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In this article, Karachale and Osheroff explain the lessons of *Estate of Hoensheid* for taxpayers who want to "stack" their qualified small business stock to multiply the exclusion benefit without triggering an assignment of income.

Qualified small business stock (QSBS) provides significant tax efficiencies for founders, investors, and employees in the start-up and technology communities. Holders of QSBS can exclude up to $10 million in gain or 10 times their basis in their shares,[1] if the company that issued the shares meets various criteria[2] and the shareholder similarly satisfies specified requirements.[3] Because the exclusion benefit applies to each taxpayer holding shares of QSBS, there is an incentive for shareholders to transfer shares by gift (so-called stacking) to augment the $10 million exclusion. However, shareholders seeking to stack QSBS benefits must carefully organize their transfers to avoid the assignment of income doctrine.[4] This article provides guidance for financial advisers, tax practitioners, and taxpayers seeking to multiply QSBS benefits through stacking. We review the general rules of the assignment of income doctrine, including the implications of the Tax Court decision in *Estate of Hoensheid*.[5]

There has been significant criticism of QSBS stacking, both in the mainstream media[6] as well as

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[1]Section 1202(b).

[2]The company issuing the shares must be a domestic C corporation (section 1202(c)(1)), the shares must be issued before the company has more than $50 million of "aggregate gross assets" (section 1202(d)), and the company must use 80 percent of its assets in a qualified trade or business (section 1202(e)). For a general review of company requirements, see Janet Andolina and Kelsey Lemaster, "Candy Land or Sorry: Thoughts on Qualified Small Business Stock," *Tax Notes*, Jan. 8, 2018, p. 205. *See also* Stefan Gottschalk and Joseph A. Wiener, "Travels Through 1202," *Tax Notes Federal*, Sept. 27, 2021, p. 2083. For a review of early guidance from the IRS on what constitutes a qualified trade or business, see Christopher A. Karachale, "New Guidance on Qualified Small Business Stock Requirements," *Tax Notes*, July 3, 2017, p. 101.

[3]The shareholder must receive the shares "at original issuance," meaning in exchange for money, property, or services (section 1202(c)); the shareholder must hold the QSBS for five years to enjoy the exclusion benefit (section 1202(a)(4)); and the company cannot engage in certain redemption transactions at or near the time the shareholder is issued the shares (section 1202(c)(3)).

[4]For almost 100 years, taxpayers have been unable to make an "arrangement by which the fruits are attributed to a different tree from that on which they grew." *Lucas v. Earl*, 281 U.S. 111, 115 (1930).

[5]*Estate of Hoensheid v. Commissioner*, T.C. Memo. 2023-34.

[6]Jesse Drucker and Maureen Farrell, "A Lavish Tax Dodge for the Ultrawealthy Is Easily Manipulated," *The New York Times*, Dec. 30, 2021.

in academic research.[7] Nonetheless, these critics acknowledge that stacking is permitted under the code,[8] which suggests it is the tax policy considerations that arguably raise the hackles of the media and academics. For practitioners and taxpayers, understanding the potential legal limitations of stacking remains a legitimate undertaking.

Stacking Basics

Generally, taxpayers may stack QSBS benefits by gifting shares to individuals (including children and other relatives) or entities (such as non-grantor trusts).[9] If properly implemented, each of those donees is a separate taxpayer entitled to exclude up to $10 million of additional gain[10] because stacking does not compromise the QSBS status of the donee's shares. Instead, section 1202(h)(1) provides that if shares are transferred by gift, the recipient will be treated as having acquired the QSBS in the same manner as the transferor and with the same holding period. So if the transferor has received the shares directly from the company (satisfying the original issuance test) and held those shares for a period of time, the donee will be treated as having received the shares in the same manner and for the same holding period.[11]

For example, assume a founder holds low-basis QSBS worth approximately $20 million and sells the shares as part of a merger.[12] The founder would be able to exclude only $10 million of the $20 million of gain.[13] However, if, before the merger, that same founder transferred half of those shares to a non-grantor trust for the benefit of the founder's children, the founder and the trust would each be entitled to a $10 million exclusion, and the entire $20 million gain could be excluded.[14]

Thus, there is a massive incentive for QSBS holders to stack their shares and maximize the exclusion benefit. But in the QSBS stacking context, avoiding an assignment of income is critical. If a shareholder's gift is not respected (for example, because of anticipatory assignment), the transferred shares will not be deemed to have been sold by a separate taxpayer. The transferred shares will be allocated back to the original shareholder and will count against the shareholder's $10 million exclusion.

