Qualified Small Business Stock: Quest For Quantum Exclusions, Part 2

by Paul S. Lee, L. Joseph Comeau, Julie Miraglia Kwon, and Syida C. Long

Paul S. Lee

L. Joseph Comeau

Julie Miraglia Kwon

Syida C. Long

Paul S. Lee is the global fiduciary strategist for The Northern Trust Company, L. Joseph Comeau is a managing director at Andersen, Julie Miraglia Kwon is a partner at McDermott Will & Emery LLP, and Syida C. Long is a managing director at Goldman Sachs & Co. LLC. The authors thank Daniel Zucker, Gary Karch, Kevin Hall, Alejandro Ruiz, and Harry Dao of McDermott for their substantial guidance and assistance with this article.

In this three-part report, the authors analyze the section 1202 qualified small business stock (QSBS) exclusion and planning with QSBS. Part 1 reviewed the shareholder- and corporate-level qualifications under section 1202. This second installment examines the section 1045 rollover provisions for individual taxpayers and partnerships, QSBS planning with C corporation formations and passthrough entity conversions, federal reporting requirements, and state income tax treatment of QSBS. Part 2 of the report continues the discussion of shareholder and corporate qualifications, covering Section II, headers I through L.

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I. Section 1045 Rollover

1. Generally.

Section 1045 allows a taxpayer to sell qualified small business stock (QSBS) and defer the recognition of gain by rolling the proceeds of the first sale into a new acquisition of QSBS within 60 days of the sale. To qualify for the rollover, the taxpayer must have held the original QSBS for more than six months at the time of the sale, and the taxpayer must elect the application of section 1045 to the original sale.[1] If these conditions are met, the taxpayer has a 60-day period beginning on the date of the original sale to purchase the replacement QSBS.[2]

Section 1045 was enacted in 1997,[3] and originally this rollover provision applied only to individual taxpayers, which did not match the eligible qualified taxpayers under section 1202. In 1998 section 1045 was amended so that it applies to any "taxpayer other than a corporation,"[4] and that amendment became effective as though it had been included when the section was originally enacted.[5]

It seems that rollover under section 1045 can be used to multiply or stack the per-issuer limitation. By way of example, a taxpayer may be able to sell QSBS and exclude a portion of the gain, subject to the taxpayer's per-issuer limitation for the original QSBS. The portion of the gain that is not excluded (that is, the eligible gain that exceeds the taxpayer's per-issuer limitation for the tax year, the non-section 1202 gain) can be rolled over under section 1045. If the proceeds are used to purchase QSBS in three different replacement qualified small business (QSB) corporations, it seems that each replacement acquisition will be treated as a new issuance of QSBS under section 1202. Because the per-issuer limitation is calculated per corporation,[6] the taxpayer would seem to acquire three new per-issuer limitations in the replacement QSBS of each corporation. There do not seem to be any limitations under sections 1202 and 1045 to prevent this result.[7]

Rollover treatment is available to the noncorporate partners of a partnership that holds QSBS. Section 1045(b)(5) provides that rules similar to section 1202(g) dealing with passthrough entities will apply for purposes of rollover. Final regulations were issued on the availability of the section 1045 rollover election to partnerships and their eligible partners, applicable for sales of QSBS after August 13, 2007.[8] To date, regulations have not been issued under section 1202(g) regarding passthrough entities. It is unclear whether the regulatory guidance issued under section 1045 would also be applicable in the context of section 1202. These regulations and planning issues with partnerships are discussed later.

2. Calculating gain rollover.

Gain from the original sale will be recognized "only to the extent that the amount realized on such sale exceeds the cost of any qualified small business stock purchased by the taxpayer"[9] (within the 60-day period), reduced by any portion of that cost previously taken into account

[1] Section 1045(a).

[2] *See* section 1045(a)(1).

[3] *See* Taxpayer Relief Act of 1997, P.L. 105-34, section 313(a).

