stock options (ISOs) is not effective for regular income tax purposes (or for Section 1202 purposes). Consider cancelling ISO and issuing restricted stock, together with 83(b) election. Conversion of an ISO to a non-qualified option may be deemed to be the grant of a new option requiring an exercise price = current per share FMV of underlying stock.
2. Election within 30 days of restricted stock grant or option exercise into restricted stock.
3. See IRC § 1202(f).
4. See IRC § 1202(i)(1)(A).

Sample Case Fact Pattern: Employee Perspective

- Engineer Ashley Yoo joined a start-up private C corporation "1202, Inc." on 6/30/2009 and received a stock option grant that fully vests in four years (7/1/2013) and expires in 10 years (7/1/2019)
- 1202, Inc. is sold in 2017 to buyer in a cash for stock transaction



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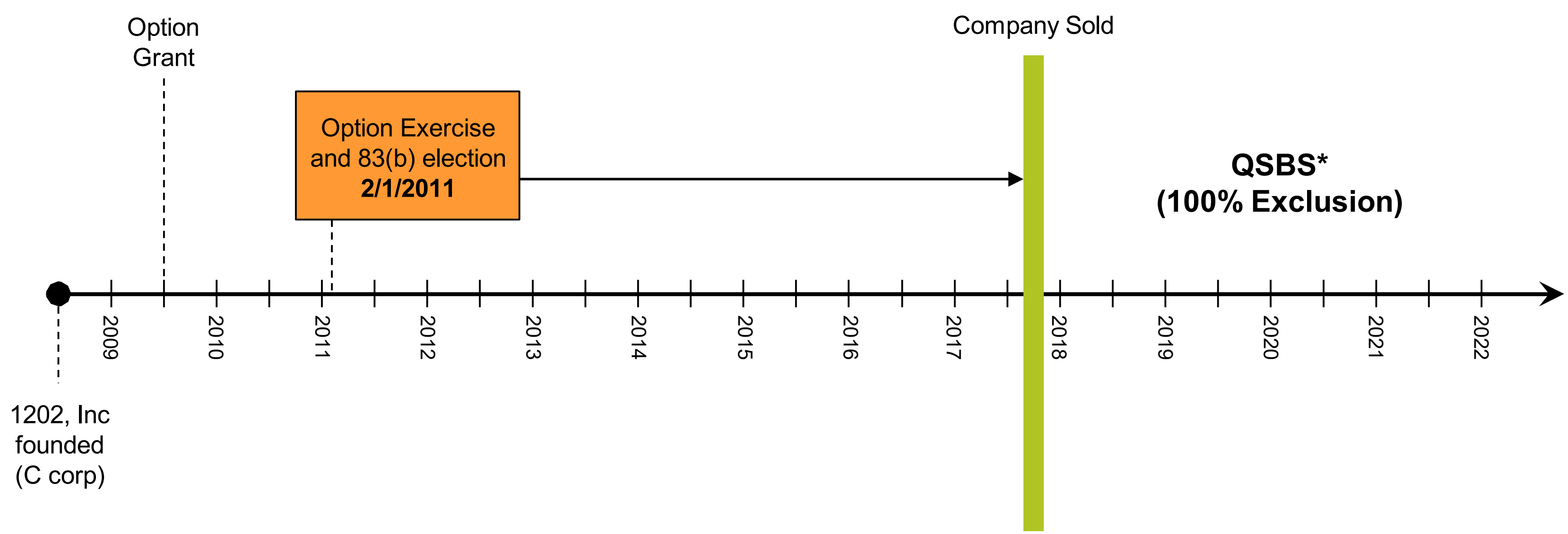


*Assumes stock met QSBS requirements at the time of option exercise (original issuance) and during substantially all of Ashley’s holding period.

Sale of QSBS Held for ≤5 years

IRC §1045: "1031 Exchange" for QSB

- IRC §1045 allows a taxpayer to defer recognition of gain on the sale of QSB stock if replacement stock is purchased within 60 days beginning on date of sale.

- Requirements:
  - Seller must be a non-corporate taxpayer
  - QSB stock that's being sold has been held for more than 6 months
  - Replacement QSB stock is purchased within 60-day period beginning on date of sale
  - Affirmative IRC §1045 election

- Gain is recognized only to the extent that the amount realized on the sale exceeds cost of replacement stock purchased during replacement period. Basis in replacement QSB stock is the purchase price less unrecognized gain from the sale of original QSB stock. The holding period from the original QSB stock is carried over to holding period of replacement QSB stock.

- IRC §1045 is particularly helpful for a taxpayer who owns stock that would otherwise qualify for QSBS exclusion except that taxpayer hasn't held the stock for the required 5-year holding period.

