



presents

2023 Estate and Gift Tax Conference

Don't Guess and Make a Mess with QSBS

Thursday, March 9, 2023
12:30 pm - 1:30 pm

Speakers:
Justin Miller

Conference Reference Materials

Points of view or opinions expressed in these pages are those of the speaker(s) and/or author(s). They have not been adopted or endorsed by the California Lawyers Association and do not constitute the official position or policy of the California Lawyers Association. Nothing contained herein is intended to address any specific legal inquiry, nor is it a substitute for independent legal research to original sources or obtaining separate legal advice regarding specific legal situations.

© 2021 California Lawyers Association
All Rights Reserved

The California Lawyers Association is an approved State Bar of California MCLE provider.

Don't Guess and Make a Mess with QSBS

Presented by:

JUSTIN MILLER, J.D., LL.M., TEP, AEP[®], CFP[®]

Partner and National Director of Wealth Planning, Evercore Wealth Management
Managing Director, Evercore Trust Company

March 2023

EVERCORE | Wealth Management
Trust Company

THE NEW STANDARD IN WEALTH MANAGEMENT

Follow at:

[linkedin.com/in/justinmilleresq](https://www.linkedin.com/in/justinmilleresq)

twitter.com/justinmilleresq

AGENDA

- I. Overview
- II. Planning Opportunities and Potential Pitfalls
- III. Hypothetical Example
- IV. QSBS “Stacking” with Non-Grantor Trust Planning
- V. Possible Legislative Threats

Overview

SECTION 1202 QUALIFIED SMALL BUSINESS STOCK (QSBS)

Exclusion in General

- For a taxpayer other than a corporation, gross income shall not include gain from the sale or exchange of qualified small business stock held for more than 5 years

Exclusion Per Issuer Amount Limitation—“Greater of” Each Year

- \$10M per taxpayer—reduced by portion of \$10M benefit from prior years
- 10 times basis per taxable year

Exclusion Per Issuer Percentage Limitation—Based on 28% Rate¹

- 8/11/1993 – 2/17/2009 (§ 1201(a)(1)): 50% exclusion
- 2/18/2009 – 9/27/2010 (§ 1201(a)(3)): 75% exclusion
- **On or after 9/28/2010 (§ 1201(a)(4)): 100% EXCLUSION!!!**

¹ Revenue Reconciliation Act of 1993 (50% exclusion); American Recovery and Reinvestment Tax Act of 2009 (exclusion increased to 75%); Creating Small Business Jobs Act of 2010 (exclusion increased to 100%); Protecting Americans from Tax Hikes (PATH) Act of 2015 (100% exclusion made “permanent”). See Section 1(h)(4)(A)(ii) for reference to the 28% gain rate applicable to QSBS.

THREE QSBS EXCLUSION PERCENTAGES

Non-QSBS Long-Term Capital Gain Tax Rates

Years	Tax Rate
1993-1996	28%
1997-2002	20%
2003-2012	15%
2013-Present	23.8%

QSBS Tax Rates

Issue Date	QSBS Exclusion Percentage	QSBS Effective Federal Tax Rate	QSBS Effective Federal AMT Rate	QSBS Effective NIIT Rate
8/11/93 - 2/17/09	50%	14%	14.98%	1.9%
2/18/09 - 9/27/2010	75%	7%	8.47%	.95%
9/28/2010 - Present	100%	0%	0%	0%

For Alternative Minimum Tax (AMT) purposes, 7% of the excluded gain is included as an AMT addback.

