Planning Opportunities Under Federal and State Income Tax Rules

The Delaware Tax Institute

December 6, 2019

By:
Daniel F. Hayward, Esq.
Gordon, Fournaris & Mammarella, P.A.
1925 Lovering Avenue
Wilmington, DE 19806
(302) 652-2900

Basics of Qualified Small Business Stock ("QSBS")

- IRC Section 1202 generally provides that gains resulting from the sale of QSBS can be realized by non-corporate taxpayers tax-free.
- Tax payer is eligible for full or partial exclusion upon a sale or exchange of QSBS if:
  - (1) The QSBS has been held for more than 5 years (§ 1202(a)(1))
  - (2) Stock was issued by a "qualified small business after August 10, 1993 (which was the date of the Revenue Reconciliation Act of 1993) (§ 1202(c)(1))
  - (3) The stock was acquired by the taxpayer at original issuance, and purchased or received for services rendered (§ 1202(c)(1)

Basics of Qualified Small Business Stock ("QSBS")

- Exclusion of Gains
  - Maximum amount of gain from sale of QSBS that can be excluded in a taxable year, <u>per taxpayer</u>, is the greater of:
    - $10 million MINUS the sum of any gains already taken by the taxpayer for the issuer in prior taxable years (§ 1202(b)(1))
    - <u>Ten times</u> the taxpayer's adjusted cost basis of QSBS disposed of during the taxable year (§ 1202(a)(1), (a)(3) and (a)(4))

Basics of Qualified Small Business Stock ("QSBS")

- Exclusion of Gains – additional notes
  - For stock acquired after 9/28/2010, excluded gain is not subject to the Alternative Minimum Tax ("AMT") regime
    - For stock acquired before that date, 7% of the excluded gain is treated as a "preference item" and therefore subject to AMT.
  - Gains in excess of the $10 million gain limit are taxed at the current long-term capital gains tax rate
  - Beware of offsetting shirt positions – this can cause § 1202 to not apply except in limited circumstances
- Exclusion of Gains at the State Level
  - States with no individual income tax have no QSBS exclusion
  - States with an income tax but no capital gains tax, and therefore no QSBS exclusion
  - States that use AGI as the starting point to determine state income tax liability, and therefore effectively take the QSBS exclusion into account
  - States that have specific QSBS exclusion statutes of their own
  - States that use gross income as starting point but have no specific QSBS statutes.

Basics of Qualified Small Business Stock ("QSBS")

- 5-year holding period – when the period begins is dependent on how the stock was acquired and the type of interest that is held
  - Acquired through exercise of an option
    - Company must pass the "qualified small business" test
    - Period begins upon date of exercise
  - Acquired through vesting of restricted shares
    - Company must pass the "qualified small business" test
    - Period begins upon date of vesting

Basics of Qualified Small Business Stock ("QSBS")

- "Qualified small business"
  1. A domestic C corporation for substantially all of the taxpayer's holding period of the stock (§ 1202(c)(2)(A)
  2. Gross assets of the corporation or any predecessor entity do not exceed $50 million (value is tested based on tax basis and not FMV) at or before the issuance of the stock (§ 1202(d)(10)
  3. Active business assets test
     - During substantially all of the taxpayer's holding period, at least 80% of the assets by value have to have been used in the active conduct of one or more qualified businesses (§ 1202(c)(2)(A) and 1202(e))
       - Stock and debt of subsidiary entities are generally disregarded in the 80% test

Basics of Qualified Small Business Stock ("QSBS")

- "Qualified small business" – active business assets test
  - Test is failed for any period during which more than 10% of the total value of the corporation's assets consists of real property that is not used in the active conduct of a qualified trade or business (§ 1202(e)(7))
  - A "qualified business" is an active trade or business, excluding various categories such as law, financial services, health, accounting, banking, insurance, consulting, financing, investing, farming, mining, operating a hotel/restaurant. (§ 1202(e)(1) and (e)(3))
  - There is not much guidance as to what <u>does</u> qualify as a qualified business, but PLR 201436001 suggests a "service test" – if the business provides a service, then it is likely not a qualified business, unless it offers value to customers using the compant's physical assets

Basics of Qualified Small Business Stock ("QSBS")