- Interesting what-if cases
  - Contingent payments? Likely not eligible for deferral if replacement QSBS isn't purchased within 60 days <u>of sale</u>
  - Venture fund investor? When partnership sells QSBS, each partner may individually purchase replacement QSBS, subject to certain limitations*

*Gain is eligible for deferral provided replacement QSBS is purchased within 60 days of sale. See Treasury Reg 1.1045-1(c).

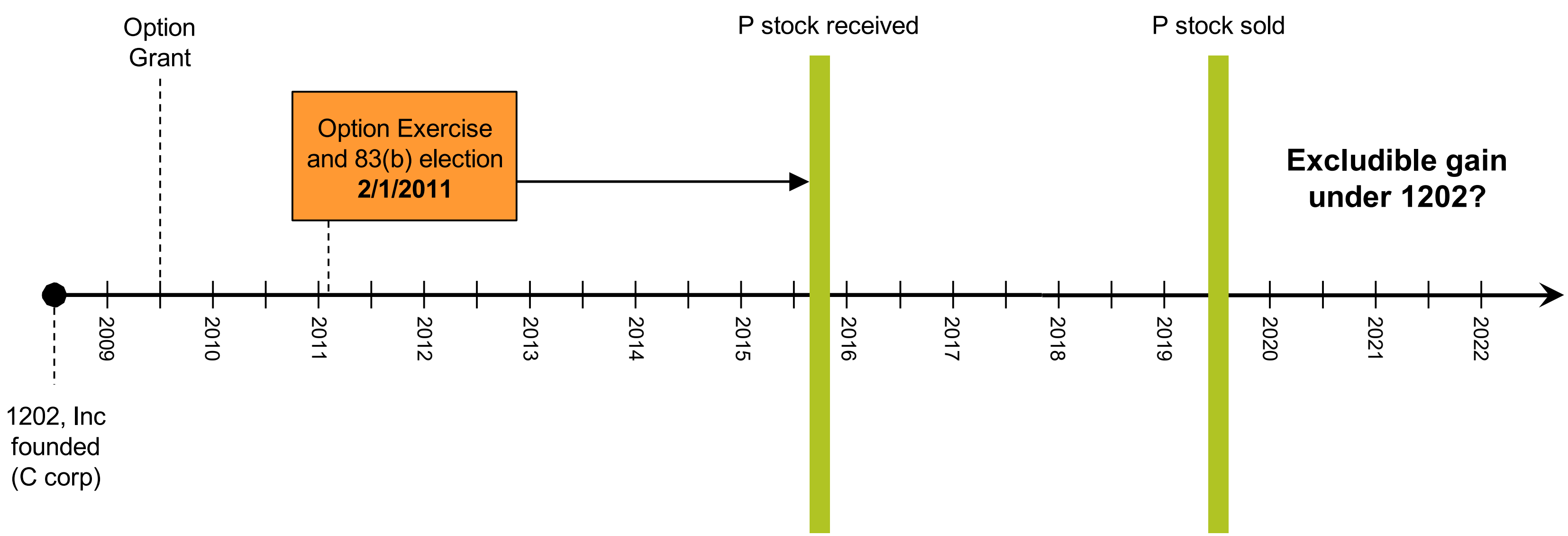
Stock-for-Stock Reorganizations

Sample Case Fact Pattern: Employee Perspective

- Engineer Ashley Yoo joined a start-up C corporation "1202, Inc." on 6/30/2009 and received a stock option grant that she exercised on 2/1/2011 for unvested shares and made an 83(b) election. 1202, Inc. met the QSBS requirements at the time of exercise.

- 1202, Inc. is acquired in 2015 by a large public company (P) in a tax-free stock-for-stock reorganization under IRC §368. Ashley's stock in P was valued at $5 million at the time of acquisition.

- Ashley sells her P stock in 2019 for $7 million.



1202(h)(4): Reorganizations Involving Nonqualified Stock

- IRC 1202(h)(4)(A)
  - If QSB stock is exchanged for non-QSB stock, then
    - Such stock will be treated as QSB (i.e. will not lose QSB status), and
    - The holding period will tack

- IRC 1202(h)(4)(B)
  - Excludible gain is limited to built-in gain at the time of exchange (unless exchanged stock is also QSBS)

- Example from previous page
  - Ashley sells P stock for $7 million
    - Post-merger gain of $2 million <u>is not</u> excludible under 1202, but
    - Built-in gain at time of merger <u>is</u> excludible under 1202

