Trust Planning Opportunities Under Section 1202

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Agenda

• Panelists
• Introduction – increased importance of Section 1202
• Basics of Section 1202
• Trust Planning Opportunities
• Questions
Introduction

• The 2017 tax act reduced the corporate income tax rate to 21%
• Taxpayers are considering changing their form of entity to take advantage of this new lower rate; however, C corporations still are subject to double taxation and may be subject to penalty taxes (accumulated earnings tax)
• Double taxation issues on a future sale may be reduced or eliminated by Section 1202, which allows noncorporate taxpayers to exclude all or a portion of the gain on the sale of C corporation stock that satisfies certain conditions
Basics of Section 1202
History of Section 1202

- Enacted in 1993 as an incentive to encourage long-term investment in small businesses and start-ups
- Little used for many years
- Has attracted more interest due to several tax law changes during the past decade
- Now, with the lower C corporation tax rate and potential for 100% exclusion, may be gaining in importance again
- Still, very little guidance
Amount of the Exclusion

- Stock acquired between 1993 and before February 19, 2009: 50% gain exclusion (Increased to 60% for empowerment zones)
- Stock acquired between February 19, 2009 – September 27, 2010: 75% gain exclusion
- Stock acquired after September 27, 2010: 100% gain exclusion
- Note that the amount of gain excluded is not subject to the 3.8% Medicare tax.
- Additionally, most states conform with the federal gain exclusion
Amount of the Exclusion

• In addition to the percentage limitation, there is a dollar limitation that applies to all sales. The maximum exclusion amount is applied first; then the applicable percentage (50%/75%/100%) is applied to the amount determined.

• The maximum amount of gain that can be excluded is the greater of:
  – $10 million (less the amount of eligible gain previously excluded by the taxpayer under §1202 with respect to the issuing corporation); and
  – 10 times the aggregate adjusted bases of the stock sold.
Amount of the Exclusion

• If stock is acquired with property, the stock basis for Section 1202 purposes is the fair market value of the property used to acquire the stock at the time of acquisition
• Built-in gain in contributed property is subject to normal capital gain taxation
Section 1202: Stock Sales, Asset Sales, Redemptions

• Section 1202 is likely most beneficial to shareholders in a stock sale
• Asset sale: Eliminates second layer of tax on liquidation
• Redemptions: Redemptions treated as a sale or exchange of stock under tax law will be entitled to potential gain exclusion
  – Need to consider Section 302
Section 1202 Requirements

- Eligible Shareholder
- Eligible Corporation
- Qualified small business: $50M test
- Qualified trade or business (QTOB)
- Assets used in Active QTOB: 80% Test
- Original Issuance
- 5 Year Holding Period
Eligible Shareholders

• Noncorporate taxpayers are eligible for the Section 1202 exclusion, including individuals, trusts, and estates

• Section 1202 gain may be allocated to eligible taxpayers through flowthrough entities (partnership, S corporation, regulated investment company, or a common trust fund), but additional requirements must be met (discussed in more detail later)
Eligible Corporations

- An eligible corporation is any domestic C corporation, other than a DISC, former DISC, § 936 corporation, corporation with a § 936 subsidiary, RIC, REIT, REMIC, FASIT, or cooperative. §§1202(d)(1); 1202(c)(2)(A); 1202(e)(4).

- An LLC that has elected to be taxed as a corporation is treated as a corporation for Section 1202 purposes. PLR 201603011
Qualified Small Businesses

• To satisfy the qualified small business requirement, the aggregate gross assets of the corporation (or any of its predecessors) must not have exceeded $50,000,000:
  – at any time on or after August 10, 1993
  – before the issuance of the stock; and
  – immediately after the issuance including amounts received by the corporation in the issuance

• The $50,000,000 is generally based on the tax basis of the corporation’s property and there is no reduction for liabilities
  – Contributed property – FMV at the time of the contribution

• All of the assets of corporations that are part of the same parent-subsidiary controlled group are included in determining whether the corporation satisfies these tests
Qualified Trades or Businesses (QTOB)

- A qualified trade or business is any trade or business other than:
  - A service business in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset is the reputation or skill of one or more of its employees;
  - A banking, insurance, financing, leasing, investing, or similar business;
  - A farming business;
  - A business involving production or extraction of products with a character that permits a §613 or §613A deduction (i.e., depletion); or
  - A business of operating a hotel, motel, restaurant or similar business
Assets Used in an Active QTOB

• The active business test must be satisfied during substantially all of the holding period

