

Katten

PRESENTATION TO CHICAGO BAR ASSOCIATION TRUST LAW COMMITTEE

SPACs and QSBS

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Agenda

- I. Quick Estate Planning Overview
- II. QSBS
- III. SPACs
- IV. Estate Planning Opportunities

Quick Estate Planning Overview

Current Transfer Tax Environment

- **Gift/Estate Taxes**

| | Federal | Illinois |
|--------------------|-----------------|-------------|
| Exemption | \$12.06 million | \$4 million |
| Inflation Adjusted | Yes | No |
| Portable | Yes | No |
| Tax Rate | 40% | 16% |



Current Transfer Tax Environment (cont.)

- **GST Taxes**

- Exemption – \$12.06 million per person, inflation adjusted.
- Exemption is **not** portable between spouses.
- Top rate is 40%.

- **Why Do I Care About GST Exemption?**

- You can allocate GST exemption to gifts you make to a trust. This means that trust assets may pass in further trust from your children to grandchildren and future descendants **free of any gift, estate or GST taxes.**



Uncle Sam as Partner

- If current assets exceed exemption thresholds, you have a silent partner in every \$1 of growth of your assets going forward.
- Uncle Sam will take 50¢ for every \$1 of growth.
- Goal is to shift growth of assets off balance sheet so Uncle Sam takes nothing.



QSBS Introduction

QSBS Introduction

- Qualified Small Business Stock (IRC §1202).
- IRC §1202 is over 25 years old, but historically hasn't been overly popular, but that may have changed with the Tax Cuts and Jobs Act ("TCJA"), which "permanently" reduced corporate rates from 35% to 21% for tax years beginning January 1, 2018.
- Significant overlap between estate planning and income tax.
- Biggest Impact – GAIN EXCLUSION (if conditions are met):

| Stock Issuance Date | IRC §1202 Exclusion Percentage (\$10MM cap) |
|-----------------------|---|
| 8/11/1993 – 2/18/2009 | 50% |
| 2/19/2009 – 9/27/2010 | 75% |
| 9/28/2010 - present | 100% |

QSBS Introduction

- For such a powerful tool, there is a lack of IRS guidance on many issues that commonly arise.
- This is a complex area wrought with traps, so proceed with caution.
- Many good materials available to help navigate the issues.
 - Excellent 3 part article written by Paul S. Lee, L. Joseph Comeau, Julie Miraglia Kwon and Syida C. Long titled “Qualified Small Business Stock: Quest for Quantum Exclusions” (Tax Notes Federal, July 6, 2020; July 13, 2020; and July 20, 2020).
- “Small Business” can be deceiving. This refers to the size of the business when the stock was issued. I’ve worked with clients with QSBS stock:
 - Approx. market cap of \$26bn (now publicly traded)
 - Approx. market cap of \$41bn (now publicly traded)
 - Approx. valuation of \$3.5bn (privately held)
- BBB Act attempted to reduce allowable gain percentage exclusion from 100% to 50% (without regard to when stock was acquired). This attempt was unsuccessful, but may signal that current QSBS benefits may be under attack in the future.

QSBS Gain Exclusion

QSBS Gain Exclusion

- Per-Issuer Limitation (IRC §1202(b))

(1) **IN GENERAL.** If the taxpayer has eligible gain for the taxable year from 1 or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation which may be taken into account under subsection (a) **for the taxable year** shall not exceed **the greater of—**

(A) **\$10,000,000 reduced by** the aggregate amount of eligible gain taken into account by the taxpayer under subsection (a) for **prior taxable years** and attributable to dispositions of stock **issued by such corporation**, or

(B) **10 times the aggregate adjusted bases** of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year. [note: this includes all QSBS stock, not just QSBS stock held for 5 years]

For purposes of **subparagraph (B)**, the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued. [note: this limitation effectively excludes any stepped-up basis under IRC § 1014]

- Referred to generally as “\$10MM Cap and 10x Basis Cap”
- \$10MM Cap is a hard cap – once it is consumed it is gone.
- 10x Basis Cap is available every year (but cuts into \$10MM Cap).
- Limitations apply on a “per-issuer” basis, so taxpayers can have QSBS holdings of different corporations, each entitled to separate QSBS gain exclusions.

QSBS Gain Exclusion

Illustrative Example:

- Taxpayer has QSBS stock with \$2MM basis and \$22MM value (acquired in 2015).
- Y1 (2022) – taxpayer disposes of \$11MM of QSBS stock. Gain is \$10MM [\$11M less basis of \$1MM]. **QSBS gain excluded is \$10MM.** This fully consumes the \$10MM limitation portion, but the 10X basis limitation is still available for subsequent years.
- Y2 (2023) – taxpayer disposes of \$11MM of QSBS stock. Gain is \$10MM [\$11M less basis of \$1MM]. **QSBS gain excluded is \$10MM.** 10x basis [\$1MM x 10 = \$10MM] authorizes the exclusion of an additional \$10MM of gain.
- Timing can be important. [note that same tax consequences would apply if all QSBS stock sold in Y1 because 10x Basis Cap would apply.]
- Often taxpayers have multiple tranches of QSBS eligible stock, all with different basis, the reason being that it is preferable from a QSBS perspective to issue new shares as opposed to making capital contributions with respect to existing QSBS stock.
- Generally, try to sell low basis first (to consume \$10MM Cap) followed by high basis in subsequent years (to utilize 10x Basis Cap to the maximum extent).

Married Individuals

- **Married Filing Separately** (IRC §1202(b)(3)(A)). In the case of a separate return by a married individual, substitute “\$5,000,000” for “\$10,000,000”.
- **Married Filing Jointly** (IRC §1202(b)(3)(B)). In the case of any joint return, the amount of gain shall be allocated equally between the spouses for purposes of applying the \$10MM Cap to subsequent taxable years.
- These provisions cause considerable confusion. Married individuals are separate “taxpayers”, both of which should be entitled to their own independent QSBS gain exclusion. The applicable QSBS gain exclusion for married filing separately is clear (i.e, \$5MM per spouse), but it is less clear whether spouses are still entitled to \$10MM **each** when filing jointly. This is (shockingly) an unresolved issue.