Active Business Requirement

Active Business Requirement: Selected IRC §1202(e) Tests

- **Portfolio Stock or Securities - IRC §1202(e)(5)(B)**. Corporation will fail active business requirement if more than 10% of the value of its assets (in excess of liabilities) consist of stock or securities in other corporations which are not greater than 50% owned (by voting power or value) subsidiaries of such corporation (other than working capital assets described in IRC §1202(e)(6)).
  - **Caution:** Cash management utilizing corporate securities (e.g., commercial paper)

- **Real Estate Holdings - IRC §1202(e)(7).** Corporation will fail active business requirement during any period during which more than 10% of the value of its assets (not reduced by liabilities) consists of real property which isn't used in the active conduct of a qualified trade or business.
  - **Caution:** The ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business

- **Working Capital - IRC §1202(e)(6).** Working capital shall be treated as used in the active conduct of a qualified trade or business if the assets are held as part of the reasonably required working capital needs of a qualified trade or business of the corporation, or are held for investment and are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business. After a corporation has been in existence for two years or more, in no event may more than 50% of the FMV of the corporation's assets qualify as used in the active conduct of a qualified trade or business pursuant to §1202(e)(6).
  - **Caution:** Large financing rounds could violate §1202(e)(6) and potentially fail the "substantially all" test

Redemptions of Shareholders

- **Pitfall for Redeemer**
  - If more than a “de minimis amount” of stock is redeemed[1], then QSBS status is lost for stock issued to the redeemer or a related party (IRC §§267(b) or 707(b)) of the redeemer during the four-year period beginning two years before the stock was issued.
  - **Example**: Stock issued on July 1, 2018 to a shareholder will not be QSBS if the company redeemed more than a de minimis amount of stock from that shareholder or a related party of that shareholder after June 30, 2016 and before July 1, 2020.

- **Pitfall for other Shareholders**
  - Stock issued to any shareholder will not be QSBS if during the two year period beginning one year before the stock was issued the company 1) redeemed more than a de minimis amount of its stock[2], and 2) the purchased stock had an aggregate value exceeding 5% of the aggregate value of all of the company’s outstanding stock as of the beginning such two year period.

- **Exceptions[3]—redemptions due to:** termination of services; death; disability or mental incompetency; or divorce.

- Redeemed shareholder may be eligible for QSBS exclusion on gain realized on redemption if redemption qualifies as a sale or exchange of shares under IRC §302 and all other QSBS requirements are met.

1. Redemption exceeds de minimis amount if the aggregate amount paid exceeds $10,000 and more than 2% of the stock held by the shareholder. See Treasury Regulation § 1.1202-2(a)(2).
2. Redemption exceeds de minimis amount if the aggregate amount paid exceeds $10,000 and more than 2% of all outstanding stock. See Treasury Regulation § 1.1202-2(b)(2).
3. See Treasury Regulation § 1.1202-2(d).

Planning Opportunities to Maximize the Gain Exclusion

Maximum Exclusion: Greater of $10 million or 10 x Basis

- IRC 1202(b)

  (1) In general If the taxpayer has eligible gain *for the taxable year* from 1 or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation which may be taken into account under subsection (a) *for the taxable year* shall not exceed the greater of—

  (A) $10,000,000 reduced by the aggregate amount of eligible gain taken into account by the taxpayer under subsection (a) for prior taxable years and attributable to dispositions of stock issued by such corporation, or

  (B) 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.

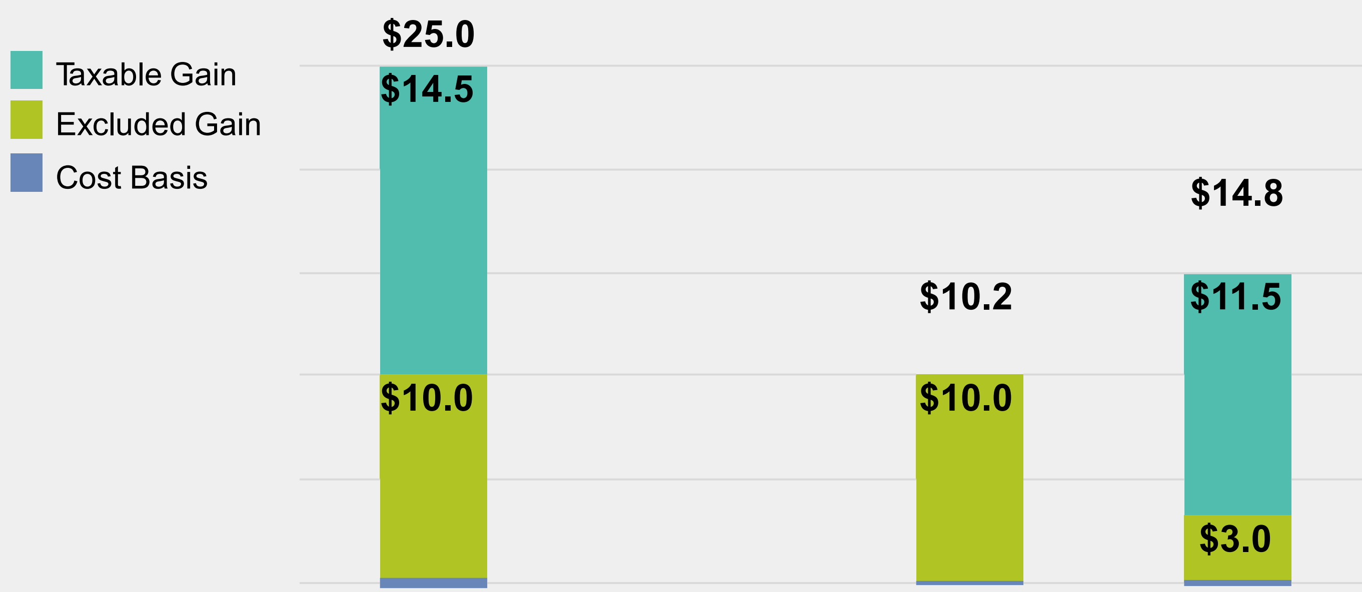
  For purposes of subparagraph (B), the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued.

