Qualified Small Business Stock: Quest for Quantum Exclusions

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In this three-part report, the authors analyze the section 1202 qualified small business stock exclusion and planning with that stock, providing insight on issues for which no or little guidance exists. This first installment focuses on the shareholder- and corporate-level qualifications under section 1202 and explains why the Tax Cuts and Jobs Act and the COVID-19 pandemic have made qualified small business stock more relevant than ever.

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A. Introduction

The exclusion for gain on qualified small business stock (QSBS) as set out in section 1202 has been available to taxpayers for more than 25 years. However, for a variety of historical and structural reasons, the exclusion was not particularly popular with investors and owners of small businesses, with the notable exception of emerging technology companies. Since its inception in 1993,[1] section 1202 has been subject to several legislative changes, and with the enactment of the Tax Cuts and Jobs Act,[2] we expect QSBS to become a mainstream planning option for owners of new and preexisting businesses, particularly those that are now structured as passthrough entities (for example, entities taxed as partnerships, disregarded entities, and S corporations).

The benefits of QSBS treatment are significant: a 100 percent exclusion of gain; the option to roll over and defer taxable gain by reinvesting in other QSBS companies; and the ability to "multiply" the exclusion through gifts, transfers at death, and careful pre-issuance planning. The qualifications for QSBS treatment are deceptively straightforward. Unfortunately, section 1202 has several internal inconsistencies, and very little case law or IRS administrative guidance on QSBS has been issued. Further, because of how QSBS qualification is structured, there are many ways to inadvertently lose QSBS status or otherwise reduce the potential benefit of the exclusion. Thus, there are many unanswered questions and potential pitfalls in the quest for QSBS benefits.

This report explains how the planning landscape has changed and makes a case for why today is the time to seriously consider QSBS for new and preexisting closely held businesses. It discusses the basic elements and qualifications of QSBS under sections 1202 and 1045. Importantly, in the third installment of this report, we address the many unresolved questions and issues surrounding QSBS planning and provide practical answers and guidance on those issues. Finally, we discuss planning opportunities that maximize the QSBS exclusion and the common mistakes made by practitioners in this area.

B. QSBS: Why Now?

1. The TCJA: Paving the way for QSBS.

By definition, QSBS is stock originally issued by a C corporation. As such, before the enactment of the TCJA, many businesses did not consider QSBS a viable planning option because it would have required them to do business as a C corporation, which was subject to tax at the entity level at 35 percent (for a minimum of five years because of the five-year holding period requirement to get the benefit of the QSBS exclusion). Effective for tax years starting after December 31, 2017, the TCJA permanently reduced the corporate tax rate to 21 percent,[3] so the "penalty" of doing business as a C corporation has been greatly reduced, particularly for businesses that do not anticipate making

[1] Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, more commonly referred to as the Revenue Reconciliation Act of 1993 (RRA 1993), section 13113. *See also Voss v. Commissioner*, 796 F.3d 2051 (9th Cir. 2015).

[2] P.L. 115-97 ("H.R. 1 — An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."). The Senate parliamentarian removed the short title "Tax Cuts and Jobs Act" as extraneous. Hereinafter, P.L. 115-97 will nonetheless be referred to as the "Tax Cuts and Jobs Act" or "TCJA."

[3] TCJA section 13001; section 11.

significant dividend distributions in the near future (thereby deferring the shareholder-level tax).

The TCJA added new section 199A[4] (qualified business income) for the benefit of any "taxpayer other than a corporation."[5] As such, this provision applies to sole proprietors, independent contractors, disregarded entities, partnerships, and S corporations. Greatly simplified, section 199A provides a temporary 20 percent deduction on the qualified business income from a qualified trade or business, which generally means any trade or business other than a specified service trade or business (SSTB) or the trade or business of performing services as an employee (other than taxpayers who do not exceed a specified threshold amount[6] in taxable income). At the same time, the TCJA also temporarily reduced the highest marginal income tax bracket on individual taxpayers from 39.6 percent to 37 percent.[7] Combined, these two provisions would tend to favor doing business through a passthrough entity because if the entire 20 percent deduction is available to the taxpayer-owner, at most the income would be taxed at an effective rate of 29.6 percent (80 percent of 37 percent), which is a lower overall effective rate than if that income is taxed at a flat C corporate rate of 21 percent and then taxed again at the individual shareholder level as a qualified dividend.

Unfortunately, most passthrough businesses will not get the full benefit of the 20 percent deduction. Generally, for taxpayers whose taxable income exceeds the threshold amounts, the section 199A deduction will be limited based in whole or in part on (1) the type of trade or business engaged in by the taxpayer; (2) the amount of Form W-2 wages paid by the trade or business; and (3) the unadjusted basis immediately after acquisition of qualified property held for use in the trade or business. The last two limitations, often referred to as the "wages and basis" limitations, can significantly limit the deduction under section 199A. Therefore, many individual owners of passthrough businesses will continue to be taxed at 37 percent or at a slightly lower rate. Moreover, although the TCJA temporarily reduced the highest marginal income tax bracket on individual taxpayers to 37 percent, it also severely limits an individual's ability to deduct state and local sales, income, and property taxes.[8] In contrast, if those state and local taxes were imposed on a C corporation (rather than being passed through to the owners as partners or shareholders of an S corporation, for example), they would be fully deductible at the entity level as an ordinary and necessary business expense. More important, the section 199A deduction expires January 1, 2026,[9] whereas the rate reduction for C corporations is permanent. Thus, even passthrough entities that are getting a significant benefit under section 199A might look to convert to a C corporation as 2026 approaches.

Interestingly, most businesses that would qualify for the section 199A deduction will also qualify for QSBS treatment if they were formed as or converted to a C corporation. This is not a coincidence; section 199A specifically refers to section 1202 in defining a qualified trade or business for purposes of the deduction. Under section 199A, qualified business income[10] is the net amount of qualified items for any qualified trade or business of the taxpayer, but it does not include any qualified real estate investment trust dividends, qualified cooperative dividends, or qualified publicly traded partnership income (those items of income are afforded a separate deduction under section 199A). As noted, a qualified trade or business means any trade or business other than an SSTB or the trade or business of performing services as an employee.[11] An SSTB[12] includes (1) services that are excluded

[4] TCJA section 11011.

[5] Section 199A(a).

[6] The threshold amount is $157,500 for each taxpayer (twice that amount for a joint return). *See* section 199A(e)(2)(A).

[7] *See* TCJA section 11001 and section 1(j) for tax years beginning after December 31, 2017, and before January 1, 2026.

[8] Limited to $10,000 per year, or $5,000 per year for married individuals filing separately. *See* TCJA section 11042 and section 164(b)(6) for tax years beginning after December 31, 2017, and before January 1, 2026.

[9] Section 199A(i).

[10] Section 199A(c)(3)(A).

[11] Section 199A(d)(1).

[12] The foregoing exclusion from the definition of a qualified business for SSTBs phases in for a taxpayer with taxable income exceeding a threshold amount and becomes fully effective once taxable income exceeds the threshold amount by $50,000 ($100,000 for a joint return).

from the definition of qualified trade or business under section 1202(e)(3)(A), but engineering and architecture services are carved out for these purposes,[13] leaving services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business whose principal asset is the reputation or skill of one or more of its employees or owners; and (2) services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.[14]

As discussed later, a qualified trade or business is defined for QSBS purposes in such a way that the universe of QSBS businesses is smaller than the universe of section 199A businesses, but there is substantial overlap. Significantly, on February 8, 2019, Treasury issued final regulations under section 199A[15] that included important guidance on definitional items that are contained in section 1202 but for which no regulatory guidance had been issued. Of course, it could be argued that the guidance under the section 199A final regulations is not applicable to QSBS planning, but sections 199A and 1202 (through deduction, on one hand, and gain exclusion, on the other) are intended to encourage the same type of activity (that is, active trades or businesses). So it is reasonable to conclude that the section 199A final regulations give important, albeit implicit, guidance on QSBS issues.

The exclusion benefit for QSBS requires a sale of the stock of the corporation, but many buyers prefer a purchase of assets, largely so the buyer can succeed to assets with an increased tax basis. One of the business incentives enacted under the TCJA is a temporary 100 percent expensing of some business assets under section 168(k).[16] The provision allows immediate 100 percent expensing for qualified property placed in service after September 27, 2017, reducing the percentage that may be expensed for property placed in service after January 1, 2023. Qualified property[17] that is eligible for bonus depreciation includes tangible personal property with a recovery period of 20 years or less under the modified accelerated cost recovery system,[18] some depreciable computer software, water utility property, qualified improvement property,[19] and some qualified film and television production property. Recapture of this type of bonus depreciation property is taxable as ordinary income under section 1245.[20] If, by way of example, a passthrough entity elects 100 percent bonus depreciation on qualified partnership property under section 168(k), a subsequent asset sale of the qualified property will be taxable to the owners at a maximum ordinary income tax rate of 37 percent (or 39.6 percent if sold after 2025). The federal income tax rate could be even higher if the owner of the passthrough entity is not actively participating in the business, thus requiring the owner to pay an additional 3.8 percent excise tax under section 1411.[21]

If the passthrough entity converts to a C corporation and the asset sale occurs thereafter, the maximum tax rate for the entity is 21 percent and the subsequent distribution of the sale proceeds would typically incur an additional 23.8 percent (resulting in an overall tax burden of 39.8 percent). However, taking advantage of QSBS can significantly reduce the overall tax burden. As a first step, the conversion to a C corporation would need to qualify for nonrecognition treatment under section 351. There seems to be no provision that would trigger recapture on the contribution (or deemed contribution) of the qualified

[13] Section 199A(d)(2)(A).

[14] Section 199A(d)(2)(B).

[15] T.D. 9847.

[16] TCJA section 13201.

[17] Section 168(k)(2)(A)(i).

[18] Section 168(k)(2)(A)(i)(I).

[19] Qualified improvement property is generally defined as "any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service." Section 168(e)(6) (pre-TCJA section 168(k)(3)(A)).

[20] *See* section 1245(a)(3).

[21] Section 1411(c). The excise tax is on net investment income, which includes gross income derived from a trade or business that is a "passive activity (within the meaning of section 469) with respect to the taxpayer." Section 1411(c)(2)(A). If an individual or trust owns an interest in a trade or business through a partnership or S corporation, the determination of whether the income is derived in an active or passive trade or business is made at the interest holder level. *See* reg. section 1.1411-4(b)(2)(i).

property to the corporation, assuming all the other requirements for nonrecognition under section 351 are met (for example, property is contributed to a controlled corporation solely in exchange for the corporation's stock).[22] If the transferor receives money, nonqualified preferred stock, or other property (that is, boot), gain is triggered to the extent of the boot under section 351(b).[23] The regulations provide that if property subject to recapture under section 1245 is contributed to a corporation and there is partial nonrecognition, the allocation of gain across all the contributed assets is based on relative fair market values.[24]

Assuming there is no recognition of gain upon conversion to a C corporation, the sale of the bonus depreciation assets will be subject to a preferential 21 percent rate. More important, if the shares of the corporation are QSBS and the shareholders have satisfied the five-year holding period requirement, the proceeds of the sale can be distributed to the shareholders upon liquidation of the corporation, and the gain on the sale will likely qualify for the 100 percent exclusion on gain under section 1202 (thereby eliminating taxation at the shareholder level). Thus, the owners of the business could significantly benefit under section 1202, even in an asset sale (saving on the rate differential between 37 percent/39.6 percent and 21 percent).

