Have Qualified Small Business Stock? Consider Section 1202 as Part of Your Estate and Trust Planning

Posted June 27, 2023
kernuttstokes.com/kernutt-stokes-blog/

Tax Strategist Insight

For individuals seeking to minimize taxes while also transferring wealth to the next generation, the income tax benefits provided under Internal Revenue Code Section 1202 can match up well with estate planning efforts. Section 1202 permits a taxpayer other than a corporation to exclude from taxable income a specified percentage of gain – and potentially the entire gain – from the sale or exchange of "qualified small business stock" (QSBS) held for more than five years. In addition, with proper planning, each recipient of a gift of QSBS is also eligible for the gain exclusion.

Overview of the Section 1202 QSBS Gain Exclusion

Enacted in 1993 to encourage investment in small businesses formed as C corporations, Section 1202 initially granted a 50% exclusion of gain from QSBS, which was later increased to 75% for QSBS acquired after February 17, 2009, and then again to 100% for QSBS acquired after September 27, 2010.

In all cases, the maximum amount of gain on QSBS that can be excluded for any taxable year by each taxpayer holding QSBS with respect to each issuing C corporation is generally limited to the greater of:

- $10 million, less the amount of gain that was excluded by the taxpayer in prior years with respect to the same issuing corporation; or
- Ten times the taxpayer's aggregate adjusted basis in the QSBS sold during the taxable year.

The $10 million exclusion limit may be reduced for married individuals (see **Gifts of QSBS to a spouse**, below.)

Significant requirements must be met for stock to qualify as QSBS. A full discussion of these requirements is beyond the scope of this article. However, a main requirement is that the stock must have been acquired directly from the C corporation issuing the stock.

Section 1202 and Gifts of QSBS

An exception to the rule that QSBS must have been acquired directly from the issuing corporation is that a person receiving a gift of QSBS (donee) will be treated the same as the person making the gift (donor). In other words, for Section 1202 purposes, the donee will be treated as acquiring the QSBS in the same manner as the donor, will take the same tax basis in the gifted QSBS shares as the donor, and will be treated as holding the QSBS during the donor's holding period. Because the gain exclusion provided by Section 1202 applies to each taxpayer holding QSBS, gifting QSBS can increase the amount of excluded gain on sales of QSBS originally acquired by the donor and deemed held for more than five years.

Insight

In addition to being eligible for Section 1202 income tax benefits, gifts of QSBS are generally subject to gift tax — which in certain cases could exceed the ultimate tax benefit of any Section 1202 gain exclusion(s).

Therefore, gift tax consequences should always be considered when engaging in Section 1202 planning using gifts of QSBS. For more information, see **Gift Tax Consequences of Gifts of QSBS**, below.

Gifts of QSBS to children
Because Section 1202 is a per taxpayer exclusion, gifting QSBS to children can potentially reduce the total income taxes due on the ultimate sale of QSBS originally acquired by the parent.

For example, assume a mother acquires QSBS in a start-up corporation. She then gifts a portion of her QSBS to her two children. If the children have held the QSBS for more than five years when it is sold (determined by tacking on the holding period of the mother), each child can exclude from their taxable income gain up to the $10 million/10 times basis exclusion limit. In addition, the mother will be entitled to her own $10 million/10 times basis exclusion amount on the QSBS she retains and that she has held for more than five years.

Gifts of QSBS to a Spouse
Controversy exists with respect to whether a gift of QSBS to a spouse may obtain the same Section 1202 income tax benefits when sold as a gift to a child. Although the statute indicates that the exclusion limits apply to each taxpayer holding QSBS, the statute also expressly limits the $10 million exclusion cap to $5 million for a married individual filing a separate return. However, because neither Section 1202 nor IRS guidance specifically addresses the maximum exclusion for joint returns, there is a high degree of uncertainty surrounding the exclusion amount for a married couple filing jointly — that is, whether the $10 million exclusion limit applies per couple or per spouse.

Married individuals claiming the exclusion or desiring to make gifts of QSBS to their spouse should carefully review the tax consequences and proper reporting of such gifts with their estate and tax advisors. In addition, for those concerned about the uncertainty, consideration could be given to making an inter-vivos gift to a Spousal Lifetime Access Trust (also see **Use of Spousal Lifetime Access Trusts**, below).

Gifts of QSBS to Trusts
Making gifts of QSBS to irrevocable trusts can provide benefits to the beneficiaries, such as possible protection from creditors and possible avoidance of future gift and estate taxes. These trusts can be designed to be either grantor or non-grantor trusts for federal income tax purposes. A grantor trust will attribute all items of income, deduction, and credit to the grantor. A non-grantor trust is a taxable entity for federal income tax purposes and will pay tax on its undistributed income. Caution should be exercised when making gifts of QSBS to trusts to avoid unintended tax consequences, some of which are discussed below.

