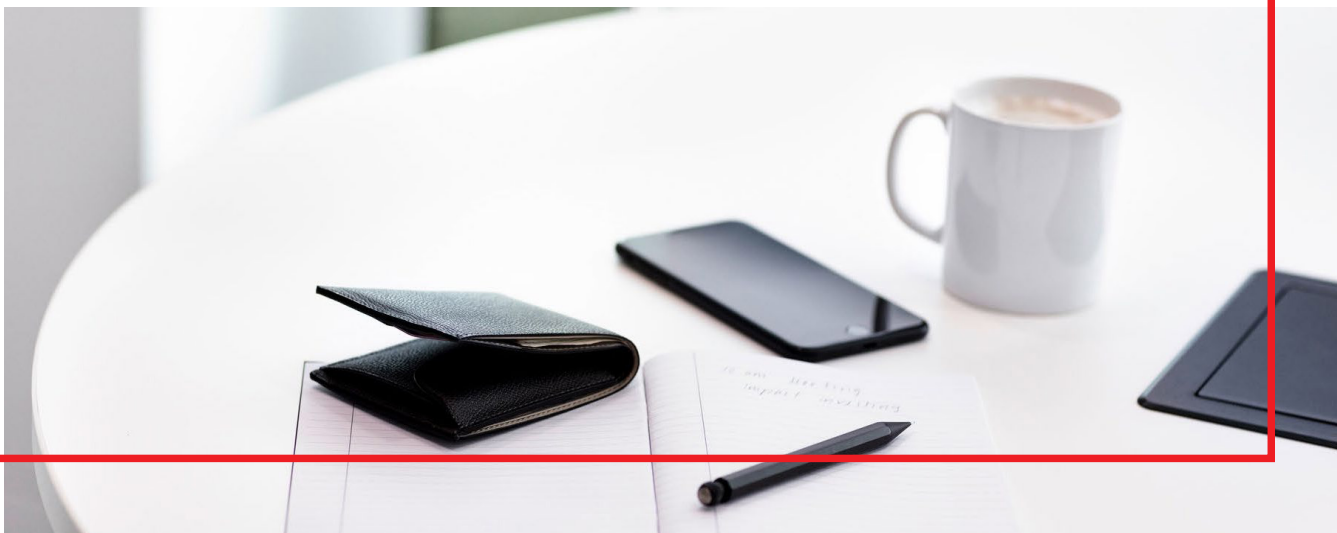


Qualified small business stock



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For some business owners, federal tax laws offer sizable tax benefits. Notably, an individual, trust, or other noncorporate person who owns qualified small business (QSB) stock can potentially defer or exclude gain on the sale or disposition of the stock. They can generally defer gain by reinvesting it in other QSB stock, and they can generally avoid any income tax on any excludible gain. For many shareholders, the excludible gain is \$10 million per company. For others, it's more. Moreover, with proper planning (often involving trusts), a shareholder can stack (multiply) the exclusion, further enhancing the benefits of owning QSB stock.

Qualifications

For shares to qualify as QSB stock, they must satisfy an intricate array of company-level requirements and shareholder-level requirements.

Company-level requirements

For its shares to qualify as QSB stock, a company must be organized in the United States, and it must be classified as a C corporation.¹ The shares of a company organized outside of the United States, thus, won't qualify as QSB stock. Likewise, the shares of a company that's classified as a partnership for federal income tax purposes also won't qualify as QSB stock. For example, membership interests in a multi-member limited liability company won't qualify as QSB stock if it's classified as a partnership for tax purposes.²

For its shares to qualify as QSB stock, the company also must engage in a qualified trade or business.³ A qualified trade or business generally is a trade or business other than:

- farming (including raising or harvesting trees),
- providing healthcare services,

- providing accounting, actuarial science, consulting, law, or professional services,
- providing engineering or architecture services,
- providing performing arts or athletics services,
- providing financial services or brokerage services,
- engaging in banking, insurance, financing, leasing, investing, or a similar business,
- producing or extracting oil, natural gas, or minerals, or
- operating a hotel, motel, restaurant, or similar business.⁴