Assignment of Income Issues

The assignment of income doctrine is the acknowledgment that income is taxed "to those who earn or otherwise create the right to receive it"[15] and that "tax could not be escaped by anticipatory arrangements and contracts however skillfully devised."[16] A person with a right to receive income cannot avoid taxation by giving away that right after it has already been established.[17] Thus, an assignment of income occurs when a taxpayer has effectively realized income but then tries to assign that income to another taxpayer.[18]

Unfortunately, there is no bright-line rule regarding the timing of gifts that may run afoul of the assignment of income doctrine. The underlying issue is whether the transferor, considering the reality and substance of all the circumstances,[19] had a fixed right to gain from the shares at the time of the transfer.

[7] *See, e.g.*, Manoj Viswanathan, "The Qualified Small Business Stock Exclusion: How Startup Shareholders Get $10 Million (or More) Tax-Free," 120 *Colum. L. Rev. Forum* 29 (Jan. 13, 2020); Gregg D. Polsky and Ethan Yale, "A Critical Evaluation of the Qualified Small Business Stock Exclusion," 42 *Va. Tax Rev.* 353 (2023).

[8] "The maneuver, which is legal, is known as 'stacking,' because the tax breaks are piled on top of one another." Drucker and Farrell, *supra* note 6.

[9] For a detailed review of stacking considerations, see Paul S. Lee et al., "Qualified Small Business Stock: Quest for Quantum Exclusions, Part 3," *Tax Notes Federal*, July 20, 2020, p. 409. For stacking alternatives, see Karachale, "The Future of Section 1202 and the Qualified Small Business Stock Exclusion: Planning Around Potential QSBS Repeal," 62 *Tax Mgmt. Memo.* No. 23 (Nov. 8, 2021).

[10] Section 1202(h)(2)(A).

[11] Section 1202(h)(1).

[12] Founders in Silicon Valley typically receive their founders' shares for de minimis consideration of $200 or $500, subject to vesting.

[13] Section 1202(b).

[14] Those gifts have separate estate and gift tax implications. The example assumes that the non-grantor trust constitutes a separate taxpayer.

[15] *Helvering v. Horst*, 311 U.S. 112, 119 (1940).

[16] *Lucas v. Earl*, 281 U.S. at 115.

[17] *See, e.g., Harrison v. Schaffner*, 312 U.S. 579, 582 (1941); and *Ferguson v. Commissioner*, 108 T.C. 244 (1999).

[18] *Ferguson*, 108 T.C. 244. In contrast, the mere anticipation or expectation of the receipt of income is generally insufficient to conclude that a fixed right to income exists. *S.C. Johnson & Son Inc. v. Commissioner*, 63 T.C. 778, 787-788 (1975).

[19] *See Jones v. United States*, 531 F.2d 1343, 1345 (6th Cir. 1976).

In *Estate of Applestein*,[20] the taxpayer transferred company shares into brokerage accounts for his children after the company's shareholders had already approved a proposed merger. The Tax Court ruled that the shareholder approval of the merger agreement was an income-triggering event even when the approval occurred roughly three weeks before the actual effective merger date.[21] Similarly, in *Cook*,[22] the Tax Court held that shareholder approval of a corporate liquidation triggered a right to income for shareholders, and it therefore disregarded a gift of shares that a shareholder had made to his children after the liquidation approval. In contrast, the Tax Court determined in *Rauenhorst*[23] that a nonbinding letter of intent (LOI) is not enough to trigger an assignment of income because the LOI "merely confirms" an intent to purchase but did not legally bind the parties to the agreement.

