Section 1202 Planning: When Might the Assignment of Income Doctrine Apply to a Gift of QSBS?

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Section 1202 allows taxpayers to exclude gain on the sale of QSBS if all eligibility requirements are met. Section 1202 also places a cap on the amount of gain that a stockholder is entitled to exclude with respect to a single issuer's stock.[i] A taxpayer has at least a $10 million per-issuer gain exclusion, but some taxpayer's expected gain exceeds that cap. In our article Maximizing the Section 1202 Gain Exclusion Amount, we discussed planning techniques for increasing, and in some cases multiplying, the $10 million gain exclusion cap through gifting QSBS to other taxpayers.[ii] Increased awareness of this planning technique has contributed to a flurry of stockholders seeking last-minute tax planning help. This article looks at whether you can "multiply" Section 1202's gain exclusion by gifting qualified small business stock (QSBS) when a sale transaction is imminent.

This is one in a series of articles and blogs addressing planning issues relating to QSBS and the workings of Sections 1202 and 1045. During the past several years, there has been an increase in the use of C corporations as the start-up entity of choice. Much of this interest can be attributed to the reduction in the corporate rate from 35% to 21%, but savvy founders and investors have also focused on qualifying for Section 1202's generous gain exclusion. Recently proposed tax legislation sought to curb Section 1202's benefits, but that legislation, along with the balance of President Biden's Build Back Better bill, is currently stalled in Congress.

The Benefits of Gifting QSBS

Section 1202(h)(1) provides that if a stockholder gifts QSBS, the recipient of the gift is treated as "(A) having acquired such stock in the same manner as the transferor, and (B) 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 statute literally allows a holder of $100

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million of QSBS to gift $10 million worth to each of nine friends, with the result that the holder and his nine friends each having the right to claim a separate $10 million gain exclusion. Under Section 1202, a taxpayer with $20 million in expected gain upon the sale of founder QSBS can increase the overall tax savings from approximately $2.4 million (based on no Federal income tax on $10 million of QSBS gain) to $4.8 million (based on no Federal income tax on $20 million of QSBS gain) by gifting $10 million worth of QSBS to friends and family.[iii]

A reasonable question to ask is whether it is ever too late to make a gift of QSBS for wealth transfer or Section 1202 gain exclusion cap planning? What about when a sale process is looming but hasn't yet commenced? Is it too late to make a gift when a nonbinding letter of intent to sell the company has been signed? What about the situation where a binding agreement has been signed but there are various closing conditions remaining to be satisfied, perhaps including shareholder approval? Finally, is it too late to make a gift when a definitive agreement has been signed and all material conditions to closing have been satisfied?

Although neither Section 1202 nor any other tax authorities interpreting Section 1202 address whether there are any exceptions to Section 1202's favorable treatment of gifts based on the timing of the gift, the IRS is not without potential weapons in its arsenal.

Application of the Assignment of Income Doctrine

If QSBS is gifted in close proximity to a sale, the IRS might claim that the donor stockholder was making an anticipatory assignment of income.[iv]

As first enunciated by the Supreme Court in 1930, the anticipatory assignment of income doctrine holds that income is taxable to the person who earns it, and that such taxes cannot be avoided through "arrangement[s] by which the fruits are attributed to a different tree from that on which they grew."[v] Many assignment of income cases involve stock gifted to charities immediately before a prearranged stock sale, coupled with the donor claiming a charitable deduction for full fair market value of the gifted stock.

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In Revenue Ruling 78-197, the IRS concluded in the context of a charitable contribution coupled with a prearranged redemption that the assignment of income doctrine would apply only if the donee is legally bound, or can be compelled by the corporation, to surrender shares for redemption.[vi] In the aftermath of this ruling, the Tax Court has refused to adopt a bright line test but has generally followed the ruling's reasoning. For example, in *Estate of Applestein v. Commissioner*, the taxpayer gifted to custodial accounts for his children stock in a corporation that had entered into a merger agreement with another corporation. Prior to the gift, the merger agreement was approved by the stockholders of both corporations. Although the gift occurred before the closing of the merger transaction, the Tax Court held that the "right to the merger proceeds had virtually ripened prior to the transfer and that the transfer of the stock constituted a transfer of the merger proceeds rather than an interest in a viable corporation."[vii] In contrast, in *Rauenhorst v. Commissioner*, the Tax Court concluded that a nonbinding letter of intent would not support the IRS' assignment of income argument because the stockholder at the time of making the gift was not legally bound nor compelled to sell his equity.[viii]

In *Ferguson v. Commissioner*, the Tax Court focused on whether the percentage of shares tendered pursuant to a tender offer was the functional equivalent of stockholder approval of a merger transaction, which the court viewed as converting an interest in a viable corporation to the right to receive cash before the gifting of stock to charities.[ix] The Tax Court concluded that there was an anticipatory assignment of income in spite of the fact that there remained certain contingencies before the sale would be finalized. The Tax Court rejected the taxpayer's argument that the application of the assignment of income doctrine should be conditioned on the occurrence of a formal stockholder vote, noting that the reality and substance of the particular events under consideration should determine tax consequences.