In several rulings—mostly involving biotech- and other healthcare-related activities—the Internal Revenue Service (IRS) has addressed whether a company is engaged in a qualified trade or business. The IRS has ruled that qualified trades and businesses include the development of software that optimizes a patient's use of medical treatment or medication,⁵ the manufacture and servicing of medical devices,⁶ the development and use of medical testing technology,⁷ the research, development, manufacture, and commercialization of drugs,⁸ and the retail sale of prescription drugs.⁹ The IRS has ruled that a qualified trade or business also includes selling insurance as an agent of an insurance company or insurance wholesaler,¹⁰ but it also has taken the position that facilitating the leasing of property through a web-based listing service is a brokerage service and thus is not a qualified trade or business.¹¹

For its shares to qualify as QSB stock, the company generally must use at least 80 percent of its assets (by value) in one or more qualified trades or businesses.¹² Subject to some conditions, assets used in startup activities, assets used for research, assets that produce computer royalties, and working capital count favorably for this purpose.¹³ Additionally, the total value of the company's real estate that is not used in a qualified trade

¹ IRC § 1202(c)(1).

² In some cases, a company that's classified as a partnership can convert into a company that's classified as a C corporation, so that its shares potentially could qualify as QSB stock. This sometimes is advantageous, but it raises a host of tax, legal, and practical issues. See, e.g., PLR 201636003 (September 2, 2016).

³ IRC § 1202(c)(1).

⁴ IRC § 1202(ae)(3).

⁵ PLR 202144026 (November 5, 2021).

⁶ PLR 202125004 (June 25, 2021).

⁷ PLR 201717010 (January 23, 2017).

⁸ PLR 201436001 (September 5, 2014).

⁹ PLR 202221006 (May 27, 2022).

¹⁰ PLR 202114002 (April 9, 2021).

¹¹ CCA 202204007 (January 28, 2022).

¹² IRC § 1202(e)(1)(A).

¹³ IRC § 1202(e)(2), (6), and (8).

or business cannot exceed 10 percent of the total value of its assets.¹⁴

The company's gross assets must not exceed \$50 million immediately after it issues the shares (and generally must not have exceeded that amount any time before then).¹⁵ If they do, the shares won't qualify as QSB stock. The company's gross assets are its cash and, subject to certain adjustments, the aggregate adjusted basis of its other assets.¹⁶

Certain redemptions can spoil the shares' qualification as QSB stock. For example, a company's shares generally will not qualify as QSB stock if the company redeems more than five percent (by value) of its stock within one year before or one year after issuing the shares.¹⁷

Shareholder-level requirements

For shares to qualify as QSB stock, the shareholder must have acquired the shares from the company either in exchange for money or other property (other than stock) or for the performance of services to the company.¹⁸ Alternatively, the shareholder must have acquired the shares by gift, upon the death of another shareholder, or from a partnership of which the shareholder was a partner, and the shares must have qualified as QSB stock in the prior shareholder's hands.¹⁹ (For this purpose, a partnership is an entity classified as a partnership for tax purposes.) Shares acquired by purchase from another shareholder in a taxable transaction will not qualify as a QSB stock.²⁰ The company must have issued the shares after August 10, 1993.²¹

Certain transactions between a company and its shareholder (or someone related to the shareholder) can spoil the shares' qualification as QSB stock. A shareholder's shares do not qualify as QSB stock if, within two years before or two years after the shareholder's acquisition of those shares, the company purchases (directly or indirectly) any of its shares from the shareholder or a related person.²² Certain hedging transactions by the shareholder (or someone related to the shareholder) can spoil the shares' qualification as QSB stock.²³ These include short sales of the stock or substantially identical property and certain options to sell the stock or substantially identical property.²⁴

Holding period

A shareholder's ability to defer or exclude gain upon the sale of QSB stock is based in part on the shareholder's holding period. A shareholder who has held shares of QSB stock for more than six months potentially can defer the gain from the sale or disposition of those shares.²⁵ A shareholder who has held shares of QSB stock for more than five years potentially can exclude some or all of the gain from the sale or disposition of those shares.²⁶ As a general rule, a shareholder's holding period begins when the company grants the shares to them.²⁷ There, however, are special rules.