2. The COVID-19 pandemic.

Global economies are now stalled as a result of the COVID-19 pandemic, forcing most businesses to close to slow the progression of the deadly virus. Many small businesses in the United States are struggling to survive, and although the U.S. government has already passed economic relief programs — for example, by enacting the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136), which includes the Paycheck Protection Program and economic injury disaster loans — it is anticipated that more relief and economic stimulus will be needed. To date, the CARES Act and other relief legislation[25] will cost the federal government $2.7 trillion. To offset the resulting budget deficit, it is speculated that income tax rates will need to be increased, which will increase the economic burden on taxpayers.

As discussed later, section 1202 was originally enacted in 1993 to spur investment in small businesses and encourage long-term economic growth. When the U.S. economy went into recession during the global financial crisis of 2007-2009 (also known as the Great Recession), section 1202 was amended to increase the exclusion benefits available to taxpayers who were willing to make long-term investments in small businesses and start-up companies. If the U.S. government is looking for ways to support small businesses and stimulate the economy, Treasury should consider section 1202 a candidate to assist in that effort, with perhaps some needed amendments. As currently written, section 1202 provides a framework and platform to allow preexisting (and new) businesses to attract capital and provide highly attractive tax benefits to long-term investors in those companies. At a time like today when businesses are and will be seeking capital to stay afloat, section 1202 could be an integral tool to stimulate and save the U.S. economy.

Unfortunately, as we discuss in this report, QSBS planning is hampered by a number of practical and structural issues. First, very little guidance has been issued by the IRS on several important aspects of QSBS (for example, the "at all times" qualification of the aggregate gross asset requirement, as defined and discussed later), many of which we highlight and for which we offer practical solutions. Second, if the U.S.

[22]It has been held that the contribution of other types of ordinary income assets qualifies for nonrecognition treatment under section 351. *See, e.g., Las Cruces Oil Co. Inc. v. Commissioner*, 62 T.C. 764 (1974), *acq.*, 1976-2 C.B. 2 (contribution of inventory). However, if the contributed asset is a market discount bond under section 1276, which generally treats the market discount as ordinary income, the ordinary income portion must be recognized. *See* section 1276(c) and (d).

[23]*See* reg. section 1.351-2. If two or more items of property are contributed to a controlled corporation, the amount and character of the gain and how the boot is apportioned among the assets is determined under two different types of methods: the asset-by-asset method and the aggregate method. *See* Rev. Rul. 68-55, 1968-1 C.B. 140, amplified by Rev. Rul. 85-164, 1985-2 C.B. 117.

[24]*See* reg. section 1.1245-4(c)(1). *See also* section 1245(b)(3), which provides: "If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property."

[25]Families First Coronavirus Response Act, P.L. 116-127.

government wants to provide significant incentives to investors in small businesses, section 1202 needs to be updated to reflect today's economics. By way of example, the aggregate gross asset requirement is capped at $50 million, and that figure has never been increased or even indexed for inflation. A significant increase of the $50 million limit would greatly increase the number of corporations that could qualify for QSBS treatment. Ironically, the recent economic downturn may have caused many corporations that were above the $50 million upper limit to fall below it, and despite that fact, these corporations may be unable to qualify for QSBS treatment because of the vagaries of the "at all times" requirement.

Finally, some consideration should be given to broadening the definition of those trades or businesses that would qualify under section 1202 and relaxing some asset-holding limitations. Some types of trades or businesses involved in real estate, hospitality, or lodging would likely not qualify under section 1202, but these are the types of industries that are particularly in need of capital today. These types of amendments would not need to be permanent changes to section 1202. What is unique to QSBS is that these broadened or relaxed qualifications can be applied to corporations that issue stock to investors within specified time frames, and afterward the qualifications can expire. Section 1202 has a history of offering different tax benefits based on the date the stock was acquired by the investor, so it is uniquely structured to provide assistance to small businesses — especially today and as the U.S. economy emerges from economic fallout from the COVID-19 pandemic.

3. Evolution of QSBS.

a. Enactment in 1993.

Section 1202 was enacted in 1993.[26] As originally enacted, it provided for a 50 percent exclusion from the sale of QSBS owned by noncorporate shareholders for more than five years.[27] The amount of the exclusion is limited to the greater of $10 million per taxpayer or 10 times the taxpayer's adjusted basis in the shares of the corporation. As discussed in more detail later, these limitations are subject to interpretation and are not as straightforward as they might seem. In any case, because the issuance date of the stock would have to occur after August 10, 1993 (section 1202's date of enactment),[28] the earliest a taxpayer would have gotten the benefit of the exclusion was 1998.

Further, since 2003,[29] 7 percent of the excluded gain was also considered a preference item for alternative minimum tax purposes.[30] Thus, if a taxpayer was subject to AMT and sold QSBS stock, 50 percent of the taxable gain plus 7 percent of the excluded gain (50 percent) was subject to the maximum AMT tax rate of 28 percent, resulting in an effective tax rate of 14.98 percent on the gain from the sale of QSBS.[31] As we discuss in more detail later, the taxable portion of gain from the sale or exchange of QSBS is subject to a maximum tax rate of 28 percent, not the maximum long-term capital gain tax rate of 20 percent, which was in effect from 1998 until May 2003. So for a taxpayer that was not subject to AMT, the maximum effective rate for the sale of QSBS was 14 percent (50 percent of 28 percent), and if the taxpayer was subject to AMT, the maximum effective rate was 14.98 percent. Thus, although the exclusion of gain for QSBS provided some benefit, the net benefit saved was relatively small (5.02 percent - 6 percent, the difference between a 20 percent capital gain tax on 100 percent of the gain versus the QSBS rate, depending on whether the taxpayer was subject to AMT). From May 2003 through 2012, the maximum long-term capital gain tax rate was 15 percent. So the savings from QSBS sales was even

[26] RRA 1993, section 13113.

[27] Section 1202(a)(1).

[28] Section 1202(c)(1).

[29] *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27, section 301(b)(3)(A) and (B), and 301(d)(3), effective for dispositions on or after May 6, 2003. As originally enacted in 1993, 50 percent of the excluded gain was a preference item. In 1997 it was reduced to 42 percent of the excluded gain. Taxpayer Relief Act of 1997, P.L. 105-34, section 311(b)(2)(B). In 1998, for stock acquired after December 31, 2000, the preference amount was reduced to 28 percent of the excluded gain. Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105-206, section 6005(d)(3).

[30] *See* sections 1(h)(7) and 57(a)(7).

[31] [50 percent taxable gain + (7 percent * 50 percent of excluded gain)] * 28 percent AMT rate = 53.5 percent gain * 28 percent rate = 14.98 percent.

smaller for those taxpayers who were subject to AMT.

b. Increased exclusion in 2009.

In 2009, in the midst of the global financial recession, section 1202 was amended[32] to provide a 75 percent exclusion on gain for QSBS issued after February 17, 2009, but before January 1, 2011.[33] In 2010 Congress amended the period so that the 75 percent exclusion applied to stock issued before September 27, 2010.[34] Because of the five-year holding period requirement, the earliest time a taxpayer would have been entitled to the 75 percent exclusion was February 18, 2014. In 2013 the maximum long-term capital gain tax rate was increased to 20 percent, and the 3.8 percent excise tax on net investment income under section 1411 became effective.[35] However, as mentioned, the taxable gain on the sale of QSBS is taxed at a maximum rate of 28 percent plus the 3.8 percent excise tax. Assuming a taxpayer sells QSBS, which is entitled to a 75 percent exclusion, and the taxpayer is not subject to AMT, the effective tax rate is 7.95 percent (25 percent x 31.3 percent). If, on the other hand, the taxpayer had been subject to AMT, and the taxable event had occurred before the amendments in 2010 (as discussed herein), 25 percent of the taxable gain plus 7 percent of the excluded gain (75 percent) would have been taxed at the maximum 28 percent AMT rate. The result is that the effective tax rate on the sale would have been 8.47 percent.[36]

c. 100 percent exclusion in 2010 and permanence in 2015.

When Congress amended section 1202 in 2010,[37] it provided for a 100 percent exclusion on gain for QSBS issued after September 27, 2010, but before January 1, 2011.[38] Moreover, the 2010 tax act eliminated the AMT preference on the excluded gain.[39] As a result, with the five-year holding requirement, for stock issued during this short period, the earliest QSBS shareholders would be entitled to the 100 percent exclusion was September 28, 2015. Each year, until the amendment in 2015, the 100 percent exclusion was subject to sunset, which would have caused the exclusion to revert to 50 percent. There were extensions in subsequent years, and ultimately the reversion never occurred. In 2015 the 100 percent exclusion[40] and the elimination of the AMT preference[41] were made permanent for all stock issued after September 27, 2010.[42]

4. Boom in private equity and venture capital.

Coinciding with the enactment and evolution of section 1202, investments in private equity and venture capital have been booming. By definition, private equity and venture capital investing involves direct investment in private companies. According to one report, in 2000 there were approximately 1,608 private equity and venture capital firms with assets of $577 billion under management. By 2017 those numbers had grown to 4,719 firms with $2.5 trillion under management.[43]

Typically, investors in these funds are cashed out if the company goes public, is sold or merged with another firm, or is recapitalized. For the taxable investor in these funds, the ability to claim an exclusion under section 1202 has become a critically important feature that will significantly increase after-tax returns. When QSBS was first enacted in 1993, investors in private equity and venture capital funds were primarily institutional investors that were either tax exempt or were not eligible holders of QSBS entitled to the exclusion. Today, taxable investors (wealthy individuals) are increasingly investing in private equity and

[32] American Recovery and Reinvestment Act of 2009 (ARRA), P.L. 111-5, section 1241.

[33] *See* ARRA section 1241.

[34] *See* section 1202(a)(3) (as amended by the Small Business Jobs Act of 2010, P.L. 111-240, section 2011).

[35] *See* American Taxpayer Relief Act of 2012, P.L. 112-240; the Health Care and Education Reconciliation Act of 2010, P.L. 111-152; and the Patient Protection and Affordable Care Act, P.L. 111-148.

[36] [25 percent taxable gain + (7 percent * 75 percent of excluded gain)] * 28 percent AMT rate = 30.25 percent gain * 28 percent rate = 8.47 percent.

[37] Small Business Jobs Act of 2010, P.L. 111-240, section 2011.

[38] *Id.*

[39] *See* section 1202(a)(4)(C).

[40] Section 1202(a)(4)(A).

[41] Section 1202(a)(4)(C).

[42] The Protecting Americans From Tax Hikes (PATH) Act of 2015, P.L. 114-113, and Consolidated Appropriations Act of 2016, P.L. 114-113, Division Q, section 126(a), struck out "and before January 1, 2015" following "Creating Small Business Jobs Act of 2010" and in the paragraph heading struck out "2011, 2012, 2013, and 2014" and inserted "and thereafter."

[43] Tawfik Hammond et al., "Capitalizing on the New Gold Age in Private Equity," The Boston Consulting Group (Mar. 7, 2017).