- The limit per "taxable year" would seem to allow the use of <u>both</u> $10 million aggregate gain plus 10 x basis if applied over multiple years

Example: QSBS with FMV of $25 million and basis of $500,000*

($Millions)

	Single Year Sale	Multi-Year Sale	
Sale Date:	12/31/2017	12/31/2017	1/1/2018
Sale %:	100%	40.82%	59.18%



	Single Year Sale		Multi-Year Sale				
Proceeds:	$25.00	Proceeds:	$10.20	+	$14.80	=	$25.00
Tax:	($3.45)	Tax:	-	+	($2.75)	=	($2.75)
	$21.55		$10.20	+	$12.05	=	$22.25

*Example assumes QSBS acquired after 9/27/2010 (100% gain exclusion stock) and 23.8% tax rate on taxable portion of sale proceeds. “Multi-Year Sale” excludible gain: 2017 equals greater of $10 million or 10 x $204,081 ($10 million limit) and 2018 equals greater of $10 million less 2017 exclude gain ($0), or 10 x 295,919 ($2.96 million limit).

QSBS Exclusion and Transfers

- Transfers by gift or at death preserve QSBS status[1]
- A transferee receiving QSBS in this manner is treated as having acquired the stock on the same date as the transferor and as holding the stock for the continuous period held by the transferor preceding the transfer[2]
- Each transferee who receives QSB stock in this manner is entitled to its own QSBS exclusion. Accordingly, a valuable strategy is to make gifts of QSB stock before a sale to multiply the number of exclusions which may benefit a family.

1. IRC §1202(h)(2)
2. IRC §1202(h)(1)

What Planning Strategies Multiply the Exclusion?

Outright Gifts

- Assume that Ashley Yoo purchased stock from 1202, Inc. at original issue in 2014 and then gifted a portion of the "2014 stock" to her daughter in 2016. Further assume that at the time of the investment, "1202, Inc." met the requirements of a QSB under IRC §1202. If 1202, Inc. were sold in 2019, both Ashley and her daughter would exclude gain pursuant to IRC §1202.

Gifts to Non-grantor Irrevocable Trust

- What if Ashley transfers some of her stock to a non-grantor, irrevocable trust for the benefit of her daughter and then 1202, Inc. is sold in 2019? In that event, both Ashley and the non-grantor, irrevocable trust should be entitled to separate QSBS exclusions (assuming all other requirements are satisfied).

- **Limitation of Number of Trusts?**
  - Is there a limit to how many trusts would qualify? Can Ashley establish non-grantor, irrevocable trusts for her daughter, her nieces, her nephews, her personal trainer, etc.?
  - So long as trusts differ in meaningful aspects, each trust should receive its own gain exclusion.
  - While there is no clear guidance, many practitioners believe that an irrevocable trust will qualify for its own QSBS exclusion if the trust is a separate taxpayer (e.g., a non-grantor trust) and if the gift of stock to the trust was a completed gift.

Documentation

QSBS Reporting Requirements

- IRC §1202(d)(1)(C) provides that a Qualified Small Business "agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section."
- At this time, the IRS has not issued any reporting requirements to establish Qualified Small Business status.
- Although the lack of reporting obligations lessens the burden on taxpayers on an ongoing basis, it means that it is important that taxpayers keep detailed, contemporaneous records so that they can establish QSB status at the time of a sale.