Restricted stock

Restricted stock is nonvested or temporarily non-transferrable shares of the company's stock, such as stock that vests over several years so long as the shareholder continues to perform services for the

¹⁴ IRC § 1202(e)(7).

¹⁵ IRC §§ 1202(d)(1)(A) and (B).

¹⁶ IRC § 1202(d)(2)(A).

¹⁷ IRC § 1202(c)(3)(B).

¹⁸ IRC § 1202(c)(1)(B).

¹⁹ IRC § 1202(h)(2).

²⁰ See IRC § 1202(h)(2).

²¹ IRC § 1202(c)(1).

²² IRC § 1202(c)(3)(A).

²³ IRC § 1202(j).

²⁴ Id. We discuss hedging transactions in more depth below.

²⁵ IRC § 1045(a).

²⁶ IRC §§ 1202(a) and (b).

²⁷ IRC § 1202(c)(1)(B).

company. For purposes of deferring or excluding gain from the sale or disposition of QSB stock, a shareholder's holding period begins upon the grant of the restricted stock if the shareholder makes an 83(b) election or the vesting of the stock if the shareholder doesn't make an 83(b) election.²⁸

Shares acquired by exercising incentive stock options or nonqualified stock options

Shares acquired by exercising incentive stock options (ISOs) or nonqualified stock options (NSOs) potentially qualify as QSB stock. For shares acquired by exercising ISOs or NSOs, the shareholder's holding period begins upon exercise of the options. ISOs and NSOs usually are exercisable only on or after they vest. In some cases, however, they allow early exercise. That is, they are exercisable before they vest. (This more likely with NSOs.) If the options allow early exercise, the individual who receives them might consider exercising them, so they can start the holding period on the shares acquired by exercising the options.

Shares acquired by gift

For shares of QSB stock acquired by gift, the donee's holding period includes the donor's holding period.²⁹ If, for example, a company's founder has held shares of QSB stock for three years and gifts those shares to a nongrantor trust, the trust's holding period would include the founder's three-year holding period. If the trust holds those shares for more than two years after the gift, it would have held the shares for more than five years, at which point it potentially would qualify to exclude some or all of the gain upon its sale or disposition of those shares. (We discuss nongrantor trusts and planning strategies involving them below.)

Shares acquired at death

For shares of QSB stock acquired at death, the transferee's holding period includes the transferor's holding period.³⁰ If, for example, a child inherits shares of QSB stock from a parent, the child's holding period generally would include the deceased parent's holding period.

Deferring gain

A shareholder who has held shares of QSB stock for more than six months can defer the gain from the sale or disposition of those shares by investing the gain in other shares that qualify as a QSB stock.³¹ The shareholder can potentially invest the gain in shares of a startup or a more established company. The shareholder must invest the gain within 60 days after the sale or disposition.³² This deferral is elective, and the shareholder makes the election on their income tax return.³³

Excluding gain

A shareholder who has held shares of QSB stock for more than five years can exclude the gain from the sale or disposition of those shares.³⁴ The shareholder can exclude the greater of:

- 100% of the gain (up to \$10 million) from shares of QSB stock issued after September 27, 2010, or
- 10 times the shareholder's adjusted basis in the QSB stock.

For shares issued before September 28, 2010, special rules apply. Most notably, the excludible percentage is less. For shares issued after February 17, 2009, and before September 28, 2010, a shareholder can exclude 75% of the gain (up to \$7.5 million). For shares issued after August 10, 1993, and before February 18, 2009, a shareholder can exclude 50% of the gain (up to \$5 million). The exclusion applies on a per-company basis.

²⁸ An 83(b) election is an election to treat the receipt of restricted property—i.e., property that's nonvested or temporarily non-transferrable—received in connection with the performance of services as a taxable event. An 83(b) election must be made within 30 days after a receipt of the restricted property. By making the election, the individual generally must include the property's fair market value in income upon its receipt, and any post-election gain usually is capital gain. The election thus may be appealing if the property's fair market value upon its receipt is minimal, the value is expected to increase substantially, and the vesting conditions are expected to be met. For a discussion of the 83(b) election, see Todd D. Mayo, *Equity Compensation* (a publication of the UBS Advanced Planning Group).

