



FEATURE: VALUATIONS

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QSBS Valuation for Enhanced Estate And Tax Benefits

A cornerstone in strategic planning to optimize clients' financial legacies

Qualified small business stock (QSBS) presents a significant opportunity for estate and tax planning, particularly for high-net-worth (HNW) individuals and business owners. Understanding the intricacies of QSBS under Internal Revenue Code Section 1202 allows for strategic planning to enhance financial outcomes, namely, reduced exposure to income tax and estate tax liability. Let's explore the definition, benefits and planning strategies associated with QSBS. Through a detailed examination of qualification criteria, valuation challenges and advanced planning techniques, this article aims to optimize the use of QSBS for estate and tax planning purposes.

QSBS Overview

QSBS refers to shares in a qualified small business that meet the criteria set forth in IRC Section 1202. This designation allows for certain tax advantages, provided the stock and the issuing company meet specific requirements.

Key income tax benefits. Key benefits include the potential to exclude up to \$10 million or 10 times the adjusted basis of the QSBS, whichever is greater, in capital gains from federal income tax. This significant tax exclusion applies to gains realized on the sale or exchange of QSBS held for more than five years.

Role in strategic estate and tax planning for HNW individuals and business owners. QSBS is a powerful tool in the arsenal of estate and tax planning strategies. For individuals looking to minimize their income tax liability while maximizing wealth transfer to heirs, leveraging the benefits of QSBS can lead to substantial tax savings and financial advantages. The ability to exclude a considerable amount of capital gains from taxation directly impacts estate planning by preserving wealth that can be transferred to future generations.

Advanced strategic gifting strategies. QSBS can be gifted to a series of specially designed irrevocable nongrantor trusts for the benefit of a spouse or children so that each trust will receive its own capital gains exemption of up to \$10 million or 10 times the adjusted basis of the QSBS, whichever is greater, on the subsequent sale of the QSBS. This strategy, which is explained in further detail below, can substantially reduce a taxpayer's gross taxable estate for estate tax purposes while simultaneously providing substantial income tax benefits on a subsequent sale of the QSBS from one or more trusts.

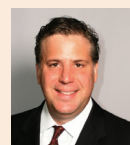
Through precise criteria and substantial tax benefits, QSBS is a cornerstone in strategic planning for those looking to optimize their financial legacies.

Qualification criteria. Qualifying for QSBS status under Section 1202 involves a set of specific criteria that companies and their stock must meet. These criteria are central to harnessing the tax advantages associated with QSBS. Attorneys and CPAs must comprehensively understand these requirements to navigate and leverage QSBS for their clients' benefit effectively.

Qualifying Business Activities

The business issuing QSBS must engage in certain qualifying activities. Primarily, it must be a domestic C corporation (C corp) (an S corporation

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doesn't qualify as a qualified small business under Section 1202) whose operations consist of active conduct of a qualified trade or business. While Section 1202 broadly defines "trade or business," it expressly excludes certain service industries such as health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any business where the principal asset is the reputation or skill of one or more of its employees. Other businesses excluded from the benefits of Section 1202 are any banking, insurance, financing, leasing, investing, or similar business, any farming business and any business operating a hotel, motel or restaurant.

Moreover, the company must not have purchased (directly or indirectly) more than \$50 million in assets, both at the time of and immediately after the issuance of the stock. This requirement ensures that the benefits of QSBS accrue primarily to smaller, growing businesses, aligning with the legislative intent behind Section 1202.

Gross assets test. A critical aspect of QSBS qualification is the gross assets test. At no point prior to the issuance of the stock can the corporation's gross assets exceed \$50 million, including the consideration received for the stock itself. The test aims to limit the QSBS designation to genuinely small businesses, fostering investment in these enterprises. After the issuance of the stock, the company's assets may grow beyond this threshold without affecting the QSBS status of previously issued stock.

Holding period requirements. For stock to qualify as QSBS, investors must hold it for at least five years. This long-term investment criterion underscores the incentive structure designed to promote sustained investment in small businesses. The holding period requirement also serves as a gatekeeping mechanism, ensuring that only truly committed investors benefit from the substantial tax advantages QSBS offers.

Common pitfalls. A frequent misconception about QSBS is that any small company's stock automatically qualifies. However, failing to meet any stringent criteria set forth above disqualifies the stock from QSBS benefits. For example, investors often overlook the active business requirement and the excluded industries, mistakenly assuming

that passive income activities or investments in the excluded service sectors can qualify.

Another common pitfall involves misunderstanding the gross assets test, particularly the timing of the \$50 million assessment. Misinterpreting this requirement can lead to incorrect assumptions about a stock's eligibility.

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Valuation Challenges

Valuing QSBS for tax purposes presents unique challenges and requires strategic approaches. Attorneys and CPAs must navigate these complexities to optimize tax benefits for their clients. Understanding when to apply the market approach versus the income approach and recognizing the influence of future cash flows, discount rates and market comparables is essential, especially when selling QSBS to a third party or gifting QSBS to an irrevocable trust.