How Can I Maximize My Chances of Qualifying for Gain Exclusion Under IRC §1202?

- **Keep clear records from the outset**
  - Date of purchase
  - Amount paid
  - Cancelled check or wire confirming the amount paid
  - Share certificate
- **Have the company provide you with proof of the following concurrent with your purchase:**
  - The corporation is a C corporation
  - The corporation has $50 million or less in assets immediately after purchase
  - At least 80% of the corporate assets are used in an active business
- **Consider obtaining an opinion letter from a law firm specializing in QSBS transactions**
- **Involve experienced professionals who understand the QSBS rules and can help you monitor the holding period and other requirements**

Summary

- The QSBS exclusion can be enormously valuable for a founder, investor or employee who invests in an emerging company.
- Great care must be taken when the business is formed AND when the applicable interest is sold in order to take advantage of the exclusion.
- The rules surrounding the QSBS exclusion are complex. It is critical for clients to partner with tax, legal and financial professionals who are familiar with these rules and can help capture (and maximize) the opportunity.

APPENDIX

After-Tax Proceeds: LLC to C-Corp Conversion

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QSBS and Advanced Transfer Strategies

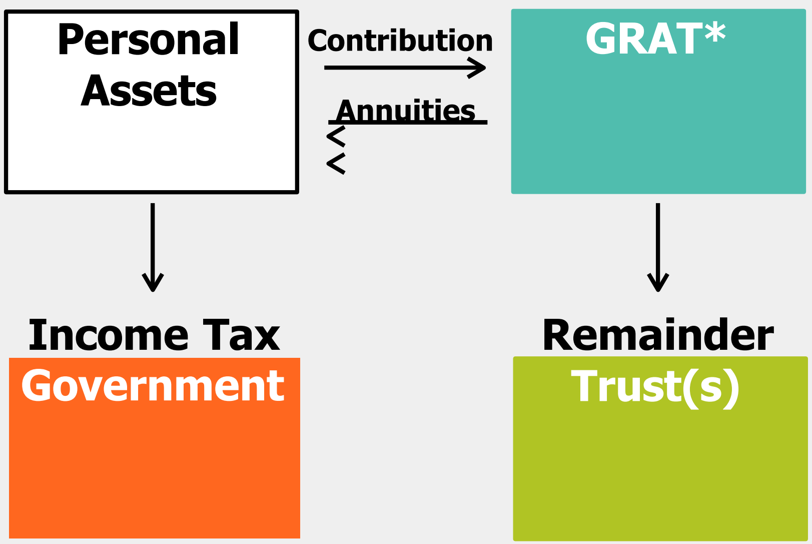
Sample Case Fact Pattern: Founder with Surplus Capital

- Entrepreneur Ashley Yoo founded a C corporation in November of 2010 and the company has a current valuation of $800 million.
- Ashley has built a $25 million diversified investment portfolio through stock sales during capital raises, and her remaining ownership in the company is currently valued at $70 million ($7.00 on a per share basis).
- Ashley would like to begin shifting wealth to family members, and her advisory team has conservatively estimated that she has $15 million of "surplus capital" available to gift.
- Ashley believes that there is a high likelihood that the company will continue to grow rapidly over the next two years, and at that time the company will either pursue an IPO or be acquired.

Question:

If Ashley utilizes a GRAT to move wealth to family members, then what GRAT term should she choose? Will her stock lose QSBS status if transferred to a GRAT?

Grantor Retained Annuity Trust (GRAT)



Key Points

- Grantor transfers assets to GRAT
- Grantor receives annual annuity payments from trust
- Grantor pays taxes on trust income
- If GRAT assets grow faster than Section 7520 rate, wealth is transferred free of gift tax**
- “Wins” go to trust (or trusts) for children and/or other family members

*The assets of a GRAT are generally invested as directed by the trustee.
**Assuming the GRAT is “zeroed-out” so that the present value of the annuity stream, discounted by the Section 7520 rate, equals the original contribution, and assuming that the grantor survives the term of the GRAT.