²⁹ IRC §§ 1202(h)(1)(B) and 1202(h)(2)(A).

³⁰ IRC §§ 1202(h)(1)(B) and 1202(h)(2)(B).

³¹ IRC § 1045(a).

³² IRC § 1045(a)(1).

³³ IRC § 1045(a). See Rev. Proc. 98-48. Under certain circumstances, the IRS has allowed a shareholder to make a late election. For example, in one case, the shareholder's accountant failed to make the election on the income tax return, even though the accountant was aware the shareholder intended to make the election. PLR 202245003 (November 11, 2022).

³⁴ IRC §§ 1202(a) and (b).

Alternative minimum tax

Upon a sale or disposition of shares of QSB stock acquired before September 28, 2010, the shareholder must include 7% of the excluded gain in income for alternative minimum tax (AMT) purposes.³⁵ This potentially reduces the tax benefits of the exclusion.

Ownership through a pass-through entity

An owner of a pass-through entity generally can exclude their allocable share of the gain from the entity's sale or disposition of QSB stock if:

- the pass-through entity held the stock for more than five years, and
- the owner held their interest in the pass-through entity when the entity acquired the QSB stock and at all times until the QSB stock was sold.³⁶

A pass-through entity includes a partnership, S corporation, regulated investment company, or common trust fund.³⁷ It includes a limited liability company that's classified as a partnership for tax purposes.

Stacking

With proper planning, a shareholder can stack (or multiply) the exclusion. If, for example, the shareholder contributes QSB stock to a nongrantor trust (which is a trust that, for income tax purposes, is treated as a separate taxpayer), the trust may qualify for its own exclusion upon its sale or disposition of the stock. A shareholder who has substantial holdings in QSB stock thus might create multiple nongrantor trusts for purposes of obtaining the benefit of multiple exclusions. These trusts may include completed gift trusts and incomplete

nongrantor (ING) trusts. When using multiple trusts for purposes of stacking, the trusts must have different primary beneficiaries. If two or more trusts have substantially the same settlors and primary beneficiaries, then they may be treated as a single trust for income tax purposes.³⁸

A completed gift trust is a trust into which contributions are gifts for gift tax purposes. This often is a trust for the settlor's children or other descendants. In some cases, the settlor's spouse may be a beneficiary, although this adds complexity and necessitates having at least a subset of the other beneficiaries consent to any distributions to the beneficiary-spouse.³⁹ In 2023, an individual generally has a \$12.92 million lifetime exemption (i.e., the exemption for purposes of gift and estate taxes).⁴⁰ This constrains the amount of shares that, when stacking, the shareholder can contribute to completed gift trusts without incurring any gift tax. To the extent that a shareholder has used their lifetime exemption (or, at least, as much of it as they are comfortable using), the shareholder might consider other strategies, such as ING trusts.

An ING trust is a self-settled spendthrift trust into which contributions are not completed gifts for gift tax purposes.⁴¹ A self-settled spendthrift trust is an irrevocable trust in which the settlor is a beneficiary and the settlor's creditors generally can't reach the trust property. (A self-settled spendthrift trust is sometimes called an asset protection trust.) Several states—including Delaware, Nevada, New Hampshire, South Dakota, Tennessee, and Wyoming—expressly recognize self-settled spendthrift trusts.

³⁵ IRC § 57(a)(7).

³⁶ IRC § 1202(g)(2).

³⁷ IRC § 1202(g)(4).

³⁸ Treas. Reg. § 1.643(f)-1(a).

³⁹ For a general discussion of trusts in which the settlor's spouse is a beneficiary, see Catherine McDermott, *Spousal Lifetime Access Trusts* (a publication of the UBS Advanced Planning Group).

⁴⁰ This assumes the individual is a US person for gift and estate tax purposes. For a discussion of the gift and estate taxation of non-US persons, see Carrie Larson, *Planning for Non-US Citizens* (a publication of the UBS Advanced Planning Group). For a US person, the lifetime exemption is indexed annually for inflation and currently includes a temporary increase. This increase expires after 2025, at which time the gift and estate tax exemption will be cut roughly in half.

⁴¹ For a more in-depth discussion of ING trusts, see Ann Bjerke and Todd D. Mayo, *ING Trusts* (a publication of the UBS Advanced Planning Group).