• To satisfy the active business test: At least 80% of the value of the corporation’s assets are used in the active conduct of a qualified trade or business

• The test is not satisfied for any period if either:
  – Portfolio stock or securities: 10% of the value of the corporation’s assets net of liabilities are stock or securities in other corporations; or
  – Real estate holdings: 10% of the value of the corporation’s assets is real property that is not used in the active conduct of a qualified trade or business.
Original Issuance

• To satisfy the original issuance requirement, the taxpayer selling the stock must have acquired it at its original issuance in exchange for money, property, or services provided to the issuing corporation
  – Purchase from existing shareholder does not qualify
• Consider check-the-box issues under Section 1244 and stock contributed to a partnership
• Stock received through a tax-free reorganization can satisfy the original issuance requirement
Original Issuance

• Certain redemption transactions before or after the issuance of the stock may result in the originally issued stock failing the original issuance requirement:
  – A significant redemption from any persons within one year before or after the issuance of the purported QSB stock, or
  – A redemption from the holder or persons related to the holder of the purported QSB stock within two years before or after its issuance

• Certain purchases by a corporation are ignored – specifically, a transfer of stock by a shareholder to an employee or independent contractor or a purchase of stock in connection with a termination of services, death, disability, mental incompetence, or divorce

• Note on the REDEEMED STOCK: A redemption of QSBS treated as sale or exchange is still eligible for the QSBS gain exclusion
5 Year Holding Period

• The taxpayer must hold the stock for more than 5 years before the sale

• When does the 5 year period start?
  – Stock acquired for cash: at the time the taxpayer acquired the stock
  – Stock acquired for property: at the time the taxpayer acquired the stock
  – Stock acquired by conversion of stock (same corporation): at the time the stock initially was acquired
  – Stock acquired by gift/death: at the time the stock initially was acquired by the gifting party/decedent
Pass-Through Entities: Holding Companies

• Taxpayers who hold qualified small business stock through a partnership, S corporation, RIC or common trust fund may be eligible for the exclusion
• There are multiple traps for the unwary and significant uncertainty in pass-through structures
• The calculation of Section 1202 exclusion, including basis and $10M max, is applied at the shareholder/partner level
• There is no “look through” on sale of partnership interest – the pass-through entity must actually sell its QSB stock
Pass-Through Entities: Holding Companies

• Two conditions must be satisfied to allocate potential Section 1202 gain to pass-through owners:
  – The stock sold or exchanged by the pass-through entity must qualify as QSB stock in the pass-through entity hands; and
  – The taxpayer must include the amount in gross income by reason of holding an interest in the pass-through entity that the individual held:
    • on the date on which the pass-through entity acquired the QSB stock and
    • at all times thereafter before the disposition of the stock by the pass-through entity

• An investor cannot contribute its stock to a partnership, even though a partnership can acquire stock potentially eligible for Section 1202 directly from the corporation
Trust Planning Opportunities
Gifts and Deaths

• If QSB stock is transferred by gift or at death, the “original issuance” and holding period of the stock carries over to the transferee
• The $10M exclusion applies on a taxpayer-by-taxpayer basis; there is no provision to allocate the $10M among gift or death transferees
• Basis
  – Gift: Transferee has a carry-over basis
  – Death: Transferee has a basis step-up; post-death appreciation is eligible for the gain exclusion
• Because of the availability of the Section 1202 gain exclusion, a taxpayer may want to make a lifetime gift of QSB stock (basis step-up on death is less valuable given the Section 1202 exclusion)
Transfers to Trusts

• Grantor Trusts: Although not stated in the Code or Regulations, stock should continue to satisfy the original issuance requirement and have a tacked holding period after a transfer to a grantor trust

• Grantor Retained Annuity Trust: Again, no specific guidance; however, commentators suggest grantor trust treatment should apply as a transfer by gift
  – Are zeroed out GRATs a transfer by “gift”, where there is no net gift?

• Sale to an Irrevocable Grantor Trust: Because the sale is ignored for income tax purposes, commentators suggest grantor trust treatment should apply; effect of losing grantor trust status is unclear
Transfers to Trusts

• Gift to Non-Grantor Trust: Again, not entirely clear, but commentators suggest that the transferee should satisfy the “original issuance” requirement and have a tacked holding period
  – Although the non-grantor trust is a separate taxpayer, the trust received the QSB stock through a gift
  – May be able to make gifts into multiple non-grantor trusts to maximize the exclusion

• For more information, WG&L, Estate Planning Journal (October 2018) Jenson & Kohn, “Maximize Qualified Small Business Stock Exclusion”
Questions?