GRATs and QSB Stock:
GRAT Must Terminate Before Sale Occurs to Capture Gain Exclusion

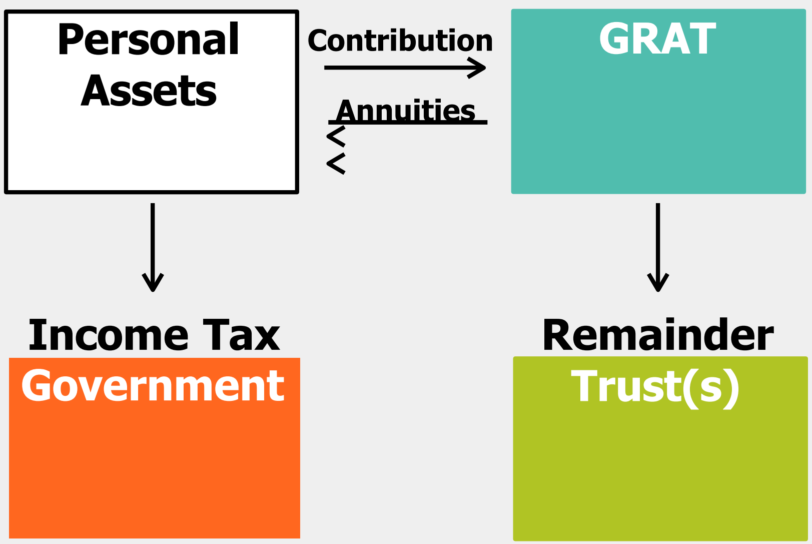
GRAT Funding: 1,000,000 shares @ $7.00 per share
Sale Assumption: Shares sold 2 years + 1 month after funding @ $20 per share

	Projected Values at Time of Sale		
	2-Year GRAT	4-Year GRAT	6-Year GRAT
Shares in GRAT	-	785,750	880,618
Shares in Remainder Trust	491,528	-	-
Stock Price	$20.00	$20.00	$20.00
GRAT Value	-	$15,715,000	$17,612,360
Remaining Annuities	-	($4,820,882)	($6,554,478)
Implied Surplus	-	**$10,894,118**	**$11,057,864**
Remainder Trust Value	**$9,830,560**	-	-

	2-Year GRAT	4-Year GRAT	6-Year GRAT
Transfer Tax Avoided*	$3,932,224	$4,357,647	$4,423,145
Income Tax Avoided**	$2,339,672	$0	$0
Total Tax Avoided	**$6,271,896**	**$4,357,647**	**$4,423,145**

*Assumes a 40% estate tax savings on all assets transferred through the GRAT (or "implied surplus" defined as GRAT value in excess of remaining annuity payments) at the time of sale.
**As compared to a "No GRAT" base case. Assumes a cost basis of $0.001/share. Further assumes that shares transferred to a taxable remainder trust retain QSBS status and the trust is eligible for QSBS gain exclusion as a separate tax payer. Any non-excluded gain is assumed to be taxed at 23.8% long-term capital gains rate.

Transferring QSBS to a GRAT: What Happens to QSBS Status?



Questions

- Would GRAT funding be considered a donative transfer and retain QSBS status under 1202(h)(2)(A)?
- If so, would the entire contribution preserve QSBS status given the retained interest in a "zeroed-out" GRAT?
- If the GRAT holds QSBS, what happens to QSBS status if shares are used in-kind to satisfy GRAT annuity payments?

What About Sale of QSBS to IDGT?

Intentionally Defective Grantor Trusts ("IDGT")

- Will stock owned by an intentionally defective grantor trust ("IDGT") qualify for a separate QSBS exclusion?
  - If QSB stock is sold while the trust is an IDGT, then the trust is the grantor for income tax purposes—so no.
  - If the IDGT becomes a non-grantor trust by reason of death, then perhaps the stock will be treated as a transfer "at death" and retain QSBS status under §1202(h).
  - If the IDGT becomes a non-grantor trust for reasons other than death, then facts may determine whether the transfer can qualify.

Planning Opportunities: Holding Companies

Holding Companies Generally

- Acquisition of C corporation stock by an individual from a third party that otherwise might qualify for §1202 doesn’t satisfy original issuance test
- Stock issued by a C corporation holding company that acquires >50% of the voting power or FMV of the stock of C corporation subsidiaries appears to qualify if subsidiaries are QSBs (subject to overall $50M gross asset threshold of combined corporate group)
  - Potential for multiple acquisitions of QSBS subsidiaries - due to corporate subsidiary look-through rule for >50% owned subsidiaries

QSBS and Pass-Thru Entities

QSBS and Pass-Thru Entities: IRC §1202(g)

- An individual taxpayer's allocable share of gain from the sale of QSBS held by a partnership, LLC, trust or S corporation is eligible for the exclusion if the following requirements are met (sale of interest in the pass-through entity does not qualify):
  - All eligibility requirements for QSBS are met;
  - The stock was held by the entity for more than 5 years; and
  - The owner of the entity interest owned such interest when the entity acquired the stock and at all times thereafter before the disposition of the stock by the pass-through entity.
  - Partner, member or shareholder cannot exclude gain to the extent that the partner's, member's or shareholder's percentage share in the entity's gain exceeded the partner's, member's or shareholder's capital interest percentage in the entity at the time the entity acquired the stock (implications for carried interest; compare to common and preferred stock in a corporation).
- If entity distributes QSBS to individual partner, the recipient may claim QSBS gain exclusion if the above requirements are met (except for the 5-year holding period). The individual's holding period tacks on to the partnership's holding period.
- If an individual transfers QSBS to a pass-thru entity, QSBS status is lost.
- What happens if an interest in a pass-thru entity that acquired QSBS is transferred? QSBS status for transferee might be retained, but subject to §1202(g)(3) limitation.