QSBS Gain Deferral

QSBS Gain Deferral (IRC §1045)

- Sometimes a taxpayer cannot satisfy the 5 year holding period because of a forced sale of the stock (most commonly a buy-out of the corporation).
- Under IRC §1045, gain from the sale of QSBS stock may be deferred.
 - Taxpayer must acquire new QSBS stock within 60 days of sale.
 - Taxpayer must have held the original QSBS stock for more than 6 months prior to the sale of the QSBS stock.
 - Taxpayer must elect the application of IRC §1045.
- Gain rollover calculation determined under IRC §1045.

Putting the “QSB” in QSBS

Qualified Small Business

- Domestic “C” corporation (other than domestic international sales corporation (“DISC”) [or former DISC], regulated investment company, real estate investment trust (“REIT”) or a cooperative – these are excluded from the definition of an “active business”).
- The aggregate gross assets of such corporation (or any predecessor thereof) **at all times** on or after December 31, 1992 and **before the issuance** did not exceed **\$50,000,000**.
- The aggregate gross assets of such corporation **immediately after** the issuance (determined by taking into account amounts received in the issuance) do not exceed **\$50,000,000**.
- “aggregate gross assets” equals cash and “aggregate adjusted bases of other property”, but property contributed to the corporation has a deemed basis equal to FMV at time of contribution. [nuances of this calculation beyond the scope of this presentation]. Liabilities not excluded—it is not a “net asset” calculation.
- Aggregation rules apply for “parent-subsidary controlled group”.
- IRS can request documentation that the above is met, so good recordkeeping can be important if a corporation is close to the \$50MM mark.

Qualified Small Business

- **Active Business Requirement.** The corporation, during “substantially all of the taxpayer’s holding period,” must use at least 80% of the assets of the corporation in the active conduct of 1 or more qualified trades or businesses. A qualified trade or business means any trade or business other than (IRC §1202(e)(3)):
 - “any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,
 - any banking, insurance, financing, leasing, investing, or similar business,
 - any farming business (including the business of raising or harvesting trees),
 - any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and
 - any business of operating a hotel, motel, restaurant, or similar business.”
- Subsidiaries are “looked-through” (i.e., look to subsidiary’s assets and activities).
- PLR 202114002 (April 9, 2021) – Insurance agent or broker is not a “brokerage service” or “insurance” business as contemplated above, and stock in such corporation can qualify as QSBS. But see CCA 202204007 (January 28, 2022) for discussion of what constitutes a “brokerage service”.

Qualified Small Business

- **Special Rules**. The following special rules apply for purposes of determining whether a corporation meets the active business requirement:
 - **Portfolio stock or securities**. A corporation shall be treated as failing to meet the “active business requirement” for any period during which more than 10% of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries of such corporation (other than working capital).
 - **Working capital**. Any assets which (a) are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or (b) are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business shall be treated as used in the active conduct of a qualified trade or business. For periods after the corporation has been in existence for at least 2 years, in no event may more than 50 percent of the assets of the corporation qualify as used in the active conduct of a qualified trade or business by reason of this paragraph.
 - **Maximum Real Estate Holdings**. A corporation shall not be treated as meeting the “active business requirement” for any period during which more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business. For purposes of the preceding sentence, the ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business.

Qualified Small Business

- **Special Rules Continued**. The following special rules apply for purposes of determining whether a corporation meets the active business requirement:
 - **Start-Up Activities/ R&D Expenses**. If, in connection with any future qualified trade or business, a corporation is engaged in (a) start-up activities described in section 195(c)(1)(A), (b) activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174, or (c) activities with respect to in-house research expenses described in section 41(b)(4), assets used in such activities shall be treated as used in the active conduct of a qualified trade or business. Any determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination.
 - **Computer Software Royalties**. Rights to computer software which produces active business computer software royalties (within the meaning of section 543(d)(1)) shall be treated as an asset used in the active conduct of a trade or business.

Disqualifying Transactions

- IRC §1202(c)(3) **CERTAIN PURCHASES BY CORPORATION OF ITS OWN STOCK.**
 - **(A) Redemptions from taxpayer or related person.** “Stock acquired by the taxpayer **shall not** be treated as qualified small business stock if, at any time during the 4-year period beginning on the date 2 years before the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b)) to the taxpayer.” This is subject to de minimus exception in regulations (\$10,000 or 2% of stock) [disqualifies only stock acquired by certain taxpayers]
 - **(B) Significant redemptions.** “Stock issued by a corporation **shall not** be treated as qualified business stock if, during the 2-year period beginning on the date 1 year before the issuance of such stock, such corporation made 1 or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of such 2-year period.” This is subject to de minimus exception in regulations (\$10,000 or 2% of stock) [disqualifies all stock (regardless of shareholder) issued by corporation caught up by the rule]
 - **(C) Treatment of certain transactions.** If any transaction is treated under section 304(a) as a distribution in redemption of the stock of any corporation, for purposes of subparagraphs (A) and (B), such corporation shall be treated as purchasing an amount of its stock equal to the amount treated as such a distribution under section 304(a).

Qualified Small Business

- Obviously analysis is needed to determine whether the requirements of a Qualified Small Business are met. Often, CPAs approach us having previously determined that certain stock is QSBS eligible stock.
- If you're dealing with a client with closely-held "C" corporation stock, pause and ask whether it could be QSBS eligible stock.

