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Maximizing QSBS Income Tax Savings With Trusts

Thoughtful planning can help taxpayers who own QSBS Shares multiply the QSBS Exclusion while simultaneously achieving their estate planning objectives.

BY JEFFREY B. KOLODNY

Section 1202 of the Internal Revenue Code (unless otherwise noted, all "Section" references are to the Internal Revenue Code) provides that a taxpayer who acquired shares of stock in a corporation that qualify as qualified small business stock (QSBS Shares) after Sept. 27, 2010, can exclude the greater of $10 million and 10 times her basis in her QSBS Shares from income (QSBS Exclusion). Section 1202(h) provides that if a taxpayer gifts QSBS Shares to another taxpayer, the recipient should also be entitled to an additional QSBS Exclusion. A taxpayer who owns QSBS Shares can gift those shares to various types of trusts to significantly reduce income tax liability on the sale of those shares.

Generally speaking, in order for stock to qualify as QSBS Shares:

- The stock must be shares in a domestic C corporation, the aggregate gross assets of which did not exceed $50 million before and immediately after the issuance of the shares;
- the shares must have been originally issued by the corporation in exchange for money, property or services;
- the taxpayer must have held the shares for at least five years before the sale or exchange;
- at all times during the taxpayer's holding period of the shares the corporation must have been engaged in a qualified trade or business described in §1202(e)(3); and
- the shares must not have been disqualified as QSBS Shares under various provisions of §1202.

Section 1202(h) provides that the recipient of a gift of QSBS Shares is treated as having (1) acquired the shares in the same manner as the taxpayer who gifted the shares and (2) held the shares for the period that the shares were held by the taxpayer donor. Consequently, the recipient of a gift of QSBS Shares should be entitled to his, her or its own QSBS Exclusion. For purposes of §1202(h), a "gift" should mean a gift for income tax purposes and not gift or estate tax purposes. A transfer of QSBS Shares should be treated as a gift for purposes of §1202(h) if (1) the recipient is a different taxpayer than the taxpayer transferring the stock, (2) under the facts and circumstances the taxpayer transferring the stock intended to make a gift, and (3) the transfer is treated as a gift for purposes of §1015.

For various reasons, including property management, asset protection, flexibility, and tax planning, many taxpayers prefer to make gifts to trusts. While grantor trusts are popular for estate planning purposes, they do not provide additional QSBS Exclusions. Since the grantor of a grantor trust is generally treated as the owner of the trust's assets for income tax purposes, QSBS Shares held by a grantor trust will be treated as the grantor's shares. Since the transfer of stock to a grantor trust would not be to a different taxpayer, this transfer does not qualify as a gift under §1202(h).

Since a non-grantor trust is a different taxpayer than the taxpayer making a gift to the trust, a gift of QSBS Shares to a non-grantor trust can

qualify as a gift for purposes of §1202 and thus qualify for its own QSBS Exclusion.

Because §1202 does not limit the number of recipients who can receive QSBS Shares from a taxpayer, there is no limitation on the number of non-grantor trusts that receive a gift of QSBS Shares from the same taxpayer that should be eligible for the QSBS Exclusions. An individual taxpayer should, of course, consider her lifetime gift tax exemption when planning to make gifts of QSBS Shares since a gift of QSBS Shares could constitute a gift for gift tax purposes. Gifts of QSBS Shares to multiple non-grantor trusts with the same beneficiaries might not be treated as separate taxpayers for these purposes.

There are several types of non-grantor trusts and flexibility in how they can be drafted.

New York tax law generally provides that taxable income is federal taxable income, with certain adjustments. Consequently, unless an adjustment applies, if the sale of QSBS Shares qualifies for the QSBS Exclusion for federal tax purposes, the same income should also be excluded for New York income tax purposes.

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New York Tax Law §605(b)(3)(D) provides that exempt resident trusts are not subject to New York State income tax. An exempt resident trust is a non-grantor trust created by a resident of New York that does not have any New York resident trustees, New York situs property and New York source income. For these purposes, a corporation, even if incorporated in New York, is not treated as New York situs property and dividends from that corporation or capital gains from the sale of that corporation are not treated as New York source income.

While QSBS Shares held in an exempt resident trust should be eligible for a QSBS Exclusion for both federal and New York income tax purposes, any gain in excess of the excluded amount should not be subject to New York state income tax. Additionally, income or gain earned by an exempt resident trust on proceeds from the sale of QSBS Shares or any other assets should also not be subject to New York income tax.

Many taxpayers would like their spouse to be a beneficiary of a trust that can qualify for the QSBS Exclusion. Unfortunately, trusts where the grantor's spouse is a beneficiary would often be treated as a grantor trust and, therefore, would not be eligible for an additional QSBS Exclusion. Section 677 provides that a trust where the grantor's spouse is entitled to income will not be a grantor trust if income can only be distributed to the grantor's spouse with the consent or approval of an adverse party. In this context, an adverse party likely means any person having a substantial beneficial interest in the trust which would be adversely affected by a distribution to the grantor's spouse. Thus, a trust to which QSBS Shares are gifted where income can only be distributed to the grantor's spouse with the consent of an adverse party should be eligible for its own QSBS Exclusion, as long as there are no other conditions that would cause the trust to be a grantor trust.

An "ING Trust" is a specially designed non-grantor trust where gifts made to that trust are incomplete for gift tax purposes. Gifts to ING Trusts do not use any of the donor's federal gift tax exemption. Using the same adverse party technique described above, the grantor can be the beneficiary of an ING Trust. A taxpayer can, therefore, make a gift of QSBS Shares to an ING Trust without using any gift tax exemption and both that trust and the taxpayer should be eligible for a separate QSBS Exclusion. In 2014, New York enacted New York Tax Law §612(b)(41) as an adjustment to federal income that is included for New York income tax purposes.

That section provides that for property that a New York resident transfers to an ING Trust, New York taxes the grantor on the income of the trust to the extent such income "would be taken into account in computing the taxpayer's federal taxable income if such trust in its entirety were treated as a grantor trust for federal tax purposes." The purpose of this section is to subject ING Trust income to New York state income tax. While it is clear that QSBS Shares transferred to an ING Trust should qualify for a separate QSBS Exclusion for federal income tax purposes, there is no guidance on the application of that section in the context of QSBS Shares. It is unclear whether a QSBS Exclusion of an ING Trust is available for New York income tax purposes.

Completed gifts of QSBS Shares by an individual taxpayer use federal gift tax exemption. A taxpayer who gifts QSBS Shares to a grantor or non-grantor trust before the stock appreciates significantly may be able to take advantage of limited powers of appointment or distributions to other trusts (commonly referred to as "decanting") to access multiple QSBS Exclusions after the QSBS Shares appreciate beyond the $10 million limit on the QSBS Exclusion. Properly structured distributions of appreciated QSBS Shares from one trust to another should not be treated as a gift for gift tax purposes and should therefore not use gift tax exemption. Although there is no authority blessing such transfers, there are good arguments that distributions from a grantor trust or a non-grantor trust to nongrantor trusts may qualify as gifts for purposes of §1202(h), and, consequently, qualify for multiple QSBS Exclusions.

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