TAX COURT CASES

IRC § 1202 AND IRC § 1045

*Natkunanathan v. Commissioner**
IRC § 1202 Applies to Stock, Not Options

- Taxpayer owned options on stock of a C corporation, Cognet, which were converted to options on Intel stock after a 2001 merger. Taxpayer exercised the Intel options and sold the Intel stock in 2003, asserting that the Intel stock qualified as QSBS. The taxpayer sought to exclude 50% of the gain under IRC 1202(a)(1), arguing that the Intel options acquired in the merger retained the QSBS nature of Cognet under IRC § 1202(f), which addressed the treatment of stock acquired on conversion of other stock.

- The Tax Court held that the taxpayer may not claim an IRC § 1202 gain exclusion.
  - The Tax Court held that the taxpayer was unable to demonstrate that Cognet was a qualified small business under IRC §1202(d) or that the taxpayer had held the Cognet (or Intel) stock for 5 years.
  - The Tax Court noted that the QSBS gain exclusion applied only to stock, and not to options. The Tax Court pointed out that the taxpayer sold the Intel stock a day after the taxpayer had exercised the options.

*TC Memo 2010-15, aff'd (9th Cir 2012) 479 Fed Appx 775

*Owen v. Commissioner**
IRC § 1202(e)(6) Safe Harbor Limitations

- Taxpayers owned interests in a variety of companies, including a C corporation, Family First Advances Estate Planning (FFAEP), which sold "prepaid legal service policies, including estate planning services." Taxpayers sold their FFAEP stock on June 17, 2002, and, in an effort to defer gain under IRC §1045, formed a jewelry company, J & L Gems, to which they contributed almost $2 million of FFAEP sales proceeds. During its first 6 months of business, J & L Gems purchases 16 pieces for approximately $150,000. However, by July 2003, it had only sold a few pieces to friends and family, and as of August 2004, it had not purchased any more jewelry or made any more sales.

- Tax Court ruled that the taxpayers could not defer gain under IRC §1045 for the following reasons:
  - The Tax Court found that FFAEP was a qualified trade or business, which was interesting given the legal and insurance nature of the company. The Tax Court also held that the taxpayers met the 60-day rollover requirement.
  - The Tax Court held that J & L Gems did not constitute an active trade or business because 92 percent of its assets were held in cash. Under IRC §1202(e)(6), after the second year of a business's existence, at least 50% of the value of assets must be used in an active trade or business. J & L Gems had only spent 8% of the initial investment on business activities after two years, which was too modest to be considered an active trade or business.

*TC Memo 2012-21

*Holmes v. Commissioner**
Planning for IRC § 1045 Rollovers

- Taxpayer cofounded two companies, MacroPore and LeonardoMD. Between 2000 and 2004, the taxpayer sold more than $3 million of MacroPore shares and made 36 separate investments in LeonardoMD. The taxpayer did not report the gain on the sale of the MacroPore stock on his personal returns, relying on IRC §1045 deferral, although no IRC §1045 election was made. Taxpayer's CPA attempted to bribe the revenue agent examining the sales, and then the taxpayer's legal counsel requested IRC §9100 relief to make a late IRC §1045 election. The matter eventually landed in Tax Court, where the taxpayer argued that LeonardoMD was a qualified small business and that the taxpayer had properly rolled over the MacroPore sales proceeds to LeonardoMD.

- The Tax Court, unsurprisingly, did not sympathize with the taxpayer.
  - The taxpayer failed to provide evidence that he received the LeonardMD shares at original issuance.
  - The taxpayer failed to provide evidence that the value of LeonardMD was less than $50 million or met the active business requirement.
  - The Tax Court held that the taxpayer failed to establish that LeonardoMD was a qualified small business under IRC §1202, so the Tax Court did not reach the question of whether the proceeds were properly rolled over under IRC §1045.