Putting the Final “S” in QSBS

Stock Requirements

- Except as provided below, **stock** must be acquired by the taxpayer **at its original issue** (directly or through an underwriter) (a) in exchange for money or other property (not including stock), or (b) as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).
- **Exceptions:**
 - IRC §1202(f). Generally, stock acquired on conversion of other stock in the same corporation.
 - IRC §1202(h)(2). (a) **by gift**; (b) at death; or (c) from a partnership to a partner of stock with respect to which certain requirements are met. If this exception applies, then the transferee is treated as having acquired the stock in the same manner as the transferor, and the transferor's holding period of the stock is added to the holding period of the transferee. [partner to partnership transfers are not authorized transfers]
 - IRC §1202(h)(4). Generally IRC §351 transactions or **IRC §368 reorganizations**. "If [QSBS] is exchanged for other stock which would not qualify as [QSBS] but for IRC §1202(h), **such other stock shall be treated as [QSBS]** acquired on the date on which the exchanged stock was acquired." [but QSBS gain exclusion capped as of the time of the transfer – you don't get to exclude under IRC §1202 subsequent appreciation on the non-QSBS stock].
- **Holding Period**. 5 years (IRC 1202(b)(2)).
 - Capital contribution for stock – holding period begins when stock acquired.
 - Services for stock – holding period begins when income is included by taxpayer under IRC §83 (look for IRC §83(b) election).
 - SAFE ("Simple Agreement for Future Equity")– must be characterized as "stock". It is clear that SAFEs are *intended* to be an "equity security" but this isn't necessarily binding on the IRS. Open debate as to whether the 5 year holding period begins to run upon issuance of the SAFE or upon issuance of underlying stock.
 - Convertible Debt – is this "stock"? Most likely a debt instrument from the corporation (but possibly open to debate). Stock definitely acquired when debt converted to equity and stock meets the "original issuance" requirement.
 - Convertible Preferred Stock – holding period begins when convertible stock acquired.
 - Stock Options – holding period begins when option is exercised and stock acquired. Stock acquired meets the "original issuance" requirement.
- **Time can be the Enemy**. Remember the gross asset test. Client could hold unexercised options that, when issued, would've qualified for QSBS if immediately exercised. The corporation could subsequently fail to meet the gross asset test. If options are exercised when company doesn't meet the gross asset test, then it isn't QSBS.

Qualified Shareholders and Other Requirements

Qualified Shareholders

- QSBS gain exclusion is available to all taxpayers other than a corporation (including individuals, trusts, and estates).
- QSBS can be held in a “pass-thru entity” (this is the spelling of the term in IRC §1202) if certain requirements are met (including partnerships and “S” corporations). Requirements are found in IRC §1202(g). Generally, the QSBS characteristics are proportionate to the ownership percentage at the time the QSBS was acquired.
- If QSBS is held through a pass-thru entity, then the owner’s QSBS gain exclusion is limited to the amount of gain allocated to that owner **at the time the QSBS was acquired** (for example, if an owner subsequently purchases a greater portion of the pass-thru entity, then no QSBS benefit for the increased portion).

What the SPAC?!

Special Purpose Acquisition Companies

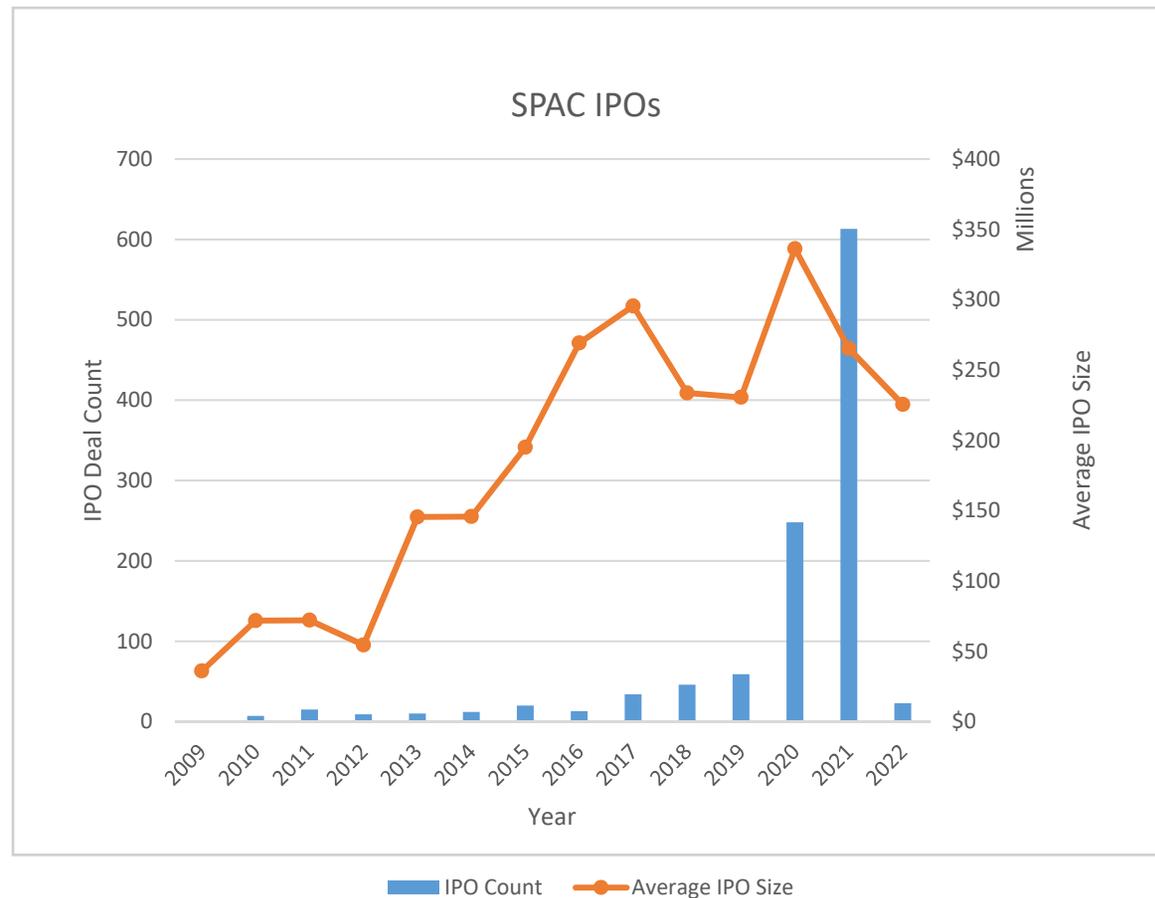
- SPACs are newly formed corporations that raise money through an initial public offering registered with the SEC. Often referred to as “**blank check**” companies.
 - Units are issued pursuant to a registration statement filed and declared effective by the SEC.
 - At least 80% of the gross proceeds of the SPAC IPO are deposited into a trust account and may only be used to fund an acquisition or redeem the shares.
 - SPAC must complete its business combination within a defined period of time or otherwise wind-up and liquidate. Generally 18-24 months, subject to extension to 36 months upon shareholder approval.
 - Following the IPO, the shares trade on either the NYSE or NASDAQ.