Guidelines for Last-Minute Gifts

Based on the guidelines established by Revenue Ruling 78-197 and the cases discussed above, the IRS should be unsuccessful if it

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asserts an assignment of income argument in a situation where the gift of QSBS is made prior to the signing of a definitive sale agreement, even if the company has entered into a nonbinding letter of intent. The IRS' position should further weakened with the passage of time between the making of a gift and the entering into of a definitive sale agreement. In contrast, the IRS should have a stronger argument if the gift is made after the company enters into a binding sale agreement. And the IRS' position should be stronger still if the gift of QSBS is made after satisfaction of most or all material closing conditions, and in particular after stockholder approval. Stockholders should be mindful of Tax Court's comment that the reality and substance of events determines tax consequences, and that it will often be a nuanced set of facts that ultimately determines whether the IRS would be successful arguing for application of the assignment of income doctrine.

Transfers of QSBS Incident to Divorce

The general guidelines discussed above may not apply to transfers of QSBS between former spouses "incident to divorce" that are governed by Section 1041. Section 1041(b)(1) confirms that a transfer incident to divorce will be treated as a gift for Section 1202 purposes. Private Letter Ruling 9046004 addressed the situation where stock was transferred incident to a divorce and the corporation immediately redeemed the stock. In that ruling, the IRS commented that "under section 1041, Congress gave taxpayers a mechanism for determining which of the two spouses will pay the tax upon the ultimate disposition of the asset. The spouses are thus free to negotiate between themselves whether the 'owner' spouse will first sell the asset, recognize the gain or loss, and then transfer to the transferee spouse the proceeds from the sale, or whether the owner spouse will first transfer the asset to the transferee spouse who will then recognize gain or loss upon its subsequent sale." Thus, while there are some tax cases where the assignment of income doctrine has been successfully asserted by the IRS in connection with transfers between spouses incident to divorce, Section 1041 and tax authorities interpreting its application do provide divorcing taxpayers an additional argument against

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application of the doctrine, perhaps even where the end result might be a multiplication of Section 1202's gain exclusion.

More Resources

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with QSBS planning. Venture capitalists, founders and investors who want to learn more about QSBS planning opportunities are directed to several articles on the Frost Brown Todd website:

- Planning for the Potential Reduction in Section 1202's Gain Exclusion
- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202
- View all QSBS Resources

Contact Scott Dolson or Melanie McCoy (QSBS estate and trust planning) if you want to discuss any QSBS issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest analysis.

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[i] References to "Section" are to sections of the Internal Revenue Code.

[ii] The planning technique of gifting QSBS recently came under heavy criticism in an article written by two investigative reporters. See Jesse Drucker and Maureen Farrell, The Peanut Butter Secret: A Lavish Tax Dodge for the Ultrawealthy. *New York Times*, December 28, 2021.

[iii] But in our opinion, in order to avoid a definite grey area in Section 1202 law, the donee should not be the stockholder's

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spouse. The universe of donees includes nongrantor trusts, including Delaware and Nevada asset protection trusts.

[iv] This article assumes that the holder of the stock doesn't have sufficient tax basis in the QSBS to take advantage of the 10X gain exclusion cap – for example, the stock might be founder shares with a basis of .0001 per share.

[v] *Lucas v. Earl*, 281 U.S. 111 (1930). The US Supreme Court later summarized the assignment of income doctrine as follows: "A person cannot escape taxation by anticipatory assignments, however skillfully devised, where the right to receive income has vested." *Harrison v. Schaffner*, 312 U.S. 579, 582 (1941).

[vi] Revenue Ruling 78-197, 1978-1 CB 83.

[vii] *Estate of Applestein v. Commissioner*, 80 T.C. 331, 346 (1983).

[viii] *Gerald A. Rauenhorst v. Commissioner*, 119 T.C. 157 (2002).

[ix] *Ferguson v. Commissioner*, 108 T.C. 244 (1997).

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