Table 1

Acquisition Date	Exclusion Percentage	Maximum QSBS Rate	Maximum QSBS AMT Rate[a]	Maximum Rate (No QSBS)
Aug. 11, 1993 to Feb. 17, 2009	50%[b]	15.9%	16.88%	23.8%
Feb. 18, 2009 to Sept. 27, 2010	75%[c]	7.95%	9.42%	23.8%
After Sept. 27, 2010	**100%**[d]	**0%**	**0%**	**23.8%**

[a]For taxpayers who acquired their stock on or before September 27, 2010, 7 percent of the excluded gain is a preference item. *See* sections 57(a)(7) and 1202(a)(4)(C) (section 57(a)(7) is applicable only to QSBS acquired after September 27, 2010). The taxable portion of the gain is subject to the maximum AMT rate of 28 percent plus the 3.8 percent excise tax on NII, but the 7 percent preference item is subject only to the AMT, not the excise tax. As a result, the 50 percent exclusion results in a maximum AMT rate of 16.88 percent, as follows: {[50 percent taxable gain + (7 percent * 50 percent of excluded gain)] * 28 percent AMT rate} + (50 percent taxable gain * 3.8 percent excise tax). The 75 percent exclusion results in a maximum AMT rate of 9.42 percent, as follows: {[25 percent taxable gain + (7 percent * 75 percent of excluded gain)] * 28 percent AMT rate} + (25 percent taxable gain * 3.8 percent excise tax).

[b]Section 1202(a)(1).

[c]Section 1202(a)(3).

[d]Section 1202(a)(4).

venture capital, and the underlying funds are taking specific steps to address QSBS for their investors.

II. Shareholder and Corporate Qualifications

A. Exclusion Percentage and QSBS Rate

As mentioned, section 1202 excludes a percentage of gain (50 percent, 75 percent, or 100 percent) on the sale or exchange of QSBS held for more than five years, and the percentage of exclusion depends on the date on which the QSBS was acquired. Although a specified percentage of gain is excluded, the non-excluded gain, defined in the code as "section 1202 gain," is taxed at a maximum 28 percent rate,[44] not the 20 percent preferential long-term capital gain rate. Section 1202 gain is defined as the excess of "the gain which would be excluded from gross income under section 1202 but for the percentage limitation in section 1202(a)," over "the gain excluded from gross income under section 1202."[45] With the addition of the 3.8 percent excise tax on NII, Table 1 sets out the maximum effective tax rates and exclusions, depending on whether the taxpayer is subject to AMT.[46]

As one can see, the maximum tax savings from QSBS comes from stock acquired after September 27, 2010. One might also note that under some circumstances, the sale of QSBS might be subject to a higher rate than if section 1202 did not apply (for example, stock entitled to a 50 percent exclusion under section 1202 sold during a time when the taxpayer's highest tax bracket is 15 percent). It's important to note that section 1202 is not elective. Under those circumstances, the taxpayer would have been better off intentionally losing QSBS status by, for example, failing the five-year holding requirement or making a disqualifying transfer, defined and discussed in more detail later in this report.

In calculating any tax liability associated with the sale of QSBS, it is important to make a distinction between section 1202 gain, gain that is excluded under section 1202(a) (the excluded section 1202 gain), and the taxable gain that is not subject to section 1202 (non-section 1202 gain). As noted, section 1202 gain is taxed at a maximum

[44]*See* section 1(h)(1)(F) and (4)(A)(ii).

[45]Section 1(h)(7).

[46]Table 1 excludes the 60 percent exclusion for some Empowerment Zone businesses acquired after December 21, 2000, because the enactment of the 75 percent and 100 percent exclusions have made the 60 percent exclusion of no value to taxpayers. *See* sections 1202(a)(2) and 1397C(b).

rate of 28 percent (31.8 percent) and is carefully defined in terms of gain that would be excluded but for the percentage limitations noted earlier. By consequence, section 1202 gain is also limited by the per-issuer limitation (discussed in detail later), which restricts the total amount of gain that is subject to the percentage exclusions. Any other gain, namely non-section 1202 gain is taxed at the preferential 20 percent (23.8 percent) long-term capital gain rate.

For example, A has an adjusted tax basis of $5 million in QSBS that is worth $100 million. Assume that A acquired the QSBS at such a time that the 50 percent limitation applies, the per-issuer limitation is $50 million, and all other conditions are met to qualify under section 1202. If A sells the stock for $100 million, assuming A is not subject to AMT, the resulting tax liability is calculated as follows[47]:

Table 2

Category of Gain	Amount of Gain	Maximum Tax Rate	Federal Tax Liability
Excluded section 1202 gain	$25 million	0%	$0
Section 1202 gain	$25 million	31.8%	$7.95 million
Non-section 1202 gain	$45 million	23.8%	$10.71 million
Totals	**$95 million**	**N/A**	**$18.66 million**

Non-section 1202 gain can include the unrecognized gain inherent in appreciated assets contributed to the corporation in exchange for stock in the corporation under section 351. Under section 358, the stock received in the corporation will receive a carryover basis, but for purposes of the per-issuer limitation, the FMV of the contributed property is used in calculating the tenfold multiplier.

B. $10 Million and 10 Times Basis Limitations

The code provides a per-issuer limitation, which prescribes the maximum gain that can be excluded under section 1202(a). Section 1202(b)(1) provides:

> 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 . . . 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 . . . for prior taxable years and attributable to dispositions of stock issued by such corporation [the $10-million-per-taxpayer limitation], 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 [the 10-times-basis limitation].

As discussed later, the foregoing provision is not a model of clarity, but it does provide some interesting opportunities to possibly multiply and maximize the amount of gain exclusion by taking advantage of multiple taxpayers and engaging in careful tax basis management before the issuance of QSBS shares. In determining the applicability of the per-issuer limitation, it's important to note that it is on a per-issuer (per-corporation), per-taxpayer basis. Further, the $10-million-per-taxpayer limitation is reduced by recognized gains in previous tax years, whereas the 10-times-basis limitation is not. And the 10-times-basis limitation, in contrast, is taken into account only for the tax year in question.

For married[48] individuals filing separate returns, the $10-million-per-taxpayer limitation is reduced to $5 million per taxpayer[49] (but the 10-

[47] See the example provided in Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997," JCS-23-97, at 49 n.75 (Dec. 17, 1997). Note, however, the highest long-term capital gain tax rate in 1997 was 20 percent.

[48] Marital status is determined under section 7703. Section 1202(b)(3)(C). As such, marital status is determined at the end of the tax year, unless a spouse dies during the tax year, in which case it is determined on the date of death. Further, an individual who is legally separated from a spouse under a decree of divorce or of separate maintenance will not be considered married. *See* section 7703(a).

[49] Section 1202(b)(3)(A).

times-basis limitation remains unadjusted). Section 1202(b)(3)(A) states that the $5 million reduction applies "in the case of a separate return by a married individual," with no mention of married taxpayers filing a joint return. However, the code goes on to provide as follows in section 1202(b)(3)(B): "In the case of any joint return, the amount of eligible gain taken into account shall be allocated equally between the spouses for purposes of applying this subsection to subsequent taxable years." In the absence of some clarification, a strict reading of section 1202 would imply one rule on the availability of the QSBS exclusion, which applies only to married taxpayers filing separately, and another rule on how gain is allocated, which applies only to married taxpayers filing jointly. As discussed later, the section 1202 exclusion is afforded to each and every taxpayer who acquires QSBS by original issuance (defined later) or who receives that stock through a permissible transfer. To that end, the separate taxpayer distinction is critical.

This seemingly disparate treatment of exclusion benefits, on one hand, and how gain or income is allocated, on the other hand, is not in conflict with the regulation, which provides: "Although there are two taxpayers on a joint return, there is only one taxable income."[50] Indeed, the Tax Court has held that "it is a long recognized legal maxim that a husband and wife are separate and distinct taxpayers notwithstanding the fact that they have filed joint Federal income tax returns."[51] Moreover, the IRS has ruled, for purposes of the $5 million limitation of section 453A, that the taxpayer and his spouse are not considered a single taxpayer. In coming to that conclusion, the IRS stated:

> In particular, if Congress had intended that married individuals be treated as one taxpayer for purposes of applying the $5,000,000 limitation . . . it could have easily provided for this attribution in express terms. . . . Where Congress is silent on this point, as in section 453A, we do not believe that an allocation between married individuals can be implied.[52]

Thus, absent other guidance or changes to section 1202, married individuals filing jointly are entitled to each claim up to $10 million of exclusion against eligible gain, but any such gain is allocated equally between the spouses in determining the $10-million-per-taxpayer limitation for subsequent tax years, regardless of which spouse sells QSBS in any tax year.

For purposes of the 10-times-basis limitation, the code provides that 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."[53] As such, if a taxpayer dies with QSBS and that stock receives a step-up in basis to FMV on the date of the taxpayer's death under section 1014(a), the increased basis may not be used in calculating the 10-times-basis limitation. In contrast, because the code refers to "any addition to basis" only if the value of the QSBS is less than the adjusted basis at the time of death, the stock will receive a step-down in basis, and the lower basis would seemingly apply for calculating the 10-times-basis limitation. However, as discussed in Part 3 of this report, the step-up in basis may be beneficial depending on the stock's applicable exclusion percentage, unrealized section 1202 gain, and unrealized non-section 1202 gain at the time of death. Further, if the QSBS is acquired by a partnership, the limitation on "any addition to basis" would also apply to any increases in tax basis resulting from a liquidating distribution[54] to a partner or inside basis adjustments to QSBS held

[50] Reg. section 1.6013-4(b). *See* section 7701(1)(14) ("The term 'taxpayer" means any person subject to any internal revenue tax."); and section 6013(d)(3) ("If a joint return is made, the tax shall be computed on the aggregate income and the liability with respect to the tax shall be joint and several.").

[51] *Nell v. Commissioner*, T.C. Memo. 1982-228.

[52] TAM 9853002.

[53] Section 1202(b)(1) (flush language).

[54] Unlike a current distribution, a liquidating distribution can result in the distributed property receiving an increase in tax basis because the liquidated partner's outside basis is greater than the tax basis of the property held by the partnership before distribution. *See* section 732(b) and reg. section 1.732-1(b).

by the partnership under section 734(b), if the partnership has a section 754 election in place.[55] These additions to basis are ignored only for purposes of the 10-times-basis limitation, so they can reduce any unrealized section 1202 gain and non-section 1202 gain.

If a taxpayer contributes property (other than money or stock) to a qualified small business (QSB) corporation in exchange for stock in the corporation, that stock "shall be treated as having been acquired by the taxpayer on the date of such exchange,"[56] and the "basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged."[57] These special rules apply only for section 1202 purposes (and section 1045 purposes, as discussed later). Thus, even though a nonrecognition contribution of property to a controlled corporation under section 351 provides for a tacking of the holding period to the exchanged stock, for section 1202 purposes, the required five-year holding period is deemed to start on the date of exchange.[58] More importantly, for purposes of the 10-times-basis limitation, the taxpayer can use the FMV of appreciated property at the time of the exchange in that calculation.