* TC Memo 2012-251, aff'd (9th Cir 2015) 593 Fed Appx 693

PLRs

ACTIVE BUSINESS REQUIREMENT

PLR 201436001*

- Ruling involved a corporation that provided products and services in the pharmaceutical industry. The business activities consisted of the following:
  - Research on drug formulation effectiveness
  - Pre-commercial testing procedures, such as clinical testing
  - Manufacturing of drugs
  - Working with clients to solve problems in the pharmaceutical industry, such as developing successful manufacturing processes.
- Ruling concludes that the corporation was engaged in an active trade or business under IRC §1202 because it was not "offering service in the form of individual expertise."
- The ruling states that the corporation was "a pharmaceutical industry analogue of a parts manufacturer in the automobile industry."
- **The ruling is helpful because it implies that that corporation can qualify as a qualified small business even if it is involved in one of the "prohibited" industries enumerated in IRC §1202(e)(3). The critical factor appears to be whether the corporation provides services to customers through its employees or other representatives**.

*Sept. 5, 2014; 2014 PLR Lexis 597

PLR 201717010*

- Ruling involved a C corporation that analyzed the results of lab testing and provided reports to health care providers. Clients of the corporation are physicians and other health care providers. The corporation does not provide any diagnostic services or treat individual patients.

- The IRS determined that the corporation is engaged in a qualified trade or business pursuant to IRC §1202(e)(3) because the corporation "is not in a trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees."

*April 28, 2017

PLRs

QSBS AND CORPORATE REORGANIZATIONS

PLR 9810010*

- Ruling involved a reorganization under IRC §§368(a)(1)(D) and 355. A qualified small business (the "Distributing Corporation") formed a new corporation (the "Controlled Corporation"), transferred one of Distributing Corporation's business lines (a qualified trade or business under §1202(e)(3)) to Controlled Corporation, and then spun Controlled off to certain Distributing shareholders in exchange for Distributing stock.
- The IRS determined that the Controlled stock received by the Distributing shareholders would be treated as QSBS pursuant to IRC §1202(h)(4)(A).
- Furthermore, the IRS held that the shareholders of Controlled could tack their holding period for the Controlled stock to their prior holding period for the Distributing stock.

**December 3, 1997

PLR 201603010*

- Shareholders of a C corporation, which was a qualified small business under IRC §1202, converted the C corporation to an LLC but checked the box so that the LLC would continue to be taxed as a corporation.
- IRS determined that under IRC §1202(h)(3), by reference to IRC §1244(d)(2), a successor corporation in an F reorganization (IRC §368(a)(1)(F)) is treated as the same corporation as its predecessor.
- Accordingly, the original stock of the corporation retains its QSBS status and holding period even after the conversion to an LLC.

**January 15, 2016

PLRs

Late §1045 Rollovers

Late IRC §1045 Rollovers

- PLR 200521021* involved taxpayers who were permitted to make a late IRC §1045 election. The taxpayers sold QSBS stock and reinvested the proceeds in new QSBS within 60 days. However, the taxpayers' CPAs failed to recognize that the gain could be deferred under IRC §1045. Since the taxpayers had not been audited and the only change to their return would have been the IRC §1045 election and deferral, the IRS granted the taxpayers an extension of time to make the election and allowed them to filed amended returns deferring the gain.
- However, in PLR200604004**, the IRS denied an extension of time to make an IRC §1045 election because the taxpayers could not demonstrate that they had relied on the advice of the return preparer in failing to make the election.
- In PLR 200906009***, the IRS denied the request of a taxpayer to make a late IRC §1045 election because the IRS had already commenced an audit of the years in question. Further, the taxpayer sought the late election only after the IRS determined that the taxpayer could not substantiate certain capital loss and zero-gain reporting positions.

* May 27, 2005
**January 27, 2006
***February 6, 2009

IRC §1202 AND STATUTE OF LIMITATIONS

Chief Counsel Advice Memo 200609024*

- Considers whether gain excluded under IRC §1202 should be counted when determining whether a taxpayer has omitted more that 25% of the taxpayer's income.
  - Generally speaking, the IRS must assess tax within 3 years of when a return is filed.**
  - Tax may be assessed within 6 years of a return being filed if the taxpayer omits from gross income an amount in excess of 25 percent of gross income reported on the return.***
- The Advice Memo concludes that "gross income" for purposes of IRC §6501(e) does not include capital gain excluded by IRC §1202.

*March 3, 2006
** IRC §6501(a)
*** IRC §6501(a)(3)

ALLEN B. WALBURN

Allen Walburn is a tax partner with the law firm of Higgs Fletcher & Mack LLP in San Diego. With over 25 years' experience as a tax lawyer, Allen Walburn helps clients plan, structure and negotiate a wide range of corporate, partnership and real estate transactions. His areas of expertise include corporate and partnership taxation; taxation matters relating to formation and operation of hedge funds; private equity funds and real estate funds; executive compensation, equity-based compensation; property tax matters; and inbound U.S. international tax planning.