SPACs are On Fire!

Why SPACs?

- Quicker
- Cheaper
- More Flexible
- Less Burdensome



SPACs – Basic Structure

- Units are sold to the public at a fixed price, typically \$10.00 per unit.
 - In connection with the IPO, the underwriter is granted an overallotment option to purchase additional units in an amount up to 15% of the base offering size for 45 days.
 - Underwriting fees are typically **5.5%** of the offering size, with **2%** paid upon closing of the IPO and 3.5% deferred until closing of the business combination.
- Units are comprised of one share of common stock and a fraction of a redeemable warrant.
 - The amount of warrant coverage ($\frac{1}{2}$ warrant, $\frac{1}{3}$ warrant, $\frac{1}{4}$ warrant, etc.) varies across the market.
 - Strike price on public warrants usually set at **\$11.50**.
- Shareholders have right to have shares redeemed in connection with a business combination for their pro rata share of the trust funds.
 - Warrants held by public shareholders are retained even if shares are redeemed.
 - Warrants provide upside potential to public investors even in the event of redemption.

SPACs – Basic Structure

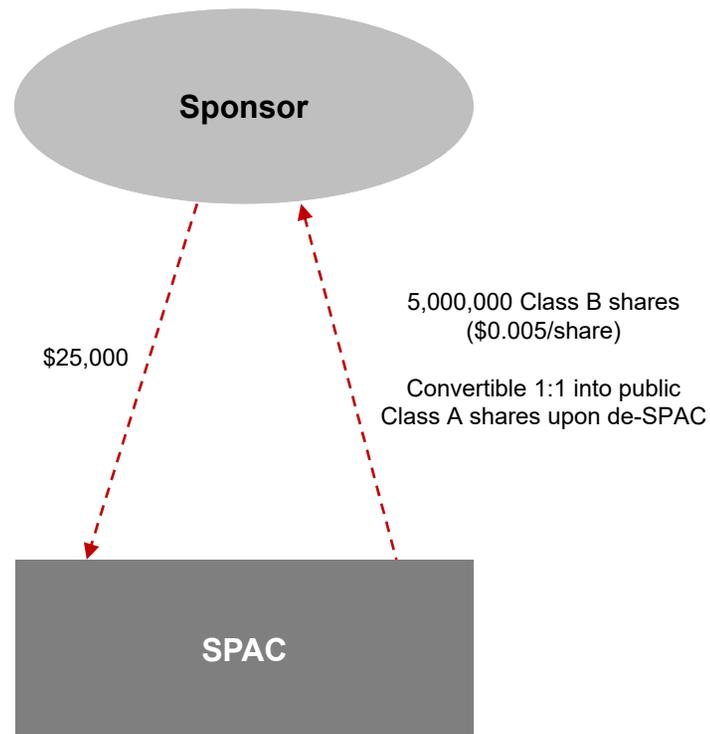
- Shares equal to **20%** of the post-IPO capitalization are issued to the sponsor for nominal consideration. This is referred to as the “promote” or “founder shares.”
 - Founder shares usually subject to a lock-up of one year from the date of the business combination.
 - Lock-up may be subject to amendment in connection with the business combination.
- Some recent deals have included alternative structures for the promote, including greater “**earn-out**” or “**performance**” shares for the sponsor.
- Sponsor may contribute a portion of the promote to SPAC management.
- Promote shares may be subject of negotiation and cutback in connection with the business combination.

SPACs – Basic Structure

- IPO expenses are typically funded through the purchase of private warrants (or shares) by the sponsor.
 - Sponsor equity purchase price funds:
 - Up-front underwriting fee (2% of offering size)
 - SEC filing fees
 - Stock exchange listing fees
 - Accounting and legal fees
 - D&O insurance
 - Marketing, operations and miscellaneous expenses
 - The equity purchase price is the sponsor’s “at-risk” capital.
 - Fees and expenses may be funded through a sponsor loan prior to closing of the IPO.