So that the ING trust qualifies as a nongrantor trust, a group of beneficiaries (excluding the settlor and the settlor's spouse) must consent to any distribution to the settlor or the settlor's spouse, and they can direct distributions to any of the beneficiaries. This usually is structured using a beneficiary committee (which is sometimes called a distribution committee or a power of appointment committee). An independent trustee or trust protector generally can remove and appoint the members of the committee. Many individuals understandably are uncomfortable granting so much control to the beneficiaries (or even a subset of them) over distributions.

The IRS has issued several favorable rulings on ING trusts, which provide some comfort when designing the trusts.⁴² In 2021, however, the IRS announced that it would no longer issue private letter rulings on certain aspects of ING trusts, until it publishes formal guidance on those issues.⁴³ Those issues generally involve (1) whether the trust qualifies as a nongrantor trust, (2) whether, for estate tax purposes, any of the trust property would be includible in the estate of a beneficiary who can participate in certain decisions concerning distributions, and (3) whether the grantor's transfer of property to the trust is an incomplete gift.⁴⁴ Although this announcement doesn't necessarily foreshadow the IRS changing its position on ING trusts, it indicates that the IRS wants to evaluate the issues more systematically. It certainly underscores the importance of understanding the risks and complexity of the tax issues involved in properly forming and administering ING trusts.

Hedging transactions

For QSB stock, hedging transactions—such as buying a put, writing a call, or establishing a collar—can be fatal to the tax benefits that the stock offers. For some directors and officers, hedging isn't feasible. Public companies often prohibit their directors and officers from hedging the company's stock. These anti-hedging policies likely save some people from stumbling into transactions that jeopardize the shareholders' ability to exclude the gain on the stock's sale.

A shareholder generally loses the exclusion if they have an offsetting short position with respect to the QSB stock.⁴⁵ An offsetting short position is a short sale of substantially identical property or an acquisition of an option to sell substantially identical property at a fixed price.⁴⁶ A short sale includes selling the stock for future delivery and writing a call option that the holder is more likely than not to exercise.⁴⁷ With the possible exception of writing a call, the degree to which a hedging transaction provides downside protection is irrelevant. The IRS hasn't published any guidance on what qualifies as substantially identical property, but it may have the same meaning as the term has for purposes of the short sale rule and as the term "substantially identical stock or securities" has for purposes of the wash-sale rule.⁴⁸

A shareholder can preserve the exclusion for the gain from the QSB stock only by electing to recognize the gain in the QSB stock as if the shareholder sold the stock on the day the shareholder established the offsetting short position.⁴⁹

⁴² See, e.g., PLR 202017018 (April 24, 2020), PLR 202014005 (April 3, 2020) to PLR 202014001 (April 3, 2020), PLR 202007010 (February 14, 2020), PLR 202006006 (February 7, 2020) to PLR 202006002 (February 7, 2020), PLR 201925005 (June 21, 2019) to PLR 201925010 (June 21, 2019), PLR 201908008 (February 22, 2019), PLR 201908003 (February 22, 2019) to PLR 201908007 (February 22, 2019), PLR 201852009 (December 28, 2018), PLR 201852014 (December 28, 2018), PLR 201850001 (December 14, 2018) to PLR 201850006 (December 14, 2018), PLR 201848002 (November 20, 2018), PLR 201848009 (November 20, 2018), PLR 201838002 (September 21, 2018) to PLR 201838007 (September 21, 2018), PLR 201836006 (September 7, 2018), PLR 201832005 (August 10, 2018) to PLR 201832009 (August 10, 2018), and PLR 201310002 (March 8, 2013) to PLR 201310006 (March 8, 2013).

⁴³ Rev. Proc. 2021-3, 2021-1 IRB 140, §§ 5.01(9), (15), and (17). In 2022, the IRS reaffirmed that it wouldn't grant rulings on these issues. Rev. Proc. 2022-3, 2022-1 IRB 144, §§ 5.01(9), (15), and (18).

⁴⁴ Id.

⁴⁵ IRC § 1202(j)(1).