THREE QSBS REQUIREMENTS ON DATE OF ISSUANCE

Domestic C Corporation Stock (§ 1202(c)(1))

- Issued after 08/10/1993

Qualified Small Business (§ 1202(d))

- Company's gross assets do not exceed \$50 million through time of stock issuance
 - Cash plus adjusted basis of company's assets—**not** based on fair market value (FMV)
 - Does not include self-created intangible value (such as goodwill)

Original Issuance (§ 1202(c)(1))

- Does NOT include shareholder who purchases stock from existing shareholder
- Shareholder must acquire stock directly from issuing corporation
 - In exchange for money or other property (not including stock)
 - As compensation for services provided to corporation (other than as underwriter)
- Gift or inheritance from shareholder who received directly from issuing company
- Distribution from a partnership—HOWEVER, no “step into shoes” treatment if partner contributed QSBS to the partnership

THREE REASONS WHY ISSUANCE DATE IS IMPORTANT

Date of Issuance

- Starts the clock for the five-year holding period
 - Date the shareholder contributes cash or property to corporation in exchange for stock
 - Date the shareholder receives stock in connection with performance of services in accordance with rules of § 83—for example, date the shareholder **EXERCISES** options, **NOT GRANT DATE**
- Determines whether 50%, 75%, or 100% exclusion applies
- Marks the date on which the \$50M gross asset test is measured

Exceptions to Date of Issuance General Rule—No Change in Date

- Stock converted into other stock of same corporation—for example, preferred to common
- QSBS received by gift, inheritance or distribution from partnership—“step into shoes”

TWO QSBS REQUIREMENTS DURING SHAREHOLDER'S HOLDING PERIOD

For “Substantially All” of the Shareholder’s Holding Period—Not Lifespan of Corporation

- Corporation must be a C corporation
 - For example, it may be acceptable for entity to have been an S corporation for less than 10% of the owner’s holding period, provided stock was not issued to shareholder when it was an S corporation
- Corporation must satisfy the “active business” requirement
 - Must be an “eligible corporation”—that is, a domestic corporation other than a current or former DISC, regulated investment company, REIT, REMIC or cooperative
 - At least 80% of assets (by value)—which includes self-created intangibles such as goodwill—must be used in an active “qualified trade or business”

§1202 and the Treasury regulations thereunder fail to define “substantially all” for purposes of 1202. For comparison purposes on the conservative side, Treas. Reg. §1.1400Z2(a)-1 defines “substantially all” as 90% for purposes of §1400Z-2(d)(2)(B)(i)(III) and §1400Z-2(d)(2)(C)(iii).

QUALIFIED TRADE OR BUSINESS FOR PURPOSES OF § 1202

“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 allowable under section 613 or 613A, and

(E) any business of operating a hotel, motel, restaurant, or similar business.

The §1202(e)(3) definition is **not** the same as the definition for purposes of §199A, which was enacted after §1202 pursuant to the Tax Cuts and Jobs Act of 2017. See CCA 202204007 (Nov. 4, 2021) (facilitating leasing is brokerage services under §6045—anyone who regularly acts as a middleman with respect to property or services—even though not under §199A) but compare with Private Letter Rulings 202125004 (Mar. 29, 2021) (manufacture of products prescribed by health care providers is not health services) and 202114002 (Jan. 13, 2021) (business that contracts with insurance companies and wholesalers is not brokerage services). See also PLRs 202221006 (Mar. 3, 2022), 202144026 (Aug. 10, 2021), and 201436001 (May 22, 2014).

80% TEST FOR ACTIVE BUSINESS REQUIREMENT UNDER § 1202

Working Capital Under § 1202(e)(6) for Purposes of 80% of Assets Test

- Assets shall be treated as used in active conduct of a trust or business if they are held
 - as part of the reasonably required working capital needs; or
 - for investment and are reasonably expected to be used within 2 years to finance research and experimentation or increases in working capital needs
- After the corporation has existed for 2 years, no more than 50% of the working capital assets qualify as used in the active conduct by reason of the above rules

Ownership of Stock or Real Estate for Purposes of 80% of Assets Test

- If the corporation owns at least 50% of the subsidiary corporation, deemed to own ratable share of subsidiary assets and liabilities
- Corporation fails the test if
 - More than 10% of net assets is stock that is not at least 50% owned by parent
 - More than 10% of net assets is real property not used in active conduct of qualified trade or business—for such purposes, ownership of, dealing in, or renting of real property is not treated as active conduct)

Planning Opportunities and Potential Pitfalls

ONE OR TWO QSBS LIMITATIONS FOR MARRIED COUPLES?