SPACs – Mechanics

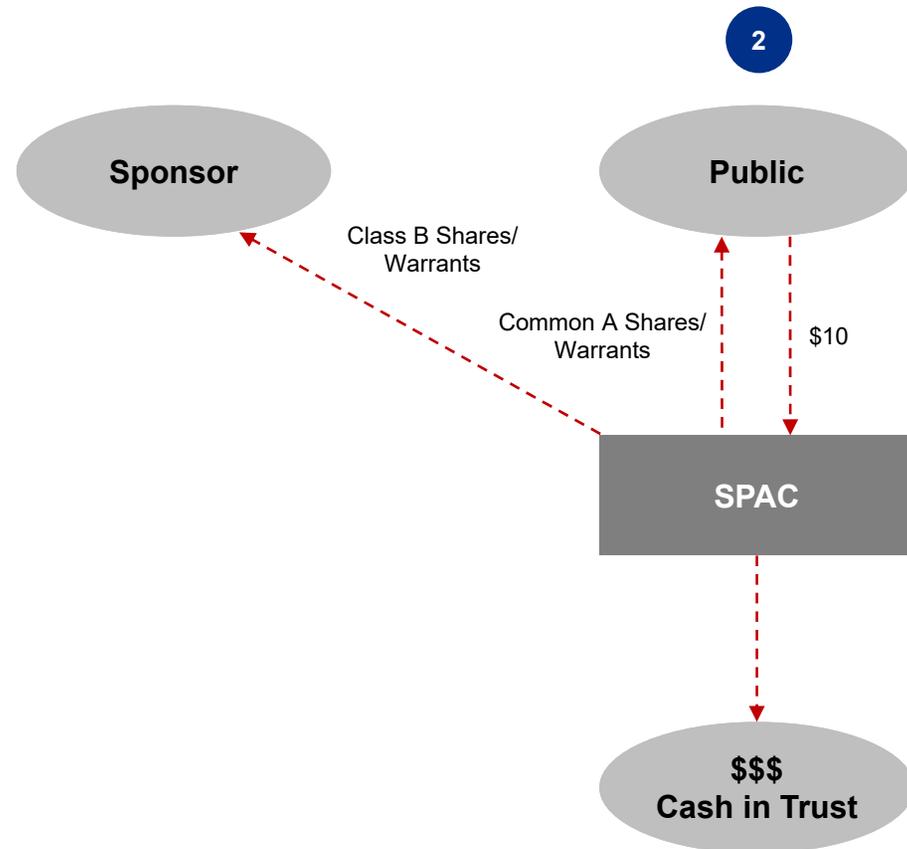
Step 1: Sponsor forms SPAC



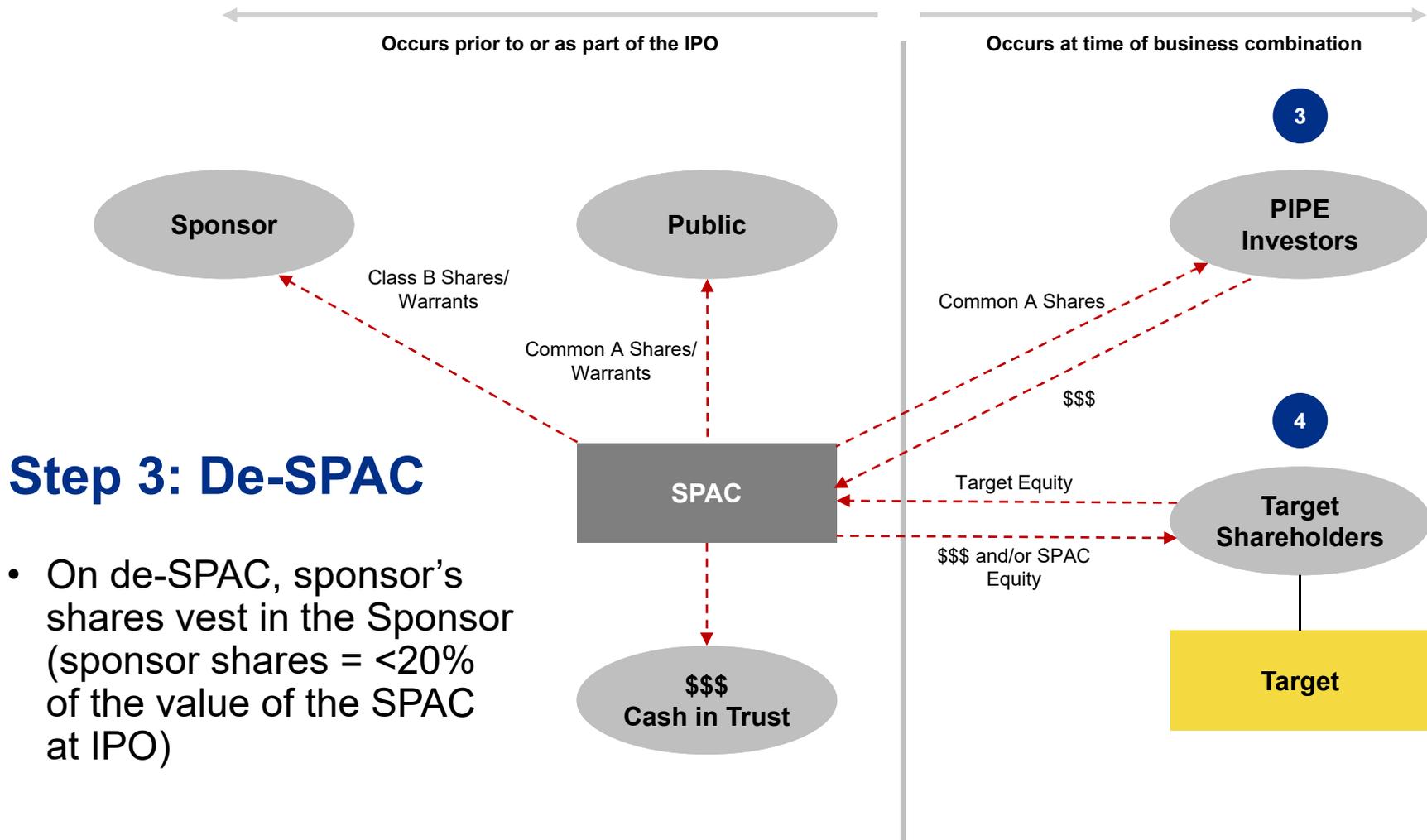
SPACs – Mechanics (cont.)

Step 2: SPAC IPO

- Public investors seed the SPAC through IPO
- IPO funds held for specific purpose of merging with a target (the “de-SPAC”)
- After IPO, SPAC has ~24 months to find a target and close on the de-SPAC
- If SPAC unable to close on the de-SPAC, then SPAC liquidates and returns funds to holders of Class A shares (i.e., public investors)