There are three main approaches to valuing a company: the cost approach, the market approach and the income approach. The cost approach estimates the value based on the replacement cost of the net assets. The market approach compares the company with similar ones that have been sold or are publicly traded. The income approach projects the future cash flows and discounts them to the present value. The choice of approach depends on the characteristics of the company and the availability of data.

Cash Flows and Discount Rates

Valuation under the income approach hinges on accurately forecasting future cash flows and selecting an appropriate discount rate. These projections must account for the company's growth trajectory and potential risks. The choice of discount rate reflects the risk associated with achieving those future cash flows, with higher rates used for higher risk ventures. Misjudgments in either area can significantly affect the valuation outcome.



FEATURE: VALUATIONS

Market comparables play a crucial role in both approaches. For the market approach, they provide direct benchmarks. In the income approach, comparables can offer insights into appropriate discount rates and validate assumptions about future performance.

The cost approach values an asset by its replacement or reproduction cost minus its liabilities. It's a secondary method for QSBS valuation, as it ignores the company's earnings and goodwill. It may apply more to companies with large, fixed assets or liquidation value.

Case Studies

Several case studies highlight the strategic advantage of adept QSBS valuation.

One case involved a hardware start-up that, through careful application of the income approach, demonstrated a higher valuation at the time of stock issuance. This increased the basis and, after a holding period of over five years, significantly reduced the capital gains tax on sale due to the QSBS exemption.

Another case centered on a medical device firm where the market approach, supported by a thorough analysis of recent transactions in the biotech sector, established a robust valuation. This not only facilitated successful fundraising but also maximized QSBS benefits for early investors.

IRS Scrutiny

The Internal Revenue Service pays close attention to QSBS valuations, given the significant tax benefits at stake. Comprehensive documentation and substantiation of the valuation method and inputs are crucial. This includes detailed financial projections, assumptions used in the discount rate calculation and evidence supporting the selection of comparables.

Failure to properly document the valuation process can lead to challenges from the IRS, potentially resulting in adjustments to the valuation, accuracy-related penalties and a corresponding increase in tax liability. Therefore, maintaining a rigorous, transparent valuation process is paramount for defending the chosen methodology and figures in case of IRS scrutiny. Additionally, on an audit of the QSBS valuation, the IRS will likely challenge

the taxpayer's assertion that the subject stock is, in fact, QSBS, which could result in the QSBS losing its status as such after the audit.

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QSBS in Estate and Tax Planning

QSBS is a potent instrument in estate and tax planning, offering avenues to minimize estate taxes and enhance wealth transfer to heirs. Effective use of QSBS requires strategic planning around gifting, integration with other estate-planning tools and careful navigation to avoid common pitfalls.

Timing and tax implications of gifting QSBS. Gifting QSBS to family members or into trusts represents a strategic method to leverage the stock's growth outside the donor's estate, potentially reducing estate tax liability. The timing of such gifts is crucial. Ideally, gifting occurs when the QSBS' value is relatively low, allowing the subsequent appreciation to accrue outside the donor's estate. This strategy not only leverages the QSBS exclusion for the donor but also facilitates wealth transfer without triggering gift taxes, thanks to the annual gift tax exclusion and lifetime gift and estate tax exemption.

Avoiding common pitfalls in transferring QSBS. Transferring QSBS as part of an estate plan demands attention to detail to prevent unintended tax consequences. One common pitfall involves violating the holding period requirement. To qualify for QSBS benefits, including the capital gains exclusion, the stock must be held for at least five years. Transferring QSBS before meeting this requirement could result in losing the tax benefits.

Additionally, understanding the implications of gifting QSBS to trusts requires careful planning; the trust must be structured so that the QSBS benefits



are preserved, and the ultimate beneficiaries can take advantage of their own capital gains exclusion of up to \$10 million or 10 times the adjusted basis of the QSBS, whichever is greater. To properly structure this type of gift transaction to a trust, the gift of QSBS stock must be made to a nongrantor trust that's treated as a separate taxpayer for income tax purposes (that is, the taxpayer isn't permitted to make a gift to himself, and to "stack" the exemption, the gift to the trust must be a completed gift for tax purposes).

Maximizing benefits through early planning. Early and strategic planning is crucial to maximizing the benefits of QSBS in estate and tax planning. This involves not only selecting the right time and method for transferring QSBS but also integrating these moves into the broader estate plan. Attorneys and CPAs play a critical role in guiding clients through the complexities of QSBS, ensuring that all comply with IRS regulations and align with the client's estate planning goals.

By effectively leveraging QSBS, HNW individuals and business owners can significantly reduce their estate taxes and enhance the transfer of wealth

to their heirs. This requires a comprehensive understanding of QSBS rules, strategic planning around gifting and the use of estate-planning tools and vigilance to avoid pitfalls that could undermine the tax benefits.

Advanced QSBS Techniques

Sophisticated strategies for leveraging QSBS can significantly amplify estate and tax planning benefits. These techniques not only offer tax advantages but also provide avenues for achieving broader financial and philanthropic goals. Understanding the intricacies of converting non-qualifying stock into QSBS, along with the role of QSBS in charitable endeavors, requires careful consideration of legal and tax implications.