§ 1202(b)(3)—Treatment of Married Individuals

(A) Separate returns

In the case of a separate return by a married individual, paragraph (1)(A) shall be applied by substituting “\$5,000,000” for “\$10,000,000”.

(B) Allocation of exclusion

In the case of any joint return, the amount of gain taken into account under subsection (a) shall be allocated equally between the spouses for purposes of applying this subsection to subsequent taxable years.

(C) Marital status

For purposes of this subsection, marital status shall be determined under section 7703.

Depending on interpretation, an opinion letter might be highly recommended

See H. Rep. No. 103-213, p. 527, 103d Cong., 1st Sess. (1993) (“the \$10 million limitation on eligible gain is applied on a shareholder-by-shareholder basis”); TAM 9853002 (“if Congress had intended that married individuals be treated as one taxpayer for purposes of applying the \$5,000,000 limitation set out in section 453A, it could have easily provided for this attribution in express terms rather than resort to a strained and unlikely interpretation”); *Nell v. Commissioner*, T.C. Memo 1982-228 (Apr. 28, 1982) (“It is a long recognized legal maxim that a husband and wife are separate and distinct taxpayers notwithstanding the fact that they have filed joint Federal income tax returns”); and section 6013(d)(3).

REDEMPTION RESTRICTIONS

Purchases by Corporation of Its Own Stock

- A shareholder's stock will not be QSBS if:
 - At any time during the 4-year period beginning on the date 2 years before the issuance of such stock, the corporation purchased (directly or indirectly) *more than a de minimis amount* of its stock from the shareholder or person related to the shareholder
 - During the 2-year period beginning on the date 1 year before the issuance of such stock, the corporation made 1 or more purchases of *more than a de minimis amount* of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all its stock as of the beginning of such 2-year period

More Than De Minimis Amount

- Aggregate amount paid exceeds \$10k and the corporation purchases more than 2% of the stock held by the shareholder or related person

Treas. Reg. §1.1202-2.

QSBS HELD BY PASSTHROUGH ENTITY

Partner or S Corporation Shareholder Exclusion of Gain from Entity's QSBS Sale

- Stock must satisfy all QSBS requirements, including 5-year holding period
- Partner/shareholder only may exclude gain in passthrough entity if held interest on date entity acquired the stock and at all times before entity's sale of stock
- Partner may only exclude the amount of gain that would have been allocated based on interest on date QSBS was originally acquired by entity

PARTNERSHIP DISTRIBUTIONS VS. PARTNER CONTRIBUTIONS

Distribution of QSBS from Partnership to Partner (§ 1202(g))

- Stock must have been QSBS in partnership's hands
- Partner must have been a partner from the date the partnership acquired QSBS through the date of distribution
- Partner cannot treat the distributed stock as QSBS to the extent the partner's share of the distributed stock exceeds the partner's percentage interest in the partnership at the time partnership acquired the QSBS

Contribution of QSBS from Partner to Partnership

- If a partner contributes QSBS to a partnership, such as a family limited partnership or family LLC—including a non-taxable § 721 contribution—it will disqualify the stock for QSBS treatment under § 1202

CONVERSION TO C CORPORATION FOR QSBS PURPOSES

LLC Conversion to C Corporation

- Check the box under § 301.7701-3 to be a C corporation
- Treated as deemed transfer of all LLC assets in § 351 transfer in exchange for stock and deemed liquidation of LLC
- Appreciated assets valued at “fair market value” for \$50M QSBS test—not historical tax basis
- Shareholder’s basis in stock for § 1202 purposes is “fair market value” of exchanged property
 - Contrary to general rule of § 358, which gives shareholder in § 351 transfer a basis in stock equal to adjusted basis of property transferred
 - Only appreciation that occurs after acquisition of QSBS is excluded under § 1202