The foregoing limitations on any "addition to basis after the date on which such stock was originally issued" and on the use of the FMV for appreciated property contributed for purposes of the per-issuer limitation were enacted so that "only gains that accrue after the transfers are eligible for the exclusion."[59] However, with no explanation, section 1202(i)(2) provides:

> If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.

As such, this subsection seems to imply that basis can still be increased for purposes of the 10-times-basis limitation, but it's difficult to envision a scenario in which a shareholder would contribute capital to a corporation that would not be treated as an additional acquisition of shares, thereby requiring the acquisition to satisfy all the other requirements of QSBS.

Some debate exists around the order in which the per-issuer limitation and the exclusion percentage are applied in arriving at the excluded section 1202 gain. We believe the per-issuer limitation is applied against eligible gain first, followed by application of the exclusion percentage. The reason for this interpretation is that section 1202(b)(1) mandates that the amount of eligible gain "which may be taken into account under subsection (a)" (the exclusion percentage) shall not exceed the per-issuer limitation. Assume A sells QSBS for $15 million of eligible gain, which qualifies for a 50 percent exclusion percentage, and the per-issuer limitation is $10 million. Based on our interpretation, of the $15 million of eligible gain, $10 million "may be taken into account under subsection (a)" (that is, the 50 percent exclusion), and the remaining $5 million of eligible gain is considered non-section 1202 gain. The result is $5 million of excluded section 1202 gain, $5 million of section 1202 gain, and $5 million of non-section 1202 gain.

Some have argued that the exclusion percentage should be applied against all the eligible gain and that the per-issuer limitation is then applied. Under that interpretation, in the foregoing example, 50 percent of the $15 million of eligible gain ($7.5 million) would be excluded section 1202 gain, and because $7.5 million is less than the per-issuer limitation of $10 million, $7.5 million of the eligible gain is excluded section 1202 gain. We respectfully do not believe this is the correct result, although it would be better for the taxpayer. Further, it is unclear, based on this interpretation, whether the remaining gain is considered non-section 1202 gain or a

[55] This can occur when higher-basis partnership property is distributed to a partner with a lower outside basis, resulting in a reduction of basis on the distributed property, or a distribution of money to a partner exceeding that partner's outside basis. An addition to basis would also occur under section 743(b) upon a taxable sale of a partnership interest, but the sale would generally disqualify QSBS treatment for that interest.

[56] Section 1202(i)(1)(A).

[57] Section 1202(i)(1)(B).

[58] There is a discussion later in this report about the interplay between the acquisition date for QSBS purposes on formation of the corporation and on conversion from a partnership to a C corporation.

[59] H.R. Rep. No. 103-213, at 526 (RRA 1993 conference report).

combination of section 1202 gain and non-section 1202 gain.

As mentioned, for section 1202 purposes, if a taxpayer contributes property (other than money or stock) to a QSB corporation in exchange for stock in the corporation, the basis in the stock will be no less than the FMV of the contributed property. As a result, taxpayers have the opportunity to increase tenfold the amount of gain subject to partial or complete exclusion by contributing appreciated property. However, because this special rule applies only for section 1202 purposes, the unrealized gain represented by the appreciation on the contributed property is not entitled to exclusion under section 1202 (or the gain rollover under section 1045).

C. Qualified QSBS Shareholders

The percentage exclusion on gain under section 1202 is available to "a taxpayer other than a corporation."[60] This includes individuals, trusts, and estates (collectively, qualified QSBS shareholders).[61] The foregoing taxpayers may be entitled to the exclusion even if the stock is held by specified passthrough entities (spelled "pass-thru" in section 1202), as long as some additional requirements are met. These passthrough entities are not per se qualified QSBS shareholders, but they are eligible holders of QSBS for the benefit of the owners of the passthrough entity who are qualified QSBS shareholders.[62]

The term "pass-thru entity" includes any partnership, S corporation, regulated investment company, and common trust fund.[63] A partner, shareholder, or owner of a passthrough entity who is a qualified QSBS shareholder will be entitled to section 1202 exclusion on gain allocated to that owner,[64] as long as the gain is (1) attributable to a sale or exchange by the passthrough entity of stock that is QSBS "in the hands of such entity (determined by treating such entity as an individual) and which was held by such entity for more than 5 years,"[65] and (2) includable in the gross income of the owner "by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-thru entity acquired such stock and at all times thereafter before the disposition of such stock."[66]

In that instance, in applying the per-issuer limitation (specifically, the 10-times-basis limitation) to the qualified QSBS shareholder, the code provides that "the taxpayer's proportionate share of the adjusted basis of the pass-thru entity in such stock shall be taken into account."[67] Further, the amount of the preferential gain exclusion allocated to the taxpayer is limited by reference to the interest held by the taxpayer in the passthrough entity on the date the QSB was acquired. The code provides that the allocated gain subject to a partial or complete exclusion "shall not apply to any amount to the extent such amount exceeds the amount . . . which . . . would have applied if such amount were determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired."[68]

Regarding RICs, Notice 97-64, 1997-47 IRB 7, provides that temporary regulations will be issued on how RICs[69] may designate dividends as section 1202 distributions. These yet-to-be-issued temporary regulations are expected to provide that (1) section 1202 gain distributions will need to be designated separately for each issuer of QSBS; (2) the exclusion under section 1202(a) will be determined at the shareholder level; and (3) the maximum distributable section 1202 gain for each

[60] Section 1202(a)(1).

[61] Similarly, the recently enacted qualified business income deduction under section 199A is allowed to a taxpayer "other than a corporation." Section 199A(a). The legislative history provides that this includes individual taxpayers, as well as trusts and estates. Joint Explanatory Statement of the Committee of Conference on H.R. 1, 115th Cong., 1st Sess., at 27 and 40 (2017) (as printed in H.R. Rep. No. 115-466 (Dec. 15, 2017)).

[62] The qualified business income deduction under section 199A is not taken at the passthrough entity level; rather, the deduction is taken at the partner or shareholder level. *See* section 199A(f)(1)(A).

[63] Section 1202(g)(4)(A) through (D).

[64] Section 1202(g)(1)(A).

[65] Section 1202(g)(2)(A).

[66] Section 1202(g)(2)(B).

[67] Section 1202(g)(1)(B).

[68] Section 1202(g)(3).

[69] A RIC is subject to the ordinary corporate income tax under section 11 on its investment company taxable income, which is taxable income subject to several adjustments, the most notable of which are the deduction for dividends paid and the exclusion of net capital gain. Net capital gains are subject to shareholder-level taxation to the extent that the company distributes the gains, but the company is subject to taxation to the extent that its net capital gain exceeds the amount of its dividends designated as capital gain distributions. *See* section 852(b).

issuer will be calculated separately from limitations on all other classes of capital gain dividends but in the aggregate may not exceed the RIC's net capital gain.[70]

D. Eligible Gain (Five-Year Holding Period)

1. Generally.

The per-issuer limitation is applied against eligible gain, which is defined as "any gain from the sale or exchange of qualified small business stock held for more than 5 years."[71] As such, eligible gain has two definitional requirements: (1) gain must be from the sale of QSBS (as defined and discussed later), and (2) the taxpayer must have held the stock for more than five years. For purpose of the foregoing, stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue. The determination whether the gross assets test is met is made at the time of exercise or conversion, and the holding period of that stock is treated as beginning at that time.[72] For convertible preferred stock, the gross assets determination is made when the convertible stock is issued, and the holding period of the convertible stock is added to that of the common stock acquired upon conversion.[73] Stock received by a taxpayer in connection with the performance of services is treated as issued when the resulting compensation income is included in the taxpayer's income under section 83. Thus, the five-year holding period is deemed to start (1) upon issuance if the stock is subject to a substantial risk of forfeiture or other vesting condition, but the taxpayer makes a section 83(b) election; or (2) upon the expiration of the substantial risk of forfeiture or the satisfaction of the vesting condition, if the taxpayer did not make a section 83(b) election.[74]

2. Tacking and permissible transfers.

The code provides that if a transferee receives stock in specified types of transfers, the transferee will be deemed to have "acquired such stock in the same manner as the transferor,"[75] and "held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under [section 1202(h)]) by the transferor."[76] As discussed in more detail later, such a transfer is defined as any transfer (1) "by gift";[77] (2) "at death";[78] or (3) "from a partnership to a partner,"[79] if the stock received from the partnership otherwise meets the requirements of section 1202(g) discussed previously (for example, limited to that shareholder's interest at the time the QSBS was acquired by the partnership) other than the five-year holding requirement.

Further, holding periods will tack in the following situations: (1) when the taxpayer acquires stock "solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer";[80] (2) when the exchange of QSBS for stock in another corporation is in a transaction described in section 351 or a reorganization described in section 368 (as discussed in more detail later);[81] and (3) when the purchase of QSBS is with proceeds from a qualifying rollover under section 1045 (as discussed later).[82] Because of the foregoing provisions, if shares of a QSB are "sold" in a tax-free exchange of shares with a publicly traded company, the publicly traded shares will qualify for the QSBS exclusion under section 1202(a), provided they are sold after the required but cumulatively calculated five-year holding period.

[70] Notice 97-64, section 8.

[71] Section 1202(b)(2). Subsection (a) of section 1202 sets out the percentage exclusion available on the sale of stock by a taxpayer other than a corporation and mirrors, but does not reference, the definition of eligible gain (any gain from the sale or exchange of QSBS held for more than five years).

[72] H.R. Rep. No. 103-213, at 526 (RRA 1993 conference report).

[73] *Id.*

[74] *Id.*

[75] Section 1202(h)(1)(A).

[76] Section 1202(h)(1)(B).

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

[78] Section 1202(h)(2)(B).

[79] Section 1202(h)(2)(C).

[80] Section 1202(f).

[81] Section 1202(h)(4).

[82] *See* section 1223(13).

3. Disqualifying hedging transactions.

Some hedging transactions can disqualify QSBS. If a taxpayer (or related party[83]) has an offsetting short position on any QSBS, the gain will not qualify for partial or complete exclusion unless (1) the QSBS was held by the taxpayer for more than five years as of the first day on which there was a short position,[84] and (2) the taxpayer elects to recognize gain as if the stock were sold on that first day for its FMV.[85] An offsetting short position includes[86] (1) a short sale of substantially identical property, (2) an option to sell substantially identical property at a fixed price, or (3) to the extent provided in the regulations, "any other transaction which substantially reduces the risk of loss from holding such qualified small business stock."

To date, no guidance has been issued on how or when a taxpayer can make that election. Further, no regulations have been issued on any other transaction that "substantially reduces the risk of loss." The phrase "substantially identical property" is used in other code sections, including sections 1233 (short sales), 1258 (conversion transactions), and 1259 (constructive sales). It seems, however, that if a taxpayer can secure a loan on a nonrecourse basis, collateralized solely by the QSBS, the loan would not be considered a recognition event, and the transaction would not be considered a disqualifying hedging transaction.