Converting non-qualifying stock into QSBS. One advanced strategy involves converting stock that doesn't initially meet QSBS criteria into qualifying stock. Although the mechanics of this conversion process are beyond the scope of this article, it's worth noting that the conversion process typically necessitates significant restructuring of the business or its assets, namely, converting the business entity into a domestic C corp from a partnership or limited liability company. Key considerations include ensuring the business engages in qualifying activities as defined in Section 1202 and maintaining the gross assets threshold under \$50 million before and immediately after the stock issuance. Importantly, on the conversion of the non-qualifying entity into a domestic C corp, the entity must also meet the 5-year holding period as discussed above.

Gifting QSBS to irrevocable trusts to "stack" the exemption. Section 1202 provides that a taxpayer can exclude up to \$10 million of capital gains tax or 10 times the adjusted basis of the QSBS, whichever is greater, resulting from the sale of QSBS. Section 1202 further provides that in the case of a transfer pursuant to a gift, the transferee shall be treated as having acquired such stock in the same manner as the transferor and having held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under this subsection) by the transferor.

This means that a taxpayer can make a completed gift of QSBS to one or more irrevocable nongrantor

SPOTLIGHT



Home Sweet Home

Vermont Hills by John Terelak sold for \$960 at Doyle's Doyle At Home auction on April 24, 2024 in New York City. Terelak is an American Impressionist artist known for his landscapes of the New England area. His paintings evoke a nostalgia for the four seasons of the northeast, whether the moody winter or crisp colorful fall.



FEATURE: VALUATIONS

trusts (for example, a spousal lifetime access trust with its own taxpayer identification number) in such a way that *each trust* will receive its own capital gains exemption of up to \$10 million or 10 times the adjusted basis of the QSBS, whichever is greater, on the subsequent sale of the QSBS. Thus, for example, if a taxpayer wishes to sell QSBS that would result in capital gains of \$20 million, the taxpayer could gift half of the QSBS to Trust 1 (for example, for the benefit of the taxpayer's spouse) and the other half to Trust 2 (for example, for the benefit of the taxpayer's children). Each trust could subsequently sell the QSBS and claim its own \$10 million capital gains exemption under Section 1202. This strategy, known as “stacking” the exemption, would not only substantially reduce a taxpayer's gross taxable estate for estate tax purposes but also simultaneously provide substantial income tax benefits on a subsequent sale of the QSBS from one or both of the trusts.

If an individual wishes to make a series of gifts to multiple irrevocable nongrantor trusts to stack the exemption, these trusts must not only be treated as nongrantor trusts but also must be specially designed to avoid the harsh application of the “reciprocal trust doctrine,” which could effectively invalidate the trusts and gifts if the trusts contain similar terms and overlapping beneficiaries. Thus, it's important to ensure that each of the trusts is considered a nongrantor trust and that: (1) the trusts have different permissible beneficiaries; (2) an independent trustee be named; and (3) the grantor of the trusts retains no incidents of ownership over the property comprising the corpus of the trust.

Legislative Changes

When employing advanced QSBS strategies, staying abreast of legal and regulatory changes is crucial. The IRS scrutinizes QSBS claims closely, making compliance and documentation paramount. Furthermore, proposed legislative changes could alter the QSBS landscape, affecting the attractiveness of these strategies. Staying informed and consulting with legal and tax professionals specializing in QSBS can provide valuable guidance and ensure that strategies remain compliant and effective.

Legislative changes on the horizon could significantly impact the rules governing QSBS, with

proposals potentially modifying the eligibility criteria, tax benefits and compliance requirements. For example, adjustments to the capital gains exclusion cap or alterations to the qualifying business activities could reshape the utility of QSBS as a tax planning tool. Such changes may also influence the valuation process, necessitating new approaches to calculate the worth of QSBS in light of altered tax implications.

Analyzing proposed legislative changes involves scrutinizing the specifics of each bill or amendment, considering the rationale behind them and evaluating their likely effects on the attractiveness of QSBS. For instance, if Congress were to increase the capital gains exclusion, this would enhance the value of QSBS in tax planning. Conversely, stricter eligibility criteria could limit the applicability of QSBS, making it less appealing. Assessing the potential impacts requires a thorough understanding of the current legislative framework and the proposed adjustments.

It's crucial for individuals and businesses leveraging QSBS to be flexible in planning and ready to adapt strategies in response to legislative changes. This might involve reevaluating the structure of investments, exploring alternative tax planning tools or adjusting long-term financial planning goals.

Effective preparation also involves scenario analysis, simulating the outcomes of different legislative changes on QSBS valuation and tax benefits. This analytical approach aids in identifying robust strategies that can withstand legislative shifts, ensuring that QSBS continues to serve its role in effective estate and tax planning.

Optimizing QSBS

QSBS presents a unique opportunity for strategic estate and tax planning, offering significant benefits that can influence wealth transfer and long-term financial planning. The keys to unlocking these benefits lie in a thorough understanding of QSBS, meticulous valuation and proactive adaptation to legislative changes. By focusing on these areas, stakeholders can optimize the use of QSBS, ensuring it plays a central role in their estate and tax planning strategies. 