For example, if fair market value was \$49M at time of conversion, then § 1202 exclusion for future appreciation after conversion would be \$490M—that is 10 times basis

CONVERSION TO C CORPORATION FOR QSBS PURPOSES

S Corporation Conversion to C Corporation

- S corporations are eligible holders of QSBS so long as the C corporation stock itself is not contributed to the S corporation—similar to partnerships
- S corporation conversion is more complicated than LLC conversion
 - S corporation establishes new subsidiary C corporation and contributes assets in § 351 transfer
 - \$50M QSBS gross asset test
 - Only shares issued after conversion are treated as QSBS
 - C corporation stock will need to be held by S corporation—unlike partnerships, distribution to shareholders terminates QSBS status and is treated as a taxable distribution

QSBS EXCHANGED IN TAX-FREE INCORPORATION OR REORG.

Shareholder QSBS Benefits Don't Disappear

- Shareholder may exchange QSBS for stock in another corporation in a § 351 tax-free incorporation or § 368 tax-free reorganization
- Stock received continues to be treated like exchanged QSBS—even if it would not otherwise qualify as QSBS
- Holding period stays the same as exchanged QSBS
- Upon subsequent disposition of QSBS, only appreciation existing at the time the original QSBS was transferred will qualify under § 1202

QSBS ROLLOVER UNDER SECTION 1045

Special Rule for § 1202 Gain Deferral

- If QSBS is held for more than 6 months, but not five years, the shareholder has 60 days to reinvest proceeds into replacement QSBS
- Gain on the sale of original QSBS will be deferred to the extent of reinvested proceeds
- New corporation must meet 80% active business test for at least the first 6 months to ensure deferral
- New QSBS is treated as having same holding period as original QSBS

§ 1045 QSBS rollover could be to an existing “Qualified Trade or Business” or a brand new one

Hypothetical Example

HYPOTHETICAL EXAMPLE

Timeline

- 1/1/2015: Founder Fred invested \$100,000
- 6/1/2016: Investor Ivan invested \$300,000
- 1/1/2017: Venture Capital Firm invested \$3M
- 6/1/2018: Employee Ellen exercised options that were granted on 1/1/2016 for \$200,000
- 12/31/2022: Company sold for \$60M in cash

Assumes issued stock is §1202 QSBS (i.e., domestic C corporation, does not exceed \$50M gross assets, and original issuance).

HYPOTHETICAL EXAMPLE

Company Sold for \$60M on 12/31/2022

	Date Stock Acquired	Initial Investment	Ownership in 2022	Gain (After \$60M Purchase)	Tax With No QSBS Exclusion	Tax With QSBS Exclusion	Federal Tax Savings
Founder Fred	1/1/2015	\$100,000	40%	\$23.9M	\$5.7M	\$3.3M	\$2.4M
Investor Ivan	6/1/2016	\$300,000	13%	\$7.5M	\$1.8M	\$0	\$1.8M
Venture Capital Firm	1/1/2017	\$3M	45%	\$24M	\$5.7M	\$0	\$5.7M
Employee Ellen (Options Exercised)	6/1/2018	\$200,000	2%	\$1M	\$238,000	\$238,000	\$0

Assumes issued stock is § 1202 QSBS (i.e., domestic C corporation, does not exceed \$50M gross assets, and original issuance).

QSBS “Stacking” with Non-Grantor Trust Planning

POTENTIAL BENEFITS OF NON-GRANTOR TRUSTS

Grantor Not Subject to Tax on Trust's Income

Avoid State Income Taxes—e.g., 13.3% California State Income Tax (subject to source rules and throwback tax)

Asset Protection—e.g., Alaska, Delaware, Nevada, South Dakota, etc.

