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Want $10 million of capital gains exclusion? How about $50 million?

For founders, investors and employees in certain emerging growth C-corp businesses that have experienced success, a hidden treasure lurks in the Internal Revenue Code. Section 1202 of the IRC allows investors to exclude some or all of the gain realized from the sale of qualified small business stock.

The infamous QSBS or 1202 election that is thrown around in founder circles is akin to a lottery ticket waiting to be cashed in by founders when their businesses reach success and liquidation. As is often the case, when planners combine income tax and estate tax planning, more tax saving opportunities arise. Specifically, the $10 million capital gains exclusion can be stacked for multiple family members.

What is QSBS?

Originally enacted in 1993, the exclusion was originally limited to a percentage of gains but over time has increased to potentially cover 100% of the capital gains exclusion. The following summarizes the applicable exclusions depending on when the stock was acquired:

- Aug. 11, 1993 – Feb. 17, 2009: a 50% capital gains exclusion.
- Feb. 18, 2009 – Sept. 27, 2010: a 75% capital gains exclusion.
- After Sept. 27, 2010: a 100% capital gains exclusion.

If eligible for QSBS treatment, the investor may exclude the greater of (1) $10 million of capital gains; or (2) 10 times the aggregate adjusted bases of the stock sold during the taxable year. At the time of stock issuance, the corporation's gross assets must be $50 million or less and at least 80% of the corporation's assets must be used in the operations of one or more of the qualified trades or businesses, as detailed below.

Allowed sectors:

- Technology .
- Retail.
- Wholesale.
- Manufacturing.

Disallowed sectors:

- Personal services.
- Financial.
- Hospitality.
- Farming.
- Mining, oil or gas.

Further eligibility requires the following:

- The investor may not be a corporation.
- The stock must have been acquired at its original issue (and not in the secondary market).
- The stock must have been purchased with cash or property or accepted as payment for a service.
- The stock must be held for a minimum of five years.

How to stack the $10 million exclusion?

While the IRS and Treasury Department have not yet issued rulings regarding the treatment of QSBS when gifted, the IRC lends support. A transfer of eligible QSBS holdings by gift or at death is treated as if the recipient had acquired the stock in the same fashion as the person who made the gift (or passed the asset upon death). Thus, it is as if the recipient steps into the shoes of the original stockholder, and if the stock was eligible for QSBS treatment, it will continue to be eligible after the transfer.

THE BUZZ

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LINDSEY PAIGE MARKUS, *a shareholder at Chuhak & Tecson P.C., draws on her early career in business, finance and clinically applied neuroscience to communicate with clients and develop creative solutions to fit their estate planning, wealth protection and corporate needs. Lindsey is a dynamic contributor to local news outlets, and has been recognized one of the 40 Under Forty.*

Surprisingly, some of the most popular estate planning tools, such as family limited partnerships or intentionally defective grantor trusts limit or disqualify stock from being eligible for QSBS capital gains exclusion. If contributed to a family limited partnership, the stock does not retain its character as QSBS because the partnership did not receive the shares on the original issuance from the corporation.

In addition, gifting to an intentionally defective grantor trust does not extend the capital gains exclusion to the trust. When gifting highly appreciated assets, planners often rush to draft intentionally defective grantor trusts, which allow income tax attributes to flow back to the grantor. When the grantor pays the income tax, it is not considered a gift and is an efficient way to continue to move assets outside of the grantor's estate.

Unfortunately, if QSBS holdings are transferred to a grantor trust, the income tax liabilities flow back to the grantor, who is limited to $10 million of capital gains (or 10 times the tax basis), whichever is greater. If instead the assets are gifted to a non-grantor or complex trust, the trust is treated as its own taxpayer and is eligible for $10 million of capital gains exclusion. A gift tax return for the value of the stock transferred to the trust would need to be filed for informational purposes with the IRS, notifying the IRS that the grantor has used up a portion of his lifetime exemption.

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Thus, imagine Founder Fred has four children and makes gifts of eligible QSBS holdings to four separate complex trusts, one trust for the benefit of each child. Fred is eligible for the $10 million capital gains exclusion, and each of the four trusts for the benefit of Fred's children is eligible, extending or "stacking" the QSBS treatment allows for potentially an additional $40 million of capital gains savings. In addition to the income tax savings, more assets are moved outside of Fred's taxable gross estate, translating to estate tax savings.

Countless founders, investors and employees of startups find themselves working 24/7 to launch their products or services. The opportunity for an additional influx of private equity funding or listing in the public markets takes them by storm and they fail to leverage additional tax planning opportunities. But for those select few who take just a little time to work with experienced planners, the capital gains and estate tax savings can be tremendous.

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