⁴⁶ IRC §§ 1202(j)(2)(A) and (B). An offsetting short position also includes any other transaction that, in its regulation, the IRS identifies as substantially reducing the risk of loss from holding QSB stock. IRC §§ 1202(j)(2)(C). So far, the IRS has not adopted any regulations identifying additional types of offsetting short positions.

⁴⁷ H. Rept. 103-213 (1993), Title XIII, I.B.2.

⁴⁸ The statute governing short sales uses the term "substantially identical property." IRC § 1233. For purposes of the short sale rule, the regulations state that "substantially identical property" is synonymous with "substantially identical stock or securities" as that term is used for purposes of the wash-sale rule. Treas. Reg. § 1.1233-1(d)(1). The statutes governing conversion transactions and constructive sales also use the term "substantially identical property." IRC §§ 1258 and 1259.

⁴⁹ IRC § 1202(j)(1).

The shareholder must have owned the QSB stock for more than five years before establishing the offsetting short position.⁵⁰ If, on the day that the shareholder establishes the offsetting short position, the shareholder hasn't met the five-year holding period, then the shareholder can't make the election, and the shareholder loses the exclusion.⁵¹ If the shareholder makes the election, the shareholder will recognize the gain in the QSB stock as if the shareholder sold the stock for its fair market value on the day the shareholder establishes the offsetting short position.⁵² Subject to the limitations on the excludable amount, the gain from this deemed sale would qualify for the exclusion.⁵³ Any gain in the stock after the deemed sale would not.

By making the election, the shareholder likely resets the holding period of the stock. If so, this may affect whether any gain upon a subsequent sale or exchange is short-term or long-term capital gain. Notably, the offsetting short position may suspend the holding period (e.g., under the rules governing straddles).⁵⁴

A shareholder also loses the exclusion if a related person has an offsetting short position.⁵⁵ A broad array of persons potentially are related persons. For example, with respect to an individual shareholder, a related person includes:

- A spouse
- Any parent, grandparent, or other ancestor
- Any sibling
- Any child, grandchild, or other descendant
- Any trust of which the shareholder is a grantor or beneficiary
- Any beneficiary of a trust of which the shareholder is a grantor
- Any partnership of which the shareholder owns 50% of the capital interests or 50% of the profits interests⁵⁶

Thus, if a shareholder creates an irrevocable nongrantor trust of which the shareholder's children are the

beneficiaries (perhaps as part of a stacking strategy), contributes QSB stock to the trust, and the trustee subsequently buys a put on the stock, the shareholder generally would no longer be able to exclude any of the gain from the sale of the QSB stock that the shareholder retained. Under this related person rule, one person potentially can spoil a good thing for a lot of people.

State income taxes

The state income tax treatment of QSB stock varies. Many states including Georgia, Illinois, and New York generally conform to federal income tax laws with respect to QSB stock, so the stock generally enjoys the same benefits for state income tax purposes as it does for federal income tax purposes. Some states like Massachusetts have modified rules governing QSB stock, providing more limited benefits. And some states like California, New Jersey, and Pennsylvania do not provide any benefits for QSB stock. For a shareholder who lives in a state that provides limited or no benefits for QSB stock, it may be possible to avoid state income taxes on the gains from QSB stock that they contribute to a nongrantor trust that does not have any nexus to their home state.

Conclusion

Despite the complexity of the rules governing QSB stock, the potential tax savings are sizable, and many shareholders avail themselves of those savings. According to one governmental estimate, shareholders will collectively exclude \$1.5 billion of gain from QSB stock in 2023.⁵⁷ Given the favorable treatment of QSB stock, business owners may benefit from structuring—or restructuring—their businesses (when feasible) so that the shares qualify as QSB stock, and they may benefit from implementing planning strategies for enhancing potential tax savings.

⁵⁰ IRC § 1202(j)(1)(A).

⁵¹ Id.

⁵² IRC § 1202(j)(1)(B).

⁵³ IRC § 1202(j)(1).

⁵⁴ IRC § 1092(c).

⁵⁵ IRC § 1202(j)(2) flush language.

⁵⁶ See IRC §§ 267(b) and 707(b).

⁵⁷ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020 – 2024* (November 5, 2020).

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Approval code: IS2300052

Expiration date: 01/31/2024

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