20% Deduction for “Qualified Business Income”

- For 2018-2025 under IRC § 199A (TCJA)
- Limited or phased out—subject to wage and asset tests—unless taxable income below \$170,050 (in 2022)

\$10K Limitation for State and Local Taxes (SALT)

- For 2018-2025 under IRC § 164(b)(6) (TCJA)

Greater of \$10M or 10 Times Basis Excluded from Capital Gains for Sale of § 1202 QSBS—for Each Non-Grantor Trust

QSBS “STACKING”

Shareholder Gifts of QSBS to Non-Grantor Trusts for Loved Ones

- Special exception for gifts under § 1202(h)(2)(A)
- Transferee “steps into shoes” of transferor
 - Same original issuance
 - Same holding period
 - Same basis

UNINTENTIONALLY DEFECTIVE GRANTOR TRUSTS (UDGTs)¹

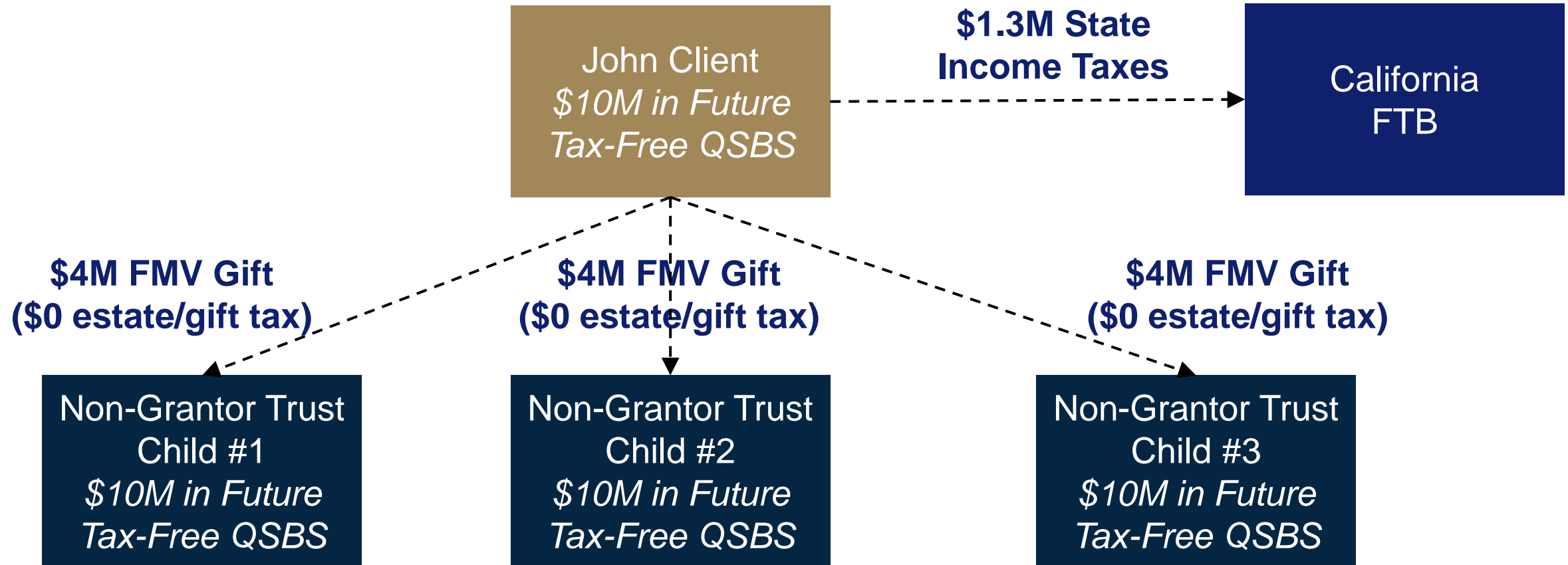
Careful Drafting Required for Non-Grantor Trusts

- Double-check your boilerplate language
- Consider a savings clause
- Avoid grantor trust “triggers”
 - § 672(e): Be careful with spouses—grantor treated as holding any power of interest held by spouse
 - § 675(2): Don’t give grantor or nonadverse party power to borrow principal or income without adequate security or interest
 - § 675(4): No substitute or swap power
 - § 674: Restrict power of disposition over beneficial enjoyment
 - § 677: No income for benefit of grantor or grantor’s spouse

¹ Term made up by Justin Miller.