Consider avoiding grantor trusts. Irrevocable grantor trusts can be advantageous, for example, because the payment of the tax on trust income by the grantor allows the assets of the trust to grow without the trust being liable for the tax. However, a gift of QSBS to an irrevocable grantor trust will not provide any additional Section 1202 tax planning benefits, since the grantor remains the only taxpayer (that is, the trust is ignored for federal income tax purposes). For gifts of QSBS to a trust to be eligible for gain exclusion under Section 1202, the trust must be a non-grantor trust.

For example, assume an owner of QSBS has two children, and she contributes a portion of her QSBS to separate non-grantor trusts for each child. Assuming the five-year holding period is met, the owner and each trust would be entitled to their own $10 million/10 times basis exclusions when their QSBS is sold.

Converting from grantor to non-grantor trust. In certain circumstances, an irrevocable grantor trust may be converted to a non-grantor trust to enable the trust to take advantage of the Section 1202 gain exclusion for QSBS. The termination of grantor trust status may have federal income tax consequences, especially if the trust has debt that exceeds the basis of its assets. Therefore, the tax and non-tax issues of a conversion must be fully vetted before terminating grantor trust status.

Use of Spousal Lifetime Access Trusts. Where a spouse has set up an irrevocable trust for the benefit of their spouse and children (commonly referred to as a Spousal Lifetime Access Trust or SLAT), having a spouse as a beneficiary will automatically trigger grantor trust status unless distributions to the spouse can only occur with the consent of an adverse party. As previously noted, a grantor trust is not entitled to its own gain exclusion under Section 1202.

Gifts to Incomplete Non-Grantor (ING) Trusts. ING trusts have often been utilized in hopes of reducing state income taxes by placing the trust in a state with little or no state income tax. The "incomplete gift" to the ING trust is not a taxable gift for federal gift tax purposes. The assets of the trust are, however, subject to estate tax in the estate of the grantor.
Although the use of ING trusts can be advantageous where the grantor has a number of beneficiaries to which they would like to transfer QSBS, the use of the ING trust is a complex and highly controversial area of the tax law and does not make sense for every grantor. Due to the risks involved, individuals should work with their estate and tax advisors when considering ING trusts.

Partnership Structures

Some families set up limited partnerships for gifting purposes. However, taxpayers should be cautious of partnership structures when planning for gifts of QSBS. QSBS that is contributed to a partnership will generally lose its QSBS status upon contribution. Also, a gift of an interest in a partnership that holds QSBS it acquired at original issuance, as opposed to a gift of the stock itself from one individual to another, could result in a loss of Section 1202 benefits. Further, special rules apply for purposes of determining whether partners are entitled to Section 1202 benefits on QSBS acquired at original issuance by the partnership.

Death of the QSBS Owner

Like gifts of QSBS, where QSBS is transferred upon the death of the owner, the transferee "steps into the shoes" of the decedent with respect to the QSBS. Because death of an owner causes a mandatory change in tax basis of the decedent's assets (including QSBS) to fair market value, the benefit of the Section 1202 exclusion may be nominal if the estate or beneficiaries sell the QSBS after death at little to no gain. If, however, the estate or beneficiary continues to hold the QSBS, any future appreciation in the stock should be eligible for the exclusion.

Gift Tax Consequences of Gifts of QSBS

As previously mentioned, gift tax consequences must be considered when planning for gifts of QSBS. Whether gift tax is due depends on the specific facts and circumstances, including, for example, the amount

of the donor's available gift tax exemption, the value of the gifted QSBS and/or whether the donor elects "gift splitting" with their spouse.

The QSBS's fair market value is used to determine the amount of gift tax due on the gift. In general, except for gifts to a U.S. citizen spouse (which automatically qualify for the gift tax marital deduction), the gifted value exceeding the donor's available gift tax exemption will be subject to a federal gift tax rate of 40%.

In some cases, the amount of gift tax due on gifts of QSBS may exceed the ultimate tax benefit of any Section 1202 gain exclusion(s). As the rules surrounding Section 1202 and gift and estate taxes are highly complex, scenario modeling that considers the taxpayers' facts and circumstances as well as their short- and long-term tax and estate planning goals is necessary to estimate the overall tax effect of the gifts.

Insight

The current lifetime gift tax exemption amount of $12,920,000 (adjusted for inflation) is scheduled to decrease by approximately one half on January 1, 2026. Although not without risk, individuals may want to consider taking advantage of the increased exemption amount by making gifts prior to that date – including gifts of QSBS – as part of their overall estate tax plan. Individuals considering making or accelerating gifts or engaging in similar planning to take advantage of the higher gift tax exemption amount should consult with their estate and tax advisors.

The information contained in this article is based on federal laws and policies in effect as of the publication date. This article discusses tax planning for federal taxes. Other applicable taxes, such as state and local income, gift, estate, and inheritance taxes, must also be considered. For example, some states have not adopted the federal QSBS exclusion, and some states have their own unique gift and estate tax laws. It is important that taxpayers consult with their estate and tax advisors when making decisions regarding any of the information mentioned in this article.