- Acquisition by the taxpayer
  - Must have been acquired by the taxpayer at the stock's original issue in exchange for money or other property or as compensation for services provided to the corporation
  - There are exceptions:
    - *** Stock is received as a transfer by gift or at death, the transferee is deemed to have acquired the stock in the same manner as the transferor and deemed to have held the stock during any continuous period immediately preceding the transfer by the transferor. (§ 1202(h)(1) and (h)(2)).
    - Stock is acquired solely through the conversion of other in the entity that is QSBS when held by the taxpayer
    - Stock received from a partnership and the § 1202(g) pass-through entity requirements are met

Planning with Trusts

- A holder who receives QSBS by gift or at death is treated as obtaining the QSBS in the same manner as the transferor and the transferor’s holding period is tacked on.
- Grantor trusts
  - Grantor and the trust treated as same taxpayer for income tax purposes only
  - While no specific guidance, because a grantor trust is often funded by a gift from the grantor to the grantor trust, it should be deemed to be acquired by the grantor trust by gift, and therefore the trust should be deemed to have acquired the stock in the same manner as the grantor and the grantor’s holding period is tacked on.
  - Sale to a grantor trust should work as well, because the transaction is ignored for income tax purposes
  - Still only <u>one</u> taxpayer that can take the exclusion on the sale of QSBS

Planning with Non-Grantor Trusts

- Advantages
  - Grantor not responsible for income tax liability
    - Can further pay down grantor's estate if estate is still taxable and lifetime gift/estate tax exemption has already been utilized
  - Avoiding/minimizing state income tax
    - Delaware does not tax that portion of trust income and capital gains accumulated and set aside for future distribution to non-resident beneficiaries
    - Popular technique with clients from high tax jurisdictions such CA, NY and NJ

Planning with DING Trusts

- Incomplete Gift Asset Protection Trusts
  - Used when the grantor does not want to use his or her unified credit and wants the assets to receive a basis step-up at death
    - Structured as grantor trusts where state income tax is not a concern, i.e., the grantor is looking only for asset protection
    - Generally set up as non-grantor trusts (DINGs) when the grantor resides in a high state income tax jurisdiction
      - Care must be taken not to trigger grantor trust status under IRC §§ 671-679
        - Distribution committee composed of parties with adverse interests (i.e., they should be members of the current beneficial class to whom distributions of income and principal can be made)

Planning with DING Trusts

- To structure as an incomplete gift, the grantor should retain
  - Lifetime limited power of appointment limited by a reasonably definitive standard (i.e. health, education, maintenance and support)
  - Testamentary limited power of appointment over the trust
  - Veto power whereby a distribution directed by any one member of the distribution committee must be approved by the grantor (Treas. Reg. § 25.2511-2(b))
- How to structure as a non-grantor trust for income tax purposes (DING trust)
  - Powers of the Distribution Committee
- PLRs 200715005, 200647001, 200637025, 200612002, 200502014, 201310002, and 201550005; IR-2007-127; Rev. Ruls. 76-503 and Rev. Rul. 77-158; CCA 201208026;

Planning Opportunities with QSBS and DING Trusts

- Acquired by gift?
  - Although the transfer of assets into a DING is not a completed gift for federal gift tax purposes, it is likely still deemed to be "acquired by gift" because:
    - The stock is still acquired by the DING via a donative transfer
    - There has still been a gift by the grantor, it is just an incomplete gift until distributions are made from the trust or when the grantor dies, at which point it becomes a completed gift.
- Possible to "stack up" $10 million gain exclusion among multiple taxpayers
  - Here, the separate taxpayers are multiple DING trusts, each of which is a non-grantor trust and is its own taxpayer
- Example
  - Client and spouse hold QSBS, valued at approximately $70-$80 million; very low basis
  - They live in a community property state
  - Expected sale of the stock in the next 12-18 months.
  - Client has two children, one adult and one minor

Planning Opportunities with QSBS and DING Trusts

- Solution
  - Client and spouse enter into a transmutation agreement under state law to sever their community property interests in the stock, so that each individually owns half of the stock they previously owned together as community property
  - Create 6 separate DING trusts – 3 created by client, 3 created by spouse. How to avoid the result where these trusts are "collapsed" into a single trust or a smaller number of trusts?
    - Different classes of beneficiaries – e.g., one trust created for one child, one trust created for the other child, one trust created for the collective benefit of both children
    - Different members of Distribution Committee
    - Alter grantor's testamentary power of appointment
    - Alter interests of remainder beneficiaries
  - End result is possible exclusion of $70-$80 million worth of gain instead of $10-$20 million
    - Work with client's local estate planning attorney so that the grantors' testamentary powers of appointment can be exercised in their Wills to fit in with their overall estate plan