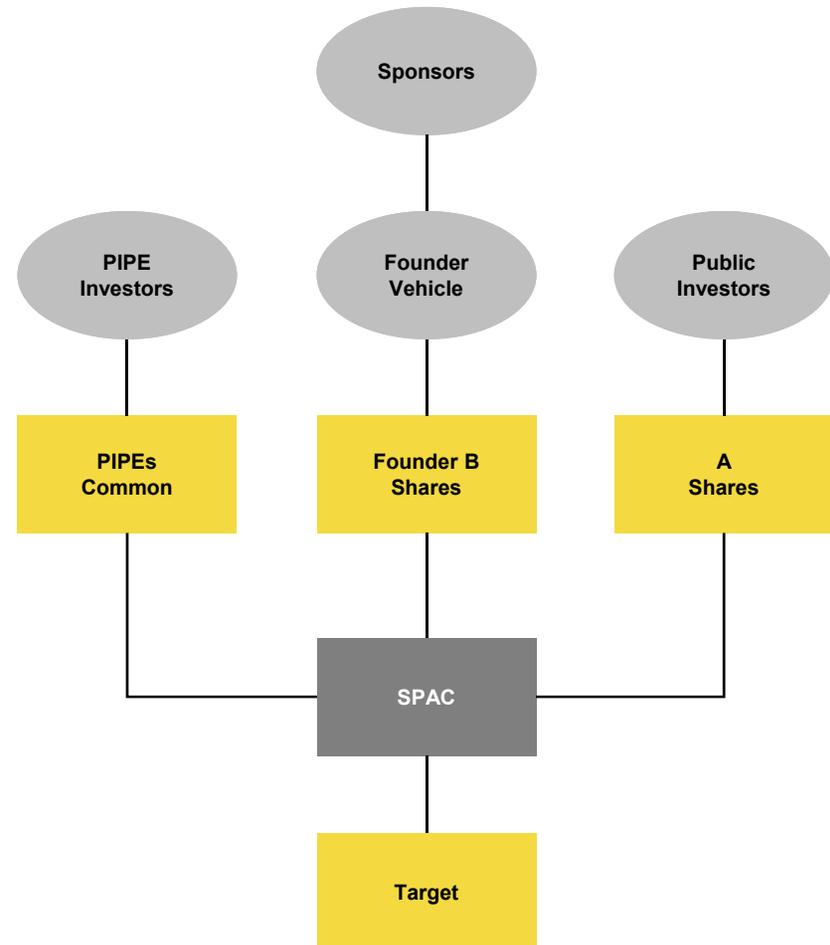


SPACs – Mechanics (cont.)



SPACs – Stakeholders

- Sponsors
 - Owners of the Founder Vehicle (which owns the Founder B Shares)
 - Individuals, PE Funds
- Public Investors in Public A Shares
- Investors in PIPE
 - PE Funds, Hedge Funds
- Owners of Target
 - Individuals, trusts, PE Funds, Family Offices



Estate Planning Opportunities

SPACs – Unique Estate Planning Opportunity for Sponsors

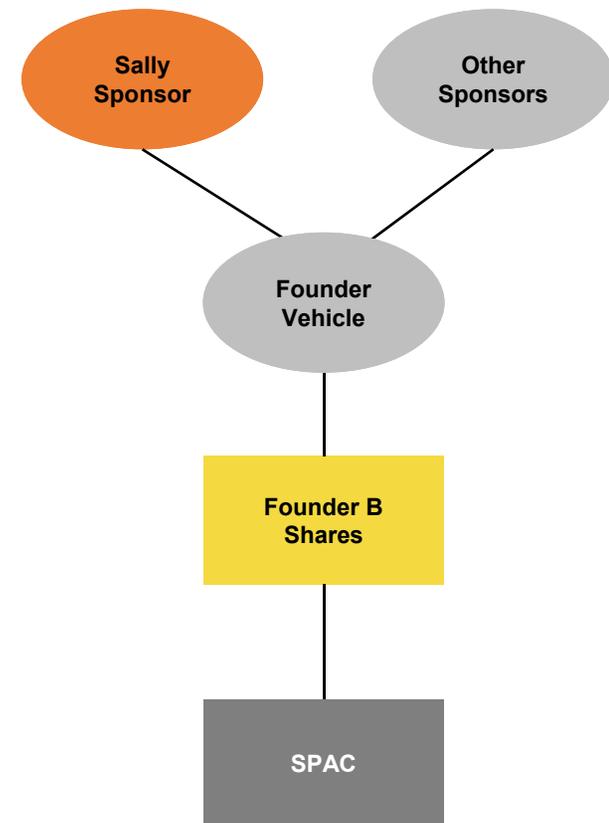
- Typically significantly reduced value early in the SPAC's life.
- Can be aggressively discounted from a valuation perspective (40% + valuation discounts not unusual).
- Potential for appreciation is extremely high.



SPACs – Unique Estate Planning Opportunity for Sponsors (cont.)

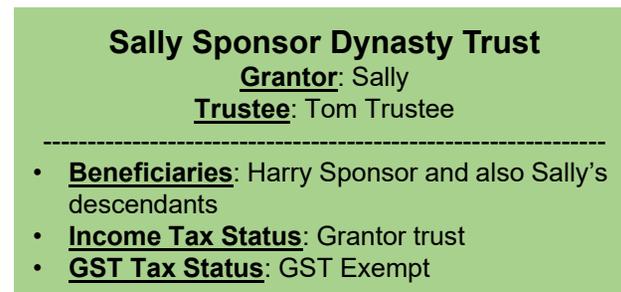
Example

- Founder Vehicle is the owner of Founder (Class B) shares (paid \$25,000 for 20% of SPAC shares) and Founder Warrants (paid \$6,650,000 for 4,433,333 Founder Warrants).
- Sally Sponsor is the owner of 10% of the Founder Vehicle.
- Sally believes that the Founder (Class B) shares (assuming exercise of Founder Warrants) will have post de-SPAC value of \$80 million in approximately 3 years (assuming \$1.3B value post de-SPAC).
- Given the inherent uncertainty (e.g., selection of target, consummation of de-SPAC, market performance, holding period, financing deals, etc.), lock-up periods, potential dilution of ownership, lack of marketability, etc. associated with the Founder (Class B) shares and Founder Warrants, a professional appraiser determines that a 40% discount is applicable.
- So, at the time of the IPO, the value of the Founder Vehicle's Founder (Class B) shares is ~\$48,000,000.
- Because Sally owns only 10% of Founder Vehicle, additional (tiered) discounts (perhaps an additional 20%?) may be justified to further reduce the value of Sally's ownership of the Founder Vehicle. Assuming an additional 20% discount, the value of Sally's interests in the Founder Vehicle ~\$3,840,000.

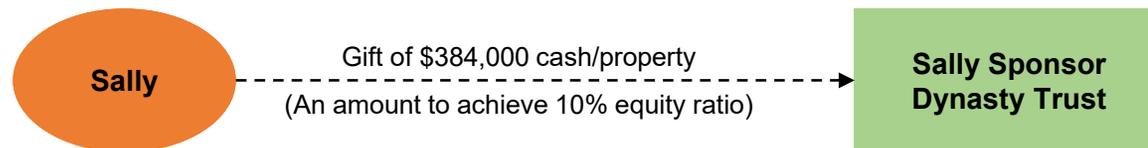


SPACs – Unique Estate Planning Opportunity for Sponsors (cont.)

- **Step 1:** Sponsor creates a “Dynasty Trust” for the benefit of spouse and descendants.