Anticipating the IRS

A new case, *Estate of Hoensheid*, helps demonstrate the potential triggers for an assignment of income and is relevant for shareholders hoping to stack QSBS. The facts of *Hoensheid* are remarkably bad, and it is surprising that the taxpayer did not settle at the audit stage. However, Judge Joseph Nega's memorandum opinion provides ample facts for taxpayers seeking to discern when is too late to transfer QSBS and stack.[24]

In *Hoensheid*, a taxpayer transferred shares in a closely held business to a charitable donor-advised fund before the sale of his business. The taxpayer and his brothers were the only shareholders of the company and held a majority of the board seats. He "began discussing the prospect of establishing" a DAF with his wealth advisers in order to make "a presale charitable contribution of some of his" shares roughly one week before the execution of an LOI.[25] In discussions with his estate planner, the taxpayer insisted on transferring the shares to the DAF only when the sale was certain: "I do not want to transfer the stock until we are 99 percent sure we are closing."[26] The taxpayer finally transferred the shares to the DAF two days before the sale was finalized, after active involvement in the negotiation process.[27]

In advance of the taxpayer's transfer of shares to the DAF, the company engaged in a cash sweep of its remaining working capital through bonus payments of $6.1 million to employees and distributions of $4.7 million to the taxpayer and his brothers. Also, before the gifts, the taxpayer's company amended its articles to facilitate the sale, and the acquiring company created a new holding subsidiary as part of the sale.

The Tax Court applied a four-factor test to determine if the taxpayer had a fixed right to income from the shares when he transferred them to the DAF:

1. was there any legal obligation to sell by the donee;
2. what actions had already been taken by the parties to effect the transaction;

[20] *Estate of Applestein v. Commissioner*, 80 T.C. 331, 345 (1983). Other assignment of income cases reach similar results. In *Estate of Smith v. Commissioner*, 292 F.2d 478 (3d Cir. 1961), a donor transferred shares to his children after a corporation had already declared a dividend. The court ruled that the corporation's declaration of the dividend created a right to the income, so the donor could not assign the income. In *Doyle v. Commissioner*, 147 F.2d 769 (4th Cir. 1945), a donor transferred his interest judgment to his wife and children after the court denied a new trial. The court ruled that the right to receive the proceeds from the judgment was "practically assured," so the donor could not transfer the judgment away and avoid tax.

[21] The court said: "The timing of the transfer makes it clear that petitioner's 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." *Estate of Applestein*, 80 T.C. at 346.

[22] *Cook v. Commissioner*, 5 T.C. 908, 912 (1945). The *Cook* court said: "The petitioner well knew that nothing remained to be done except to have the actual proceeds of liquidation distributed among the shareholders. . . . It was thus patently never his intention that his sons should exercise any ownership over the stock, but merely that they should participate in the proceeds of liquidation."

[23] *Rauenhorst v. Commissioner*, 119 T.C. 157, 177 (2002).

[24] As described in greater detail below, *Estate of Hoensheid* involves a transfer of shares to a charitable beneficiary. But its teachings are clearly relevant for founders and early shareholders hoping to stack QSBS and avoid assignment of income.

[25] *Estate of Hoensheid*, T.C. Memo. 2023-34, at 4.

[26] *Id.* In fact, the taxpayer's counsel acknowledged the timing issue. The Tax Court later in the opinion quotes her: "Any tax lawyer worth [her] fees would not have recommended that a donor make a gift of appreciated stock" so close to the closing of a sale. *Id.* at 34.

[27] At the annual shareholder meeting 35 days before the closing, the taxpayer and his siblings acknowledged that "they have been involved throughout the process, understand and accept all terms associated with the transaction." *Id.* at 6.