E. QSBS: Original Issuance Requirement

1. Generally.

For stock to be considered QSBS, it must be (1) stock in a C corporation;[87] (2) originally issued after August 10, 1993 (the date of enactment of the Revenue Reconciliation Act of 1993);[88] (3) on the date of issuance, issued by a corporation that is a QSB, as defined below;[89] and (4) with some exceptions noted herein, acquired by the taxpayer at its original issue,[90] in exchange for money or other property (not including stock),[91] or as compensation for services provided to that corporation.[92] The foregoing is often referred to as the original issue requirement or the original issuance requirement. The term "original issue" refers to an issuance of stock directly from the corporation to a qualified QSBS shareholder, as opposed to, for example, an acquisition of that stock on a secondary market or acquisition from another person. It does not refer to the timing of the issuance of stock. In other words, it should not be interpreted to mean that only the first issuance of stock from a corporation will be considered QSBS.

2. Permissible transfers.

The original issuance requirement is not violated if a taxpayer receives the stock "by gift"[93] or "at death."[94] Thus, if the transferred stock satisfied the original issuance requirement in the previous owner's hands, it continues to satisfy that requirement. However, as discussed in the third part of this report, the breadth of transfers that would be considered by gift and at death is unclear. Because section 1202 is an income tax section, it is reasonable to conclude that transfers by gift and at death are defined as they would be under chapter 1 of title 26 (for example, transferee basis would be determined under sections 1015 and 1014), rather than as these transfers would be defined under chapters 11 and 12 (estate and gift tax).

Also, the original issuance requirement is not violated if a taxpayer receives the stock in a transfer "from a partnership to a partner,"[95] provided the stock received from the partnership otherwise meets the requirements of section 1202(g) (for example, limited to that shareholder's interest at the time the QSBS was acquired by the partnership) other than the five-year holding requirement. This exception applies only to

[83] Under section 1202(j)(2) (flush language), the term "taxpayer" includes any person who is related as defined in section 267(b) or 707(b).

[84] Section 1202(j)(1)(A).

[85] Section 1202(j)(1)(B).

[86] Section 1202(j)(2).

[87] Section 1202(c)(1).

[88] *Id.*

[89] Section 1202(c)(1)(A).

[90] Section 1202(c)(1)(B).

[91] Section 1202(c)(1)(B)(i).

[92] Section 1202(c)(1)(B)(ii).

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

[94] Section 1202(h)(2)(B).

[95] Section 1202(h)(2)(C).

partnerships and apparently does not apply to distributions from other types of passthrough entities (as defined in section 1202(g)(4)), like S corporations, although they are eligible holders of QSBS. Notably, what is not included is a transfer from a partner to a partnership. Whether a contribution of QSBS to a partnership (typically a nontaxable event) automatically disqualifies QSBS is discussed in more detail later.

The original issuance requirement is also met if a preexisting business that is a sole proprietorship, disregarded entity, or partnership for federal income tax purposes converts to a C corporation and as part of that conversion issues shares to the owners of the business. Although section 1202 contains an aggregate gross asset limitation, there is no time frame by which a preexisting trade or business must convert to a C corporation, so even businesses that have been in existence for a long time could become QSBS companies. As mentioned, in the wake of the enactment of the TCJA, the ability to convert preexisting businesses to C corporations and qualify them for QSBS is an important planning option to consider. This is discussed in greater detail in Part 3 of this report.

Given the aggregate gross asset requirement (defined and discussed later), it remains to be seen if a preexisting business can divide its business to meet the gross asset test at the time of original issuance. To that end, the code provides, "The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including regulations to prevent the avoidance of the purposes of this section through split-ups, shell corporations, partnerships, or otherwise."[96]

3. Disqualifying redemptions and purchases.

As discussed in more detail later, to prevent a possible abuse surrounding the original issuance requirement, the QSBS exclusion is not available if the issuing corporation redeems or otherwise purchases its stock within a period of time surrounding the issuance of the stock.[97]

Presumably, these rules are to ensure that taxpayers do not convert non-QSBS stock to QSBS or to give QSBS status to investments that are essentially replacements of previous investments. To that end, stock will lose QSBS status if the issuing corporation "at any time during the 4-year period beginning on the date 2 years before the issuance of such stock . . . purchased (directly or indirectly) any of its stock from the taxpayer or from a person related . . . to the taxpayer."[98] The disqualification applies only to stock "acquired by the taxpayer,"[99] not to other stock held by other shareholders. A person is deemed related under section 267(b) or 707(b). As such, the family of an individual includes his "brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."[100] The regulations provide that QSBS status is retained if the purchase or redemption from the taxpayer or related party is limited to a de minimis amount.[101] For this purpose, a de minimis amount is exceeded if (1) the aggregate amount paid for the stock exceeds $10,000, and (2) more than 2 percent of the stock held by the taxpayer and related person is acquired.[102]

Stock will lose QSBS status if the issuing corporation "during the 2-year period beginning on the date 1 year before the issuance of such stock . . . 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."[103] Unlike a related-party redemption, this disqualification applies to all stock "issued by a corporation."[104] For purposes of this rule, the regulations provide

[96] Section 1202(k).

[97] *See* H.R. Rep. No. 103-213, at 523 (RRA 1993 conference report) (stating that the redemption rules are "to prevent evasion of the requirement that the stock be newly issued").

[98] Section 1202(c)(3)(A).

[99] *Id.*

[100] Section 267(c)(1). There is also constructive ownership through trusts, estates, and business entities. *See* sections 267(b) and 707(b).

[101] Reg. section 1.1202-2(a)(1). The regulation was issued in 1997, but the de minimis exception applies to all stock issued after August 10, 1993. Reg. section 1.1202-2(e).

[102] Reg. section 1.1202-2(a)(2). For purposes of the 2 percent limitation, "the percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase." *Id.*

[103] Section 1202(c)(3)(B).

[104] *Id.*

that QSBS status is retained if the purchase or redemption is limited to a de minimis amount.[105] For this purpose, a de minimis amount is exceeded if (1) the aggregate amount paid for the stock exceeds $10,000, and (2) more than 2 percent of all the outstanding stock is purchased.[106] For purposes of the 2 percent limit, "the percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase."[107] Note that the de minimis calculation is determined at the time of the purchase, but the 5 percent limit described in the code is determined at the beginning of the two-year period.

In the context of start-up businesses, disqualifying redemptions are not as rare as one might think. Consider a QSB that is founded by two shareholders — an entrepreneur and a friend — as equal shareholders, each providing an equal amount of initial funding. At the end of the first year, when the company still has very little value, the friend decides that the start-up company life is not what he wants. The corporation redeems the friend's shares and raises capital from other investors. The redemption of the shares disqualifies all the stock from QSBS treatment, specifically including the entrepreneur's shares. This result could have been avoided if the entrepreneur had purchased the stock from the friend. The purchased shares from the friend would not have met the original issuance requirement, but the entrepreneur's initial shares would still have maintained their QSBS status.

For purposes of (related-party and significant) redemptions under section 1202, if a distribution is treated under section 304(a) as a redemption of stock in any corporation, that corporation shall, for QSBS purposes, be treated as purchasing an amount of stock equal to the value of the amount treated as a redemption under section 304(a).[108]

Section 304(a) generally provides that if one or more persons are in control of two corporations, and in return for property, one of the corporations acquires the stock of the other corporation, the property shall be treated as a distribution in redemption of stock of the corporation acquiring that stock.[109] For this purpose, "control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock."[110] In determining the foregoing, constructive ownership under section 318(a) applies,[111] except that in determining attribution from or to corporations, 5 percent replaces 50 percent.[112] Under section 318(a), an individual is deemed to own the stocked owned by his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), children, grandchildren, and parents.[113]

For purposes of the related-party and significant redemption rules, the following purchases are ignored:

1. a transfer of stock by a shareholder to an employee, independent contractor, or beneficiary of either is not treated as a purchase by the issuing corporation, even if the stock is treated as having been transferred to the corporation and then to the recipient under the regulations relating to transfers by shareholders to employees or independent contractors being treated as compensation;[114]
2. a stock purchase in connection with death, disability, mental incompetence, or divorce is ignored;[115]
3. a purchase of stock is ignored if the shareholder acquired the stock in connection with the performance of services as an employee or director of the

[105] Reg. section 1.1202-2(b)(1). As noted, the regulation was issued in 1997, but the de minimis exception applies to all stock issued after August 10, 1993. Reg. section 1.1202-2(e).

[106] Reg. section 1.1202-2(b)(2).

[107] The regulations also provide: "The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase." *Id.*

[108] Section 1202(c)(3)(C).

[109] *See* section 304(a)(1).

[110] Section 304(c)(1).

[111] Section 304(c)(3).

[112] Section 304(c)(3)(B).

[113] Section 318(a)(1)(A).

[114] Reg. sections 1.1202-2(c) and 1.83-6(d)(1).

[115] Reg. section 1.1202-2(d).

issuing corporation and the stock is purchased from the shareholder incident to the shareholder's retirement or other bona fide termination of services;[116]

4. a purchase of stock in connection with the death of an individual is ignored if before the decedent's death, the stock (or an option to acquire the stock) was held by (1) the decedent, the decedent's spouse, or both; (2) the decedent and a joint tenant; or (3) a trust revocable by the decedent, spouse, or both,[117] and the stock is purchased (a) from the decedent's estate, a beneficiary that receives the stock either by bequest or lifetime gift, an heir, a surviving joint tenant, a surviving spouse, or from a trust established by the decedent or the decedent's spouse;[118] and (b) within three years and nine months from the date of the decedent's death.[119]

F. QSBS: Active Business Requirement

1. Generally.

Stock in a corporation will not be considered QSBS unless "during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements . . . and such corporation is a C corporation."[120] "Substantially all" refers to the taxpayer's holding period, and there is no guidance or safe harbor that describes what period will be considered sufficient for these purposes. Although the Tax Court has held in two cases that the taxpayers failed to meet the active business requirement, it provided no guidance on how "substantially all" is to be determined.[121]

Under section 1202(e)(1), a corporation is deemed to meet the active business requirement for any period if during that time (1) at least 80 percent (by value) of the assets of the corporation are used "in the active conduct of 1 or more qualified trades or businesses,"[122] and (2) the corporation is an "eligible corporation"[123] (defined as any domestic corporation other than (a) a domestic international sales corporation or former DISC, (b) a RIC, REIT, or real estate mortgage investment conduit, or (c) a cooperative).[124]

2. Defining 'substantially all.'

Not only are there questions about how the 80 percent test will be calculated, but no guidance has been issued to prescribe how the "substantially all" holding period should be applied in conjunction with the 80 percent test. Recently issued guidance on qualified Opportunity Zones (QOZs) may be helpful in this respect. The TCJA enacted new sections 1400Z-1 and 1400Z-2 (QOZ investments through a qualified opportunity fund), which give taxpayers several benefits similar to QSBS, including a deferral and reduction of recognized gains and an abatement of post-investment appreciation, provided the taxpayers meet specific holding company requirements. In fact, section 1400Z-2 refers to the disqualifying redemptions and purchases rule in section 1202(c)(3) in describing QOZ stock,[125] and regulations impose an original issuance requirement for QOZ stock.[126] Because QSBS and QOZ investments are meant to provide an incentive for specific types of investments (that is, small business growth with QSBS investments, and economic growth in distressed communities with QOZ investments), it is reasonable to look to the recently issued QOZ guidance, which has been rapid and prolific since the sections' enactment, while QSBS guidance continues to be sorely lacking.

[116] Reg. section 1.1202-2(d)(1)(i). Note that regulations reserve a section for the treatment of stock purchases from independent contractors, but to date, that section has not been issued. Reg. section 1.1202-2(d)(1)(ii).