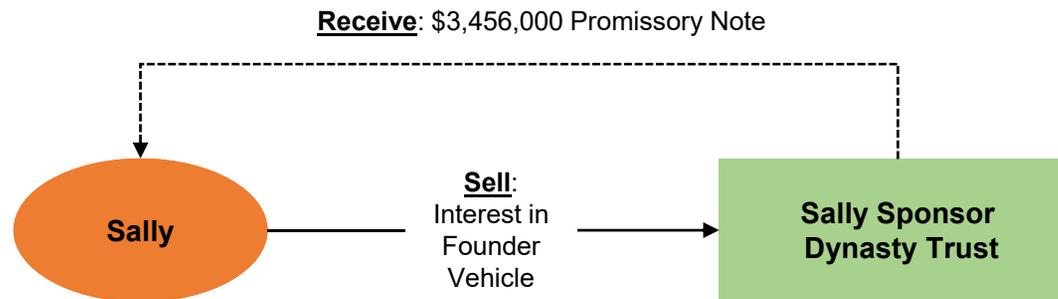


- **Step 2:** Sponsor seeds the Dynasty Trust with 10% equity (cash or other assets, including interests in Founder Vehicle) to the Dynasty Trust (gift tax return will be filed reporting the gift, which will consume gift exemption and GST exemption will be allocated).



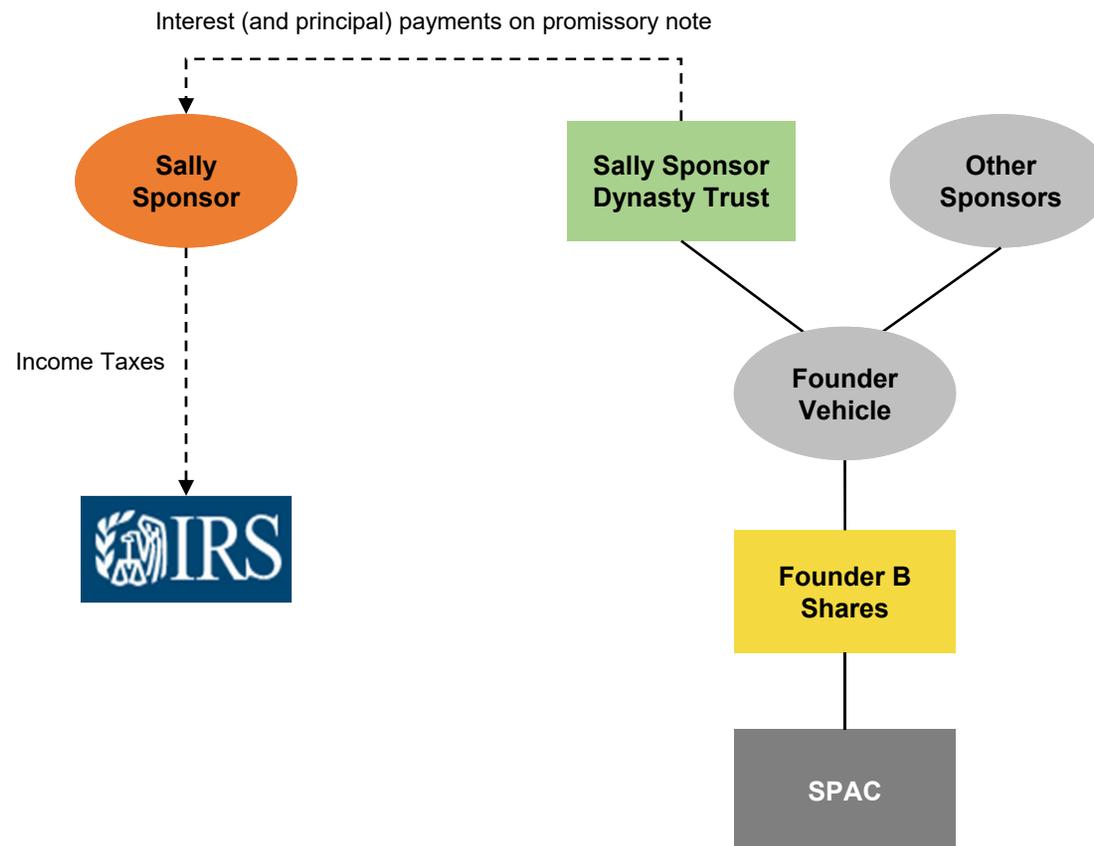
SPACs – Unique Estate Planning Opportunity for Sponsors (cont.)

- **Step 3**: Appraise Sally’s interests in Founder Vehicle.
- **Step 4**: Sally then sells her interests in the Founder Vehicle to the Dynasty Trust in exchange for a promissory note carrying interest at AFR.



SPACs – Unique Estate Planning Opportunity for Sponsors (cont.)

- **Step 5:** Administration Following Sale



SPACs – Unique Estate Planning Opportunity for Sponsors (cont.)

- **Perfect Recipe for Successful Estate Tax Planning**
 - **Timing** (freeze) - transferred when value low
 - **Leverage** (squeeze) – used very little exemption; took advantage of valuation discounts; and transferred high growth asset
 - **Dynasty Trust** (burn) – GST exempt, unlimited term; grantor trust.



Example

- **During Nine-Year Term of Note**

- Initial seed gift and eventual liquidation of Sponsor vehicle may be used to make payments on note (no payments are required until maturity).

- **End of Nine-Year Term of Note**

- Value of Dynasty Trust is \$8 million.

- Dynasty Trust pays back promissory note, \$4.1 million retained in trust.

- **End of 25 Additional Years**

- \$4.1 million @ 5% for 25 years = \$14 million.

- Never subject to gift, estate or GST taxes.



Example (cont.)

- **What Has Been Accomplished?**
 - \$14 million of value moved off the estate tax balance sheet consuming only \$384,000 of exemption. That is leverage!
Estate tax savings of ~\$7 million.
 - \$14 million in a Dynasty Trust for family—perpetual term, GST exempt and creditor protected!



Risks

- **Risk #1 – Valuation Risk**

- IRS could say the value of the carry is \$4.8 million instead of \$3.8 million and argue that the difference is an additional gift.
- Estate planners build in safeguards to the transaction, but no guarantees they work.
- Not a substantial risk anymore given the increase in exemption amounts (increased exemption acts as cushion against this risk).