§ 1202 QSBS FLOWCHART EXAMPLE

\$0 Federal Income Taxes on \$40M (Four QSBS Exclusions);
\$0 State Income Tax on \$30M (Subject to State Laws); **AND**
\$0 Federal Gift, Estate, or GST Taxes



Assumes a pre-transaction discounted fair market value gift of \$4M to each child’s non-grantor trust, a \$12.92 million lifetime exemption amount as of 2023, and the anticipatory assignment of income doctrine does not apply. State income tax consequences depend on trust terms, administration, and state laws—for example, fiduciaries, non-contingent beneficiaries, and throwback tax in California. For § 1202 QSBS planning purposes, do not transfer stock to a partnership.

MULTIPLE NON-GRANTOR TRUSTS?

IRC § 643(f) Multiple Trusts

- Treat two or more trusts as one trust if:
 - Substantially same grantor(s) and beneficiary(ies)
 - Principal purpose is avoidance of tax

Final Regulations Under §§ 199A and 643(f) (Feb. 2019)

- Removed definition and related examples that were in proposed regulations—“principal purpose” would have been presumed if significant tax benefit, unless significant non-tax purpose that could not have been achieved without separate trusts

Rev. Proc. 2021-3, IRB 2021-1

- No rulings on multiple trusts or incomplete gift non-grantor (ING) trusts

IRC § 643(f) (2010) and Treas. Reg. §§ 1.199A-6(d)(3)(vii) (2019) and 1.643(f)-1 (2019) (anti-abuse rules to prevent taxpayers from establishing a non-grantor trust or contributing additional capital to an existing non-grantor trust with the principal purpose of avoiding federal income tax).

DINGS, NINGS AND WINGS

Incomplete Gift Non-Grantor Trusts (INGs)

- PLRs 201310002 – 201310006; PLRs 201410001 – 201410010
- *But see* PLRs 201642019 and 201426014

Potential Benefits

- Accumulation of income free of state income taxes
- Asset protection

Potential Concerns

- California “throwback tax”
- Could it be a grantor trust or a completed gift?
 - No more IRS Private Letter Rulings on INGs (Rev. Proc. 2021-3, IRB 2021-1)
 - Could be a “self-settled” trust subject to rights of creditors, which is a grantor trust
 - California Governor’s 2023-2024 Budget Proposal (proposed effective date of 2023)—similar to New York legislation, which treats as a grantor trust as of 2014¹

¹ Similar legislative proposal in California in November 2020 with effective date of January 1, 2022, was not enacted.

Possible Legislative Threats

PROPOSED LEGISLATIVE CHANGES TO QSBS—NOT ENACTED!

House Ways and Means Committee Proposal (Sep. 12, 2021)

- Page 628 of 881

House of Representatives Proposed Reconciliation Bill, H.R. 5376 (Sep. 27, 2021)

- Page 2,213 of 2,466

House of Representatives Proposed Reconciliation Bill, H.R. 5376 (Oct. 28, 2021)

- Page 1,645 of 1,684

Sec. 138149. Limitation on Certain Special Rules for Section 1202 Gains

- After Sep. 13, 2021, only baseline 50% exclusion in section 1202(a)(1) for:
 - Taxpayers with AGI of \$400k or more
 - Trust or estate regardless of AGI
- Effective Date
 - Sales or exchanges on or after Sep. 13, 2021, **unless** written binding contract in effect on Sep. 12, 2021, and not materially modified thereafter

