Morgan Stanley

WEALTH MANAGEMENT

Qualified Small Business Stock (QSBS)

Estate Planning Strategies

The beneficial tax treatment of Qualified Small Business Stock ("QSBS") under the Internal Revenue Code is meant to encourage investment in start-up companies and, in turn, attract the financial and intellectual capital essential to fostering scientific and technological innovation. This benefit allows shareholders to exclude from income a portion of capital gains on the sale of their interest in qualifying business entities, provided they meet certain requirements.

Wealth and Estate Planning Strategists

Family Office Resources

Qualified Small Business

The Internal Revenue Code ("the Code") defines a Qualified Small Business ("QSB") as an active domestic C corporation, the value of whose aggregate gross assets did not exceed $50 million at the time the potential QSBS was issued or immediately after it was issued. Additionally, at least 80% of the company's assets must be deployed in the active conduct of one or more qualified trades or businesses. Notably, the Code provides a laundry list of specific activities that are NOT "qualified trades or businesses." For example, an entity that provides services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset is the reputation or skill of one or more of its employees, or whose business is in banking, insurance, financing, leasing, or similar business, or any farming business are not qualified trades or businesses for QSBS purposes. Additionally, any business of operating a hotel, motel, restaurant, or similar business is not a "qualified trade or business." In addition to the above requirements, the Code dictates that an entity's activity will not be characterized as a "qualified trade or business" if more than 10% of the entity's value is invested in other corporations that are not subsidiaries or in real estate not used in the active conduct of a qualified trade or business. Finally—other than during the first two years of a company's existence—not more than 50% of its value may be held for working capital needs or investment.

Qualified Small Business Stock

In order to be considered QSBS, (1) the underlying corporation must have been a QSB at the time the shares were issued and (2) the shares must have been issued after the QSBS Code provision was enacted in 1993. The shareholder must have acquired the shares at original issue from the QSB (i.e., not through purchase on a secondary market), in exchange for cash or property (except stock), or as compensation for services provided to such corporation. The Code also allows for QSBS to maintain its status if it is transferred by gift or bequest.

The Benefit

Provided a shareholder has held the QSBS for at least five years, upon a sale, the shareholder can exclude from federal[1] taxable gain up to the greater of $10 million or 10x the shareholder's basis in the stock.[2] The $10 million cap applies to unmarried, individual taxpayers; to married individuals who file joint returns; and to other eligible taxpayers (e.g., irrevocable non-grantor trusts). Married individuals who file separate returns may each exclude up to $5 million from capital gains. A shareholder who acquired the QSBS via gift or bequest steps into the shoes of the donor for the holding period requirement (i.e., the recipient shareholder need not satisfy the five-year holding period on their own).

Enhancing the Benefit

Although the maximum benefit is capped per taxpayer, shareholders may be able to gift QSBS to other individuals or to certain trusts for the benefit of others. Each donee-shareholder may, in turn, benefit from a separate exclusion, subject to the limitations set forth above. Practitioners refer to this technique as "stacking" QSBS exclusions. Shareholders should work with their attorneys and tax advisors to ensure that any recipient trust is structured as a non-grantor trust (i.e., a distinct taxpayer responsible for its own income tax liability and not the income tax alter ego of the grantor) and that, if gifts to more than one such trust are made, each has a distinct beneficiary.

Assume, for example, Adam is married to Betty and that together they have three children, Christie, Daniel, and Edward. Adam is a founder of Z Corp., a C corporation that meets the criteria required to be a QSB, and he acquired his shares in 2018. Adam holds one million shares of Z Corp., which represents a 15% ownership in the company, and has a basis of $0.

Each share of Z Corp. is worth $1 and Adam is confident that the value will increase exponentially in the coming years. Adam works with his estate planning attorney to execute a separate irrevocable non-grantor trust for the benefit of each of Christie, Daniel, and Edward and to make a gift of 200,000 shares to each trust. He uses $600,000 of his gift and estate tax exemption in the process.

Five years later, Adam's vision for Z Corp. has been realized; Adam and the other shareholders decide to

Notes:
[1] Shareholders should consult with their tax counsel regarding whether their state conforms with federal treatment of QSBS. California, for example, does not conform to the federal rule and California taxpayers will be subject to California income tax on the gain, even if excluded from federal income tax.
[2] The portion of excluded gain up to the above discussed maximum depends on when the QSBS was acquired. Taxpayers who acquired QSBS (i) prior to February 18, 2009, may exclude up to 50% of the greater of $10 million and 10x basis from gain; (ii) between February 18, 2009, and September 27, 2010, may exclude up to 75% of the greater of $10 million and 10x basis from gain; and (iii) on or after September 27, 2010, may exclude up to 100% of the greater of $10 million and 10x basis from gain.

sell the business to a private equity firm for $100 per share.

Adam realizes a capital gain of $40 million on the sale of his own 400,000 shares. Adam and Betty file a joint income tax return and so are eligible to exclude $10 million of the gain from income, effectively saving ~$2 million in federal income taxes, assuming a 20% federal long term capital gains tax rate. Each of the three irrevocable non-grantor trusts realizes a capital gain of $20 million on the sale of its 200,000 shares. Because each trust is an independent taxpayer and has a distinct beneficiary, it will be entitled to its own $10 million exclusion from federal income tax. Adam's savvy planning results in his family excluding $40 million of capital gain from income and saving ~$8 million in federal income taxes.

Reinvestment

The Code also permits taxpayers to rollover the proceeds from a sale of QSBS, upon proper election, that is held for at least six months to another QSB within sixty days of the sale and to defer the gain on the amount reinvested until a subsequent sale of the newly acquired shares. The taxpayer's basis in the newly acquired QSBS is adjusted downward by the amount of gain deferred on reinvestment.

Assume that within sixty days after the sale of Z Corp., Adam applied $2 million of the amount realized to purchase 10,000 shares of Y Corp.—another QSB—for $200 per share. Adam is eligible to defer the gain attributable to the $2 million reinvested. His basis in the Y Corp. shares is equal to the purchase price of $2 million, less the amount of gain deferred ($2 million), or $0.

If Adam had not held his shares in Z Corp. for five years prior to a sale, thereby failing to meet the holding period requirement to be eligible for gain exclusion, he could still rollover some or all of the amount realized to purchase shares in Y Corp.—another QSB—and in so doing, defer the gain attributable to the amount reinvested until a sale of his Y Corp. shares. He can also tack his Z Corp. QSBS holding period to his Y Corp. QSBS holding period when determining eligibility for gain exclusion upon the subsequent sale of Y Corp QSBS.

Conclusion

The rules around QSBS are complex and nuanced. Clients should work closely with their tax and legal advisors to determine whether they may be eligible to leverage this valuable tax benefit.

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Important Disclosure

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