[117] Reg. section 1.1202-2(d)(2).

[118] Reg. section 1.1202-2(d)(2)(i).

[119] Reg. section 1.1202-2(d)(2)(ii).

[120] Section 1202(c)(2)(A).

[121] *See Owen v. Commissioner*, T.C. Memo. 2012-21; and *Holmes v. Commissioner*, T.C. Memo. 2012-251, *aff'd*, 593 F. App'x 693 (9th Cir. 2015).

[122] Section 1202(e)(1)(A).

[123] Section 1202(e)(1)(B).

[124] Section 1202(e)(4).

[125] Section 1400Z-2(d)(2)(B)(ii).

[126] *See* reg. section 1.1400Z2(d)-1(c)(2)(i)(A), requiring that the QOZ stock be acquired "at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash."

In January the IRS published final regulations on investments in QOZs,[127] retaining the basic approach and structure of two sets of proposed regulations issued in 2018[128] and 2019,[129] respectively. Section 1400Z-2 imposes a "substantially all" holding period requirement and a "substantially all" test on assets.[130] For example, it provides that the term "qualified opportunity zone business property" means "tangible property used in a trade or business of the qualified opportunity fund if . . . during substantially all of the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone."[131] For purposes of the foregoing, the 2020 QOZ final regulations include four new definitional phrases or terms:

1. *"70-percent tangible property standard*. The term 70-percent tangible property standard means the requirement in section 1400Z-2(d)(3)(A)(i) that a qualified opportunity zone business must satisfy with respect to qualified opportunity zone business property (see [reg.] section 1.1400Z2(d)-2) that the qualified opportunity zone business holds, whether the qualified opportunity zone business property is owned by the qualified opportunity zone business or leased by the qualified opportunity zone business from another person."[132]
2. *"70-percent use test*. The term 70-percent use test means the test described in [reg.] section 1.1400Z2(d)-2(d)(4)(ii) that is used to determine if a QOF or qualified opportunity zone business satisfies the requirement in sections 1400Z-2(d)(2)(D)(i)(III) and 1400Z-2(d)(3)(A)(i) that substantially all of the use of tangible property was in a qualified opportunity zone."[133]
3. *"90-percent qualified opportunity zone property holding period*. The term 90-percent qualified opportunity zone property holding period means the minimum portion of a QOF's holding period in stock of a corporation or interests in a partnership, during which the corporation or partnership qualifies as a qualified opportunity zone business in order for the stock or the partnership interests to meet the substantially all requirement under section 1400Z-2(d)(2)(B)(i)(III) to be treated as qualified opportunity zone stock or the substantially all requirement under section 1400Z-2(d)(2)(C)(iii) to be treated as qualified opportunity zone partnership interests, as applicable, held by the QOF."[134]
4. *"90-percent qualified opportunity zone business property holding period*. The term 90-percent qualified opportunity zone business property holding period means the minimum portion of a QOF's or qualified opportunity zone business's holding period in tangible property during which the 70-percent use test with respect to the tangible property must be satisfied, in order for the tangible property to meet the requirement under section 1400Z-2(d)(2)(D)(i)(III) to be treated as qualified opportunity zone business property held by the QOF or qualified opportunity zone business."[135]

The 2020 final QOZ regulations generally require that a QOF apply a holding period and asset use requirement in a compound manner.[136] The preamble to the final regulations states: "Due to the compound application of the 90-percent threshold, the 70-percent tangible property standard, and the 70-percent use test, the Treasury Department and the IRS sought to ensure that each percentage requirement, when taken together, would remain significant." As previously explained in the preamble to the 2018 proposed QOZ regulations:

[127] T.D. 9889.

[128] REG-115420-18.

[129] REG-120186-18.

[130] *See* section 1400Z-2(d)(2)(B)(i)(III), (2)(C)(iii), (2)(D)(i)(III), and (3)(A)(i)(III).

[131] Section 1400Z-2(d)(3)(A)(i) and (A)(i)(III).

[132] Reg. section 1.1400Z2(a)-1(b)(2).

[133] Reg. section 1.1400Z2(a)-1(b)(3).

[134] Reg. section 1.1400Z2(a)-1(b)(4).

[135] Reg. section 1.1400Z2(a)-1(b)(5).

[136] *See generally* reg. section 1.1400Z2(d)-1(b) and (c).

> Several requirements of section 1400Z-2(d) use *substantially all* multiple times in a row (that is, "substantially all of . . . substantially all of . . . substantially all of . . . ."). This compounded use of substantially all must be interpreted in a manner that does not result in a fraction that is too small to implement the intent of Congress.[137]

Although 90 percent may seem unusually high, the preamble to 2019 proposed QOZ regulations explains:

> The Treasury Department and the IRS have determined that a higher threshold is necessary in the holding period context to preserve the integrity of the statute and for the purpose of focusing investment in designated qualified opportunity zones. Thus, the proposed regulations provide that the term substantially all as used in the holding period context in sections 1400Z-2(d)(2)(B)(i)(III), 1400Z-2(d)(2)(C)(iii), and 1400Z-2(d)(2)(D)(i)(III) is defined as 90 percent. Using a percentage threshold that is higher than 70-percent in the holding period context is warranted as taxpayers are more easily able to control and determine the period for which they hold property. In addition, given the lower 70-percent thresholds for testing both the use of tangible property in the qualified opportunity zone and the amount of owned and leased tangible property of a qualified opportunity zone business that must be qualified opportunity zone business property, applying a 70-percent threshold in the holding period context can result in much less than half of a qualified opportunity zone business's tangible property being used in a qualified opportunity zone. Accordingly, the Treasury Department and the IRS have determined that using a threshold lower than 90 percent in the holding period context would reduce the amount of investment in qualified opportunity zones to levels inconsistent with the purposes of section 1400Z-2.

Mathematically, when taken together, the compound "substantially all" requirements result in a combined percentage requirement of at least 63 percent (0.9 x 0.7). Assuming a similar rule would be applicable to QSBS, "substantially all" could be interpreted to mean approximately 80 percent of the holding period. When combined with the 80 percent asset test for QSBS discussed later, the combined percentage requirement is at least 64 percent (0.8 x 0.8). Perhaps not coincidentally, the term "substantially all" in other code sections leads to a general rule, in other contexts, of 80 percent.[138]

It may seem erroneous to combine percentages in this manner, but the preamble to the 2019 proposed QOZ regulations does, in fact, do this:

> For example, these regulations imply that a QOF could satisfy the substantially all standards with as little as 40 percent of the tangible property effectively owned by the fund being used within a qualified opportunity zone. This could occur if 90 percent of QOF assets are invested in a qualified opportunity zone business, in which 70 percent of the tangible assets of that business are qualified opportunity zone business property; and if, in addition, the qualified opportunity zone business property is only 70 percent in use within a qualified opportunity zone, and for 90 percent of the holding period for such property. Multiplying these shares together (0.9 x 0.7 x 0.7 x 0.9 = 0.4) generates the result that a QOF could satisfy the requirements of section 1400Z-2 under the proposed regulations with just 40 percent of its assets effectively in use within a qualified opportunity zone.[139]

[137] Preamble to REG-115420-18, 83 F.R. 54279, 54285 (Oct. 29, 2018).

[138] *See, e.g.*, reg. section 1.41-4(a)(6); and Rev. Proc. 92-33, 1992-1 C.B. 782. *Cf.* Rev. Proc. 77-37, 1977-2 C.B. 568 (for purposes of sections 354(b)(1)(A), 368(a)(1)(C), 368(a)(2)(B)(i), and 368(a)(2)(E)(i), "substantially all" is satisfied if there is a transfer of assets of at least 90 percent of the FMV of the net assets and at least 70 percent of the FMV of the gross assets immediately before the transfer).

[139] Preamble to REG-120186-18, 84 F.R. 18652, 18670 (May 1, 2019).

3. 80 percent test.

It is unclear whether the 80 percent test should be interpreted to mean that at all times the corporation must use at least 80 percent of assets in the active trade or business, or if during the period in question an average of at least 80 percent will suffice. For purposes of the 80 percent test, there is a look-through rule for any subsidiaries of the parent. Under the rule, the value of any stock and debt in any subsidiary is disregarded, and the parent corporation is "deemed to own its ratable share of the subsidiary's assets, and to conduct its ratable share of the subsidiary's activities."[140] For this purpose, a corporation will be considered a subsidiary if the parent owns more than "50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent in value of all outstanding stock, of such corporation."[141] Further, a corporation will be deemed to fail the 80 percent test for any period during which "more than 10 percent 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,"[142] other than assets that would be considered working capital under section 1202(e)(6), as defined later. The latter restriction is intended to ensure that a corporation does not hold a passive portfolio of stock or securities that will not be reasonably used in the conduct of the active trade or business.

For purposes of the 80 percent test, any assets that are reasonably required for the working capital needs of the trade or business will be treated as used in the active conduct of a qualified trade or business. These working capital assets are described as any assets that are held for (1) "reasonably required working capital needs of a qualified trade or business of the corporation,"[143] or (2) "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."[144] If the corporation has been in existence for at least two years, no more than 50 percent of the assets of the corporation under this working capital safe harbor will be considered used in the active conduct of a qualified trade or business.[145]

It should be noted that under some accounting conventions, working capital includes inventory because working capital could be defined as "the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business."[146] Some active trade or businesses involved in the retail or grocery industry often have a large percentage (70 percent or more) of their current assets in inventory. Section 1202 was never intended to preclude these types of businesses from the definition of a qualified trade or business. Thus, it is reasonable to conclude that working capital is more narrowly defined.

Here again, the guidance surrounding QOZs is instructive. Commentators to the 2020 final QOZ regulations asserted that "inventory should never be treated as qualified opportunity zone business property because such inventory (i) is a transitory asset, (ii) does not add value to the QOZ, and (iii) does not meet the requirements for either the original use or substantial improvement requirement."[147] Ultimately, those final regulations provide that for purposes of the 90 percent investment standard and the 70 percent tangible property standard, a QOF may choose to include or exclude the inventory in the calculation, but once a QOF makes that choice, it must do so consistently. Further, the final QOZ regulations adopt the definition of working capital provided in section 1397C(e)(1). Section 1397C(e)(1) excludes from the definition of nonqualified financial property reasonable

[140] Section 1202(e)(5)(A).

[141] Section 1202(e)(5)(C).

[142] Section 1202(e)(5)(B).

[143] Section 1202(e)(6)(A).

[144] Section 1202(e)(6)(B).

[145] Section 1202(e)(6) (flush language).

[146] Accounting Research Bulletin 43(3), para. 3 (codified in Financial Accounting Standards Board Accounting Standards Codification 210-10-05 through 210-10-60, 310-10-45, 340-10-05, 470-10-45 through 470-10-60, and 958-210-60).