Risks (cont.)

- **Risk #2 – IRC § 2701**

- Sponsors typically own multiple classes of interests: (1) Founder Class B shares; and (2) Founder Warrants.
- **Example** – Sponsor's Class B shares valued at \$1 million and Sponsor's Founder Warrants valued at \$750,000.
 - Sponsor transfers the Founder Warrants worth \$750,000 to the Dynasty Trust in exchange for a \$750,000 note, but does not transfer the Founder Class B shares.
 - For purposes of Section 2701, the warrants would likely represent an applicable retained interest in the form of an extraordinary payment right, which are problematic.
- Section 2701, if applicable, would cause the Sponsor to be treated as if the \$1 million Class B shares were **gifted** to the Dynasty Trust.



Risks (cont.)



Make a Note of This!

EXCEPTIONS!!

- **Risk #2 – IRC § 2701 (contd.)**

- **Exceptions**

- Vertical Slice – IRC § 2701 does not apply if SPAC Sponsor transfers, say, 50% of his or her Founder Class B Units and 50% of his or her Founder Warrants.
- Transfer All – IRC § 2701 does not apply if SPAC Sponsor transfers his or her entire interest in the SPAC.

The SPAC/QSBS Intersection

The SPAC/QSBS Intersection

- With a SPAC, there will inevitably be numerous “players” all potentially with different tax objectives.
- What if your client has QSBS in the target company?
 - If 5 year holding period is met, client may prefer all cash deal.
 - If 5 year holding period isn’t met, client may prefer IRC §368 reorganization (recall IRC §1202(h)).
 - IT MAY BE OUT OF YOUR CLIENT’S CONTROL! Just remember the tools you have at your disposal (including IRC §1045 [rollover into new QSBS]).
 - If your client is a big enough player, he/she may be able to sway what method is chosen.
 - Normal pre-IPO considerations apply (current value v. anticipated value, etc.)

QSBS Wrinkle

What if QSBS Shares are Involved?

- The “burn” component is a very powerful estate planning tool. The burn occurs as a result of the trust’s grantor trust status.
- Sometimes clients are more motivated by immediate income tax savings (which can include state income tax savings) than long-term gift/estate tax planning.
 - With grantor trust planning, the income tax is due and owing in all events, it is just paid by the taxpayer individually.
 - With QSBS, you can actually reduce the amount of income tax owed (i.e., there is an economic advantage).
- If QSBS is involved, a different approach may be considered.
- It is often a good idea to get information about timing upfront (e.g., when are 409As issued (are other valuations obtained and when?), possible exit events).
- Can you have your cake and eat it too?

Estate Planning Opportunities (QSBS) – Setting the Stage

- QSBS is a “per-issuer”, “per-taxpayer” exclusion.
- Recall that IRC §1202(h)(2) classifies transfers “by gift” and “at death” as transfers that will retain QSBS benefit in the hands of the transferee.
- **By Gift:**
 - IRC §1202 is an income tax provision. Do we use the concept of a gift interpreted under income tax principals or do we use transfer tax principals? (issue open to debate). REMEMBER THAT THIS ISSUE HASN'T BEEN DEFINITELY DETERMINED.
- **At Death:**
 - Not defined for purposes of IRC §1202. Probably encompasses all of the normal methods (Will/Revocable Trust, intestacy). Other statutory provisions (e.g., IRC §1245(b) regulations) and case law (Lyeth v. Hoey, 305 U.S. 188 (1938)) support a broad definition.
 - IRC §1014 basis step-up. Not allowed for calculation of 10x Basis Cap, but provision is silent for purposes of calculating \$10MM Cap.

Estate Planning Opportunities – Create More Taxpayers

- **Low-Hanging Fruit**. Gift (from an income tax perspective and a transfer tax perspective) QSBS eligible stock to separate complex trusts.
 - Requires thorough analysis of grantor trust rules.
 - Planning becomes more complicated if spouse is intended recipient.
 - Normal estate planning considerations apply (i.e., current value of gift vs. potential upside). Practical issues can arise with already heavily appreciated stock.
 - Be cautious of trust aggregation rules under IRC §643(f).
 - Common planning is 1 trust per child, if possible.
 - Goal is to gift amount to a trust that will fully utilize \$10MM Cap upon sale (usually requires projections).
 - This planning can also provide a state income tax benefit, so keep that on your radar as well.
- **Grantor Trusts**. Gifts to grantor trusts do not qualify for additional QSBS gain exclusion, so from QSBS perspective there is no benefit (that isn't to say this is bad estate planning, though).

Estate Planning Opportunities – More Exotic Possibilities

- **ONLY QUALIFYING TRANSFERS RETAIN QSBS BENEFIT!**
 - Contribution to GRAT and remainder to individuals or separate complex trusts. The initial contribution to the GRAT (i.e., a grantor trust as to the grantor) is disregarded for income tax purposes (i.e., it isn't a transfer at all), and expiration of the GRAT and distribution to remaindermen would be a gift for income tax purposes.
 - ING planning (gift for income tax purposes, not a gift for transfer tax purposes).
 - Sale to grantor trust and then “turn-off” grantor trust status. The sale isn't a transfer at all for income tax purposes, and the conversion from grantor trust to non-grantor trust is a transfer “by gift” under income tax principals.
 - Transfer from partner to partnership is not a qualified transfer. Be cautious with LLC planning. Transferring to a disregarded entity is ok, but conversion from disregarded entity to partnership likely disqualifies any QSBS stock held by the then partnership.

The GTR

IRS Disclosure



- **Disclosing Transaction to IRS**
 - If disclosed – Three-year statute of limitations
 - If not disclosed – Unlimited statute of limitations
- **Audit Rates**
 - Gift tax returns – Approximately 1%
 - Estate tax returns – Nearly 100% of taxable returns are reviewed
- **Conclusion** – With increased exemption amounts, scale has tipped in favor of disclosure and obtaining finality.
- **409A Valuations** – Do not technically meet the standard of “adequate disclosure” for federal transfer tax purposes.

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