3. were there remaining unresolved transactional contingencies; and
4. what was the status of the corporate formalities required to finalize the transaction?[28]

Regarding the first factor, the Tax Court acknowledged that the IRS had "not sufficiently established the existence of any informal, prearranged understanding between [the taxpayer] and [the DAF] that might otherwise constitute an obligation" for the DAF to sell the shares.[29] Thus, the Tax Court found that this factor cut against the IRS's argument that the taxpayer had assigned income from the shares to the DAF.[30]

Under the second factor, the Tax Court reviewed the steps the selling company and acquiring company had taken before the taxpayer made the gift of shares to the DAF. It focused on the cash sweep undertaken by the taxpayer's company in advance of the sale. According to the Tax Court, it was "highly improbable that petitioner and his two brothers would have emptied [their company] of its working capital if the transaction had even a small risk of not consummating. . . . In the reality of the transaction, the cash sweeps were thus highly significant conditions precedent to consummating the transaction."[31] Thus, distribution of working capital demonstrated that the taxpayer's right to income from the shares was fixed before the gift because the sale was a virtual certainty.

The Tax Court then analyzed what unresolved sale contingencies remained between the acquiring company and the taxpayer's company at the time of his gift. At trial, the taxpayer argued that "several negotiated issues, including an environmental liability" existed and were unresolved until the day before the close of the transaction (one day after the taxpayer's transfer of the shares to the DAF).[32] The court was unconvinced, finding that in the hours before the taxpayer's gift, when the acquiring company's counsel "ran a redline comparison of a new draft [indemnity agreement], the environmental liability provision had already been accepted into the draft agreement."[33] The Tax Court found that none of the unresolved contingencies remaining on the date the taxpayer transferred the shares to the DAF "were substantial enough to have posed even a small risk of the overall transaction's failing to close."[34] Therefore, this factor tended to show that the taxpayer had assigned income from the sale of the shares to the DAF.

Finally, the Tax Court considered the status of the corporate formalities necessary to carry out the transaction. It acknowledged that "shareholder approval of a transaction has often proven to be sufficient to demonstrate that a right to income from shares was fixed before a subsequent transfer," but that "such approval is not necessary for a right to income to be fixed, when other actions taken establish that a transaction was virtually certain to occur."[35] The court pointed out that all "three Hoensheid brothers, and particularly [the taxpayer], were involved in negotiating the transaction, making their approval all but assured as of" the date of the taxpayer's transfer to the DAF.[36] Therefore, the Tax Court found that "formal shareholder approval was purely ministerial, as any decision by the brothers not to approve the sale was, as of [the date of the transfer to the DAF], 'remote and hypothetical.'"[37] Interestingly, the Tax Court

[28] *Id*. at 29.

[29] *Id.* The Tax Court also pointed out that the terms and conditions of the DAF's organizational documents expressly disclaimed any obligation to sell the shares.

[30] A donee's obligation to sell the shares weighs more heavily than the other factors. The *Estate of Hoensheid* court acknowledged the importance of this factor: "While we consider a donee's legal obligation to sell as significant to the assignment of income analysis, it is only one factor to be considered in ascertaining the realities and substance of the transaction." *Id.* at 28 (internal quotations and citations omitted).

[31] *Id*. at 30-31. Consider that the $6.1 million bonus payments to the employees occurred three days before the taxpayer's gift to the DAF; however, the $4.7 million distribution to the taxpayer and his brothers occurred one day *after* that gift. The Tax Court reasoned that before the date of the gift, the company and the "taxpayer had distributed and/or determined to distribute over $10 million out of the corporation."

[32] *Id*.

[33] *Id*. at 31. The court cited *Robert L. Peterson Irrevocable Trust #2 v. Commissioner*, T.C. Memo. 1986-267, *aff'd sub nom. Peterson v. Commissioner*, 822 F.2d 1093 (8th Cir. 1987), which found that remaining contingencies "at best . . . represent remote and hypothetical possibilities that the stock purchase would be abandoned."