[147] Preamble to T.D. 9889, 85 F.R. 1866, 1904 (Jan. 13, 2020).

amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less.[148]

For purposes of the 80 percent test, some assets used in start-up activities and for research will be deemed to be used in the active conduct of a trade or business. Assets used for (1) "start-up activities described in section 195(c)(1)(A),"[149] (2) "activities resulting in the payment or incurring of expenditures that may be treated as research and experimental expenditures deductible under section 174,"[150] and (3) "activities with respect to in-house research expenses described in section 41(b)(4)"[151] will be treated as used in the active conduct of a qualified trade or business, regardless of whether the corporation has "any gross income from such activities at the time of the determination."[152]

A corporation will not be treated as meeting the 80 percent test for any period during which "more than 10 percent 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."[153] For those purposes, "the ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business."[154]

Specific to technology companies, for purposes of the 80 percent test, some computer software assets that produce royalties will be deemed to be used in the active conduct of a trade or business. This applies only to "rights to computer software which produces active business computer software royalties (within the meaning of section 543(d)(1))."[155] Generally, active business computer software royalties apply only to corporations that are actively engaged in the computer software business.[156]

4. Qualified trade or business defined.

A qualified trade or business is defined by negation. It is any trade or business, other than any:

1. "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 one or more of its employees;"[157]
2. "banking, insurance, financing, leasing, investing, or similar business;"[158]
3. "farming business (including the business of raising or harvesting trees);"[159]
4. "business involving the production or extraction of products that would provide depletion deductions under sections 613 and 613A"[160] (for example, oil, natural gas, and minerals); or
5. "business operating a hotel, motel, restaurant, or other similar businesses."[161]

Notwithstanding the exclusion of some companies performing "services" in specified fields like health, the IRS has ruled that companies that deploy technology, manufacturing assets, or other intellectual property to provide services exclusively to clients in the healthcare industry

[148] *See* reg. section 1400Z2(d)-1(d)(3) (reference to section 1397C(b)(8) and prop. reg. section 1.1400Z-2(d)-1(d)(5)(iii)).

[149] Section 1202(e)(2)(A). Section 195(c)(1)(A) broadly defines a start-up expenditure as any amount paid or incurred in connection with (1) "investigating the creation or acquisition of an active trade or business," (2) "creating an active trade or business," or (3) "any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business." Section 195(c)(1)(A)(i)-(iii).

[150] Section 1202(e)(2)(B). Section 13206(a) of the TCJA amended section 174, requiring specified research or experimental expenditures, including software development expenditures, to be capitalized and amortized (rather than immediately deductible at the election of the taxpayer), generally, over a five-year period. The amendment applies to amounts paid or incurred in tax years beginning after December 31, 2021. It is unclear whether or how this amendment may affect how the 80 percent test is to be applied under section 1202.

[151] Section 1202(e)(2)(C). Section 41(b)(4) provides that a taxpayer is treated as meeting the trade or business requirement if "at the time such in-house research expenses are paid or incurred, the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of a future trade or business." Section 41(b)(4).

[152] Section 1202(e)(2) (flush language).

[153] Section 1202(e)(7).

[154] *Id.*

[155] Section 1202(e)(8).

[156] *See* section 543(d)(2).

[157] Section 1202(e)(3)(A).

[158] Section 1202(e)(3)(B).

[159] Section 1202(e)(3)(C).

[160] Section 1202(e)(3)(D).

[161] Section 1202(e)(3)(E).

would nonetheless qualify for QSBS status.[162] LTR 201436001 involved a company that worked exclusively with clients in the pharmaceutical industry to commercialize experimental drugs. Specifically, the company's activities included research on drug formation effectiveness, pre-commercial testing procedures, and manufacturing of drugs. The IRS explained that "the thrust of section 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners)." The IRS ruled:

> Company is not in the business of offering service in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers. Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, . . . Company does not perform services in the health industry within the meaning of section 1202(e)(3).

LTR 201717010 involved a company that was formed to provide more complete and timely information to healthcare providers. In particular, the company owned and deployed patents and other technology for the detection of B, in accordance with which it performed X testing, analyzed the results of X testing, and prepared laboratory reports for healthcare providers. In ruling that the company qualified for QSBS status, the IRS noted that the company simply provided lab results to healthcare professionals, did not discuss diagnoses or treatment, did not discuss lab tests with patients, and had contact with patients only for billing purposes. Further, the skills of the company's employees were not useful in performing the tests, and they were not subject to state licensing requirements as healthcare professionals. Finally, none of the company's revenue was earned in connection with patients' medical care.

It is not clear whether all those factors must exist for a company that works in excluded service fields to have QSBS status, but it seems important that there be a physical asset, process, proprietary method, technology, patent, or other IP such that the company is not a trade or business whose principal asset is the reputation or skill of one or more of its employees.[163]

5. Guidance from section 199A final regulations.

No regulations have been issued under section 1202 on the meaning and scope of the trades or businesses that would not qualify for QSBS status because they involve the "performance of services" in enumerated fields. However, section 199A(d)(2)(A) defined an SSTB as any trade or business described in section 1202(e)(3)(A), with the exclusion of engineering and architecture. Section 199A(d)(2)(B) also provides that an SSTB is any trade or business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. Section 1202(e)(3)(B) excludes banking, insurance, financing, leasing, investing, or "similar business."

Given that the IRS has issued the final section 199A regulations, practitioners might infer how these definitions may be interpreted for QSBS purposes. A detailed discussion of the final regulations is beyond the scope of this report, but they provide interesting insights (in many instances drawing on guidance from section 448(d)(2)[164]) about how some enumerated personal service fields will be defined.

a. Trade or business.

Sections 1202 and 199A apply to a trade or business, but neither provides a definition of the term. The term is defined in several different code

[162] *See* LTR 201436001 and LTR 201717010.

[163] LTR 201717010.

[164] Section 448(d)(2) addresses limitation on the use of the cash method of accounting for qualified personal service corporations, which generally includes a corporation that involves the performance of services in the "fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting." Section 448(d)(2)(A).

sections, but the final section 199A regulations conclude that section 162 provides the most appropriate definition of a trade or business. The final section 199A regulations provide that a trade or business means "a trade or business that is a trade or business under section 162 . . . other than the trade or business of performing services as an employee."[165] The courts have held that under section 162, a trade or business requires that the taxpayer carry on activities with a good-faith intention to make a profit or in the belief that a profit can be made from the activity.[166] Also, the courts have held that the scope of activities should be sufficient to be considered a trade or business, and they have generally held that the offering of goods and services to the public suffices to be considered a trade or business. To that end, in the field of investments (which would be excluded from QSBS consideration under section 1202(3)(B)), a dealer who purchases and sells securities for the accounts of others is generally considered to be in a trade or business, whereas an investor who trades on his own account is not in a trade or business.[167] Further, whether a trader who manages his own account is considered to have a trade or business is based on the amount of activity and whether the activity is considerable, regular, and continuous.[168]

b. Health.

"Performance of services in the field of health" means "the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals performing services in their capacity as such."[169] It does not include the "provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient"[170] — for example, the operation of health clubs or health spas that provide physical exercise or conditioning to their customers; payment processing; or research, testing, and manufacture or sales of pharmaceuticals or medical devices.

c. Law.

"Performance of services in the field of law" means "the performance of services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such."[171] It does not include "the provision of services that do not require skills unique to the field of law; for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services."[172]

d. Accounting.

"Performance of services in the field of accounting" means "the provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such."[173] The preamble to the proposed section 199A regulations[174] explains that the provision of services in the field of accounting is not limited to services requiring state licensure as a CPA. The aim is to capture the common understanding of accounting, which includes tax return and bookkeeping services, even though the provision of those services may not require the same education, training, or mastery of accounting principles as a CPA. As such, the field of accounting does not include payment processing and billing analysis.

e. Actuarial science.

"Performance of services in the field of actuarial science" means "the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such."[175] The preamble to the proposed section 199A regulations explains that the field of actuarial science does not include the provision of

[165] Reg. section 1.199A-1(b)(14).

[166] *See Doggett v. Burnet*, 65 F.2d 191 (D.C. Cir. 1933), *rev'g Doggett v. Commissioner*, 23 B.T.A. 744 (1931).

[167] *See King v. Commissioner*, 89 T.C. 445 (1987); *Crissey v. Commissioner*, T.C. Summ. Op. 2017-44; and *Kay v. Commissioner*, T.C. Memo. 2011-159.

[168] *See, e.g., Kay*, T.C. Memo. 2011-159.

[169] Reg. section 1.199A-5(b)(2)(ii).

[170] *Id.*

[171] Reg. section 1.199A-5(b)(2)(iii).

[172] *Id.*

[173] Reg. section 1.199A-5(b)(2)(iv).

[174] REG-107892-18.

[175] Reg. section 1.199A-5(b)(2)(v).

services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

f. Performing arts.

"Performance of services in the field of the performing arts" means "the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such."[176] It does not include "the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts."[177] Nor does it include "the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public."[178]

g. Consulting.

"Performance of services in the field of consulting" means "the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems."[179] The final section 199A regulations specifically provide that consulting includes "providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such."[180] It does not include "the performance of services other than advice and counsel, such as sales (or economically similar services) or the provision of training and educational courses."[181] For those purposes, the determination of whether a person's services are sales or economically similar services is based on all the facts and circumstances of that person's business,[182] including, for example, how the taxpayer is compensated for the services provided.[183] Further, consulting does not include "the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services."[184]

h. Athletics.

"Performance of services in the field of athletics" means "the performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing."[185] It does not include "the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events"[186] or "the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public."[187]

i. Financial services.

"Performance of services in the field of financial services" means "the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities and similar services."[188] It includes services provided

[176] Reg. section 1.199A-5(b)(2)(vi).
[177] *Id.*
[178] *Id.*
[179] Reg. section 1.199A-5(b)(2)(vii).
[180] *Id.*
[181] *Id.*
[182] *Id.*
[183] *Id.*
[184] *Id.*
[185] Reg. section 1.199A-5(b)(2)(viii).
[186] *Id.*
[187] *Id.*
[188] Reg. section 1.199A-5(b)(2)(ix).

by financial advisers, investment bankers, wealth planners, and retirement advisers and other similar professionals. It does not include taking deposits or making loans, but it does include "arranging lending transactions between a lender and borrower."[189] Section 1202(e)(3)(A) includes the term "financial services" but then separately lists banking in section 1202(e)(3)(B). For that reason, the preamble to the proposed section 199A regulations points out that the term "financial services" does not include banking services.

j. Brokerage services.

"Performance of services in the field of brokerage services" includes services in which "a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee."[190] This includes services provided by stock brokers and other similar professionals but specifically does not include services provided by real estate agents and brokers, or insurance agents and brokers.[191]

k. Investing and investment management.

"Performance of services that consist of investing and investment management" refers to a "trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments."[192] It does not include directly managing real property. The preamble to the proposed section 199A regulations states that investing and investment management would include a trade or business that receives a commission, a flat fee, or an investment management fee calculated as a percentage of assets under management.

l. Reputation or skill of one or more of its employees.

Any trade or business whose principal asset is the reputation or skill of one or more of its employees means:

> any trade or business that consists of any of the following (or any combination thereof): (A) A trade or business in which a person receives fees, compensation, or other income for endorsing products or services, (B) A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, (C) Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.[193]

The final section 199A regulations provide two examples, one involving a celebrity chef and another involving a well-known actor. In the first example,[194] the chef receives an endorsement fee for the use of their name on a line of cooking utensils and cookware. The regulations conclude that the chef's restaurant business is a trade or business that is not an SSTB, but the chef's endorsement business is an SSTB. In the other example,[195] the actor enters into a partnership with a shoe company, under which she contributes her likeness and the use of her name. The regulations conclude that the actor's income from the partnership is an SSTB.