RETROACTIVE FEDERAL TAX LAW CHANGES—POSSIBLE, BUT RARE

Constitution Prohibits Retroactive Changes—Ex Post Facto—Only for Criminal Law

- Omnibus Budget Reconciliation Act of 1993 retroactively increased tax rates to beginning of 1993, even though law enacted in Aug. 1993
- Supreme Court unanimously upheld retroactive repeal of a tax deduction in U.S. v. Carlton:¹

“Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code”

¹ U.S. v. Carlton, 512 U.S. 26 (1994).

Thank You!

BIO

Justin Miller, J.D., LL.M., TEP, AEP®, CFP®

**Partner and National Director of Wealth Planning, Evercore Wealth Management
Managing Director, Evercore Trust Company**

Justin Miller is a Partner and National Director of Wealth Planning at Evercore Wealth Management and a Managing Director at Evercore Trust Company, where he works collaboratively with accountants, attorneys, and other advisors to provide comprehensive wealth planning advice to clients. Prior to joining Evercore in 2021, Justin was a national wealth strategist for 10 years at BNY Mellon. He previously was a managing director at Wells Fargo and began his career as a tax attorney at Sidley Austin.

Justin also is an adjunct professor at Golden Gate University School of Law, a Fellow of the American Bar Foundation, and a Fellow of the American College of Trust and Estate Counsel. He has served in leadership positions with the American Bar Association, California Bar Foundation, San Francisco Estate Planning Council, and State Bar of California, and is a former editor-in-chief of the *California Tax Lawyer*. Additionally, he is a past recipient of the Outstanding Conference Speaker Award from the California Society of CPAs and the V. Judson Klein Award from the California Tax Bar.

Justin received a B.A., with honors, from the University of California, Berkeley, and a J.D. and LL.M. in Taxation from New York University School of Law. He also holds the Accredited Estate Planner® and CERTIFIED FINANCIAL PLANNER™ designations and is a member of the State Bar of California.

DISCLOSURES

The information provided is for illustrative/educational purposes only. It is based on assumptions that we believe are reasonable within their context; however, actual results will vary. All investment strategies referenced in this material come with investment risks, including loss of value and/or loss of anticipated income. Past performance does not guarantee future results. No investment strategy or risk management technique can guarantee returns in any market environment. This material is not intended to constitute legal, tax, investment or financial advice. Effort has been made to ensure that the material presented herein is accurate at the time of publication, however, we have no obligation to update, modify or amend this information or to otherwise notify a reader in the event that any such information becomes outdated, inaccurate, or incomplete. This material is not intended to be a full and exhaustive explanation of the law in any area or of all of the tax, investment or financial options available. The information discussed herein may not be applicable to or appropriate for every investor and should be used only after consultation with professionals who have reviewed your specific situation.

Hypothetical and Future Looking Statements. This document includes projections or other forward-looking statements regarding future events, targets, intentions or expectations. Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statements. There is no guarantee that projected returns or risk assumptions will be realized or that an investment strategy will be successful. No representation, warranty or undertaking is made as to the reasonableness of the assumptions made herein or that all assumptions made herein have been stated. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this document, will be profitable, equal any corresponding indicated performance level(s), or be suitable for your portfolio.

Evercore Wealth Management, LLC (“EWM”) is registered with the Securities and Exchange Commission (the “SEC”) under the Investment Advisers Act of 1940. Registration with the SEC does not imply a certain level of skill or training. The SEC has not reviewed or approved any calculation or presentation of performance results included in these materials. EWM’s performance results are available upon request. Evercore Trust Company, N.A., is a national trust bank regulated by the Office of the Comptroller of the Currency. EWM obtained the information in this presentation from multiple sources believed to be reliable as of the date of publication; EWM, however, makes no representations as to the accuracy or completeness of such third-party information.

©2023 All rights reserved.