[34] *Id*. In this factor, the Tax Court also focused on the taxpayer's intent, rather than just the unresolved sale contingencies. The court pointed out that the taxpayer, "consistent with his '99 percent sure' statement, waited until all material details had been agreed to" before he transferred the shares to the DAF. *Id*. at 33.

[35] *Id*. (citing *Ferguson*, 108 T.C. at 244, 262-263).

[36] *Id*.

[37] *Id*. (citing *Jones*, 531 F.2d at 1346).

concluded that this fourth factor was neutral as to whether the taxpayer's right to income was fixed.

Thus, the Tax Court concluded that under the assignment of income doctrine, the taxpayer's right to income from the sale of shares was fixed as of the date of the gift because the transaction had simply "'proceeded too far down the road to enable [the taxpayer] to escape taxation on the gain attributable to the donated shares.'"[38]

Conclusions and Observations

For founders and early employees of start-ups hoping to stack QSBS, *Hoensheid* is a cautionary tale. Founders should avoid nearly every step undertaken by the taxpayer in *Hoensheid* or risk creating anticipatory assignment of income as part of their QSBS stacking.

First — and perhaps most important — taxpayers must not have any informal, prearranged understanding under which a donee will sell shares after the gift. For example, assume a founder is going to sell QSBS to an investor in a secondary round (following a financing round for the founder's company) and establishes a non-grantor trust with the understanding that the trust will also sell shares. If the founder has a formal or informal agreement that the non-grantor trust will sell the QSBS as part of the secondary round, that agreement may run afoul of the first *Hoensheid* prong.[39]

Second, a founder must make a gift of QSBS to another taxpayer when genuine contingencies exist that are substantial enough to prevent the transaction from closing. The *Hoensheid* court focused on the fact that the taxpayer-donor had been actively involved in the negotiations for sale of his company from the beginning and, with his brothers, controlled the board. The court seems to have found this control over decision-making dispositive for assignment of income purposes. The taxpayer's control allowed him to dictate the resolution of contingencies to consummate the sale (including the negotiated issues).

In the traditional Silicon Valley start-up context, founders normally do not have the same degree of control as the taxpayer in *Hoensheid*. The board of the start-up will be composed of venture capitalists whose goals are not necessarily aligned with those of the founders. Start-up founders seeking to avoid assignment of income should document their lack of control, including board minutes or correspondence with company counsel. Those founders' inability to unilaterally dictate the terms or timing of the sale of their company will help distinguish *Hoensheid*.

Third, timing matters. A founder simply cannot wait until the sale of the QSBS is 99 percent sure to occur before making the transfer to the non-grantor trust. Despite the favorable guidance in *Rauenhorst* finding that a nonbinding LOI was not enough to trigger assignment of income, we strongly suggest that founders try to make gifts of QSBS before receiving an LOI. After the receipt of an LOI, the founder materially starts down the road with no escape from taxation on the gain attributable to the donated shares. *Hoensheid* makes clear that by the time the company seeks shareholder approval for the sale of the shares, it is too late to gift shares.

Finally, we advise founders and their counsel to be circumspect about QSBS benefits. It is unclear whether the taxpayer in *Hoensheid* truly wanted to make a gift of the shares to the DAF absent the sale. In fact, the taxpayer's counsel appears to have advised him that the gift to the DAF was too late: "Any tax lawyer worth [her] fees would not have recommended that a donor make a gift of appreciated stock" so close to the closing of a sale.[40] But the taxpayer made the gift anyway. It is incumbent on taxpayers' advisers to provide founders and early employees with candid and honest advice. Stacking QSBS is a valid way to increase the benefits. But when advisers encourage or condone stacking in a situation in which assignment of income may come into play, they abuse the advantages of QSBS just as critics in the media and academia allege. ■

[38] *Id.* at 34 (quoting *Allen v. Commissioner*, 66 T.C. 340, 348 (1976)).

[39] Arguably, the existence of an independent trustee of a non-grantor trust can help obviate this factor.

[40] *Estate of Hoensheid*, T.C. Memo. 2023-34, at 34.