G. QSB Defined

Under section 1202(d), a QSB is a domestic C corporation[196] that meets the following requirements (collectively, the aggregate gross asset requirement): (1) the aggregate gross assets of the corporation (or any predecessor) "at all times" on or after August 10, 1993, and before the issuance did not exceed $50 million;[197] and (2) the aggregate gross assets of the corporation "immediately after the issuance (determined by taking into account amounts received in the issuance)" do not exceed $50 million.[198] Aggregate

[189] *Id.*
[190] Reg. section 1.199A-5(b)(2)(x).
[191] *Id.*
[192] Reg. section 1.199A-5(b)(2)(xi).
[193] Reg. section 1.199A-5(b)(2)(xiv).
[194] Reg. section 1.199A-5(b)(3)(xv), Example 15.
[195] Reg. section 1.199A-5(b)(3)(xvi), Example 16.
[196] Section 1202(d)(1).
[197] Section 1202(d)(1)(A).
[198] Section 1202(d)(1)(B).

gross assets means the "amount of cash and the aggregate adjusted bases of other property held by the corporation."[199] However, for this purpose, the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of the contributed property) is determined as if the basis of the contributed property (immediately after the contribution) were equal to its FMV at the time of the contribution.[200]

On the other hand, unrealized appreciation in an asset that is contributed in a section 351 exchange that qualifies as a purchase of section 1202 stock is not ignored — and it may need to be permanently taken into account going forward. For example, consider a controlling shareholder who contributed property (not stock) to a newly formed corporation. The property had an adjusted tax basis of $20 million and an FMV of $40 million. The shares issued in that contribution would be eligible for QSBS status, in part because the adjusted basis of the company assets was $40 million — less than the $50 million threshold. If, however, the company later raises $30 million of cash in a single round of equity financing, the company's tax basis in its assets immediately after the capital raise would be $70 million, and none of those shares would qualify for QSBS treatment, even though books would show only $30 million of cash on the balance sheet. This information is often not readily available in normal financial statements, and advisers need to be alert to this issue to avoid foot faults.

The "at all times" language requires taxpayers to be vigilant about the size and timing of different rounds of financing. By way of example, if a corporation is expected to need $60 million in funds, rather than doing a single round of financing (none of which would be considered a QSB because it violates the aggregate gross asset requirement), the corporation could do an initial round at $40 million and a second round at $20 million. The initial round would presumably qualify for QSBS status (assuming all other requirements are met), and the second round may or may not. It depends on whether the corporation's aggregate gross assets exceeded $50 million before and after the second issuance.

Read literally, the "at all times" requirement would require that the corporation meet the aggregate gross asset requirement not only when that stock is issued but also every day in between issuances. Although unrecognized appreciation in corporate assets will not alone cause a corporation to exceed the aggregate gross asset requirement because the $50 million figure is based generally on adjusted basis, a taxable sale of assets and revenue might cause the corporation to exceed the cap, perhaps just temporarily. For example, a corporation has cash and assets with an aggregate tax basis equal to $45 million. The FMV of the corporation's assets is $60 million. Assuming no appreciated property was contributed to the corporation, the corporation still meets the aggregate gross asset requirement. The corporation sells an asset that has a tax basis of $5 million for $11 million of cash, resulting in an increase of $6 million of cash at closing. Because the aggregate gross asset requirement ignores liabilities, the $6 million increase in cash causes the calculation to increase to $51 million, even though the net after-tax figure would increase the figure to only $49.74 million ($6 million gain minus 21 percent corporate income tax liability equals $4.74 million net after-tax proceeds). Can this really mean that the corporation has violated the aggregate gross asset requirement, and all future stock issuances of stock would no longer be considered QSBS? Does "at all times" truly mean each day, or can corporations satisfy this requirement if they are able to show that they meet the requirement on average or at the end of fiscal year in between issuances and at the time of issuances? Again, some IRS guidance would be appreciated.

Although the aggregate gross asset requirement is sometimes interpreted to mean that only corporations that have assets of $50 million in value or less can issue QSBS-eligible stock, that is not technically correct. For example, a series of investors contribute $20 million of cash in exchange for shares in a newly formed corporation. The shares received would obviously not violate the aggregate gross asset requirement. Assume that the cash is invested in property that

[199] Section 1202(d)(2)(A).

[200] Section 1202(d)(2)(B).

appreciates to $50 million in value. In a second round of financing, investors contribute an additional $30 million in exchange for additional shares in the corporation. Although the corporation at that time would already have assets valued at $80 million after this issuance, the shares received in the second round would still be eligible for QSBS status. The appreciation occurring within the corporation is ignored for purposes of the calculation.

On the other hand, unrealized appreciation in an asset that is contributed in a section 351 exchange is not ignored. For example, a controlling shareholder contributes property to a newly formed corporation. The property has an adjusted tax basis of $20 million and an FMV of $40 million. The shares issued in this contribution would be eligible for QSBS status. If, however, the shareholder subsequently contributes an additional $30 million of cash to the corporation, the shares received in this additional round of financing would violate the aggregate gross asset requirement, and these shares would not be eligible for QSBS treatment. As discussed later, a conversion of a passthrough entity like a partnership to a C corporation is, in effect, a contribution of the partnership assets to a newly formed C corporation in exchange for the shares of the corporation in a section 351 exchange. Under those circumstances, taxpayers need to be sure that the value of the partnership property at the time of conversion has a value of $50 million or less. If the assets are more than $50 million in value, none of the shares received in the exchange will be eligible for QSBS treatment.

For purposes of determining whether a corporation is a QSB, all corporations that are part of the same parent-subsidiary controlled group as defined in section 1563(a)(1) are treated as one corporation, except that "more than 50 percent" is substituted for the "at least 80 percent" requirement in that section. As such, a parent-subsidiary controlled group means one or more corporations connected through stock ownership with a common parent if (1) stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote (or more than 50 percent of the total value of shares of all classes of stock of each of the corporations), except the common parent corporation, is owned by one or more of the other corporations; and (2) the common parent corporation owns stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote (or more than 50 percent of the total value of shares of all classes of stock of at least one of the other corporations), excluding, in computing that voting power or value, stock owned directly by those other corporations.[201]

The parent-subsidiary controlled group restriction prevents a parent corporation with assets greater than $50 million from avoiding a violation of the aggregate gross asset requirement by contributing assets to other corporations in exchange for stock in that corporation. The aggregate gross asset requirement and the parent-subsidiary limitation apply only to corporations, not to passthrough entities (for example, upper- and lower-tier partnerships). Further, there is no corresponding rule under section 1202 for a brother-sister controlled group, as defined in section 1563(a)(2).[202]

Section 1202(d)(1)(C) includes an additional qualification: To be considered a QSB, a corporation must agree "to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section."[203] Under section 6652(k), if a corporation fails to make the report that contains the required information on the date prescribed (determined with regard to any extension of time for filing), it is subject to a penalty of $50 (per year covered). If the failure is attributable to negligence or intentional disregard, the penalty is $100. However, no penalty will be imposed for a failure that is shown to be attributable to reasonable cause and not willful neglect.[204]

[201] In applying these tests, stock ownership includes constructive ownership under section 1563(d)(1) (constructive ownership from options and attribution from partnerships, estates, and trusts). *See* section 1563(e). Also, affiliated companies are not treated as a separate group for purposes of the QSB test. Section 1202(d)(3)(B).

[202] "Two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own . . . stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation." Section 1563(a)(2).

[203] Section 1202(d)(1)(C).

[204] Section 6652(k).

H. Tax-Free Exchanges

If a taxpayer exchanges QSBS for other stock in a transaction described in section 351 (contributions to a controlled corporation) or section 368 (corporate reorganizations), the taxpayer will retain QSBS status over the newly acquired stock, even if the newly acquired stock is not otherwise QSBS.[205] If the newly acquired stock is not QSBS, the section 1202(a) exclusion will apply only to the extent of the gain that would have been recognized at the time of the transfer "if section 351 or 368 had not applied at such time."[206] In other words, the gain exclusion benefits are capped at the amount of gain rolled into the non-QSBS, determined at the time of the exchange. For example, QSBS is exchanged for shares in a non-QSBS company, and the unrealized gain is $1 million at that time. If those newly acquired shares are then sold and the taxpayer recognizes $1.5 million in gain, $1 million will be excluded section 1202 gain, and $500,000 will be non-section 1202 gain (taxable at 23.8 percent). If the newly acquired stock is QSBS, all those shares will be entirely QSBS.[207]

There is no limit to the number of section 351 and section 368 transactions under which QSBS status will be preserved. However, after the first exchange of QSBS for non-QSBS, stock received in any subsequent transaction will be subject to the limitation noted above based on the first exchange for non-QSBS.[208] For a transaction described in section 351, the preservation of QSBS status will apply only if, immediately after the transaction, the corporation issuing the stock owns, directly or indirectly, stock representing control of the corporation whose stock was exchanged.[209] Control is defined as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."[210] In other words, the issuing corporation must, after the transaction, hold at least 80 percent of the contributed QSB corporation.

If the newly acquired stock qualifies as QSBS, the foregoing limitations on the exclusion benefit do not apply (other than the per-issuer limitation). As such, an exchange in a reorganization described in section 368(a)(1)(F) ("a mere change in identity, form, or place of organization of one corporation, however effected") would extend QSBS status without any limitations.[211] Section 1202(h)(3) provides that "rules similar to the rules of section 1244(d)(2) shall apply for purposes of this section." Section 1244(d)(2) provides, in part, that a successor corporation in a reorganization described in section 368(a)(1)(F) will be treated as the same corporation as its predecessor.

Section 1202(f) provides that if any stock in a corporation is acquired solely through the conversion of other stock in the corporation that is QSBS in the hands of the taxpayer, (1) the acquired stock will be treated as QSBS in the hands of the taxpayer, and (2) it will be treated as having been held during the period during which the converted stock was held. As such, an exchange of stock in a reorganization described in section 368(a)(1)(E) (a recapitalization) would extend QSBS status without any limitation.

If the stock received in an exchange described in section 351 or any other section 368 reorganization is also QSBS, QSBS status is extended without limitation (provided the additional control requirement is met).[212] The IRS has ruled favorably on a divisive D reorganization under sections 368(d)(1)(D) and 355. In that ruling, the QSB (Distributing) formed a new corporation (Controlled), contributed one of Distributing's lines of business into Controlled, and then spun Controlled off to some of the shareholders of Distributing. The IRS ruled that stock of Controlled received by the Distributing shareholders would remain QSBS under section 1202(h)(4)(A), and the shareholders would be able to tack the holding period in Distributing to their Controlled stock.[213] ■

[205] Section 1202(h)(4)(A).

[206] Section 1202(h)(4)(B).

[207] *Id.*

[208] Section 1202(h)(4)(C).

[209] Section 1202(h)(4)(D).

[210] Section 368(c).

[211] LTR 201603011, LTR 201603010, and LTR 201636003.

[212] Section 1202(h)(4)(A).

[213] LTR 9810010.