[4] Section 1045(a).

[5] *See* Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105-206, section 6005(f)(1).

[6] *See* section 1202(b)(1). As an aside, section 1045 rollover can only result in a reduction of basis in the replacement QSBS. Thus, the prohibition against any "addition to basis" is not violated. *See* section 1202(b) (flush language).

[7] Section 1045(b)(5) provides that "rules similar to the rules of subsections (f), (g), (h), (i), (j), and (k) of section 1202 shall apply." None of the foregoing subsections would seem to restrict the creation of a new per-issuer limitation.

[8] T.D. 9353.

[9] Section 1045(a) and (a)(1).

under section 1045.[10] To illustrate, consider the following examples:

Example 1: A acquires QSBS for $1 million. In the same year, but more than six months later, A sells the stock for $1.5 million, realizing a gain of $500,000. A month later, A purchases QSBS in another company for $1.5 million and elects rollover treatment under section 1045. A recognizes no gain.

Example 2: Same facts as Example 1, except A purchases $1.4 million of replacement QSBS in another company. A recognizes $100,000 in gain.

Example 3: B acquires two blocks of QSBS, the first block for $100,000 and a second block for $500,000. The following year, B sells the first block for $800,000 (realizing a gain of $700,000) and then sells the second block for $700,000 (realizing a gain of $200,000). A month later B acquires replacement QSBS for $1 million. If B elects rollover treatment, B will not recognize any gain on the sale of the first block of stock (thereby deferring $700,000 of gain). On the second sale, the maximum amount that can be recognized is the excess of the amount realized of $700,000 over the cost of the new QSBS reduced by the cost previously taken on the first sale, which is $200,000 ($1 million - $800,000). Under the formula of section 1045(a), no more than $500,000 can be recognized, but the second sale resulted only in $200,000 of gain. As a result, B recognizes $200,000. The end result is: (1) B invested $600,000 in the first QSBS company; (2) sold that investment for $1.5 million; (3) reinvested $1 million in a second QSBS company, retaining $500,000 in cash; and (4) recognized only $200,000 in gain.

Example 4: Same facts as Example 3, except B sells the second block first (realizing $200,000 of gain), followed by a sale of the first block (realizing $700,000 of gain). B will not recognize any gain on the sale of the second block of stock (thereby deferring $200,000 of gain). For the sale of the first block, under the formula of section 1045(a), the maximum amount that can be recognized is the amount realized of $800,000 over the cost of the new QSBS reduced by the cost previously taken on the previous sale, which is $300,000 ($1 million - $700,000), so B will recognize $500,000 of gain on the sale of the first block. The end economic result here is the same as in Example 3, except B recognized $500,000 of gain, rather than $200,000.

As one can see, under the basis rules applicable to the sale of stock, if a taxpayer is practicing separate lot accounting on adequately identified blocks of stocks,[11] the taxpayer can avoid the result in Example 4 by ensuring that the first block is sold before the second block. If the taxpayer fails to adequately identify the lots sold in each transaction, a first-in, first-out accounting convention is used to determine gain or loss,[12] which would have negated the result in Example 4.

3. Rollover basis rules.

When a taxpayer elects to roll over proceeds of a sale of QSBS, to the extent that gain goes unrecognized, it reduces the taxpayer's adjusted basis in the replacement QSBS.[13] If the taxpayer purchases replacement QSBS in more than one transaction, the basis reduction is applied in the order acquired.[14] To illustrate, in Example 3, B's new basis in the replacement QSBS is $300,000. The cost for the replacement QSBS is $1 million, which is then reduced by the amount of the unrecognized gain of $700,000. Section 1045 did not defer any of the gain on the subsequent sale of the second block of stock. In Example 4, B's new basis in the replacement stock is $600,000 ($1 million - $200,000 unrecognized gain from the sale of the second block - $200,000 of unrecognized gain from the sale of the first block).

4. Holding period rules.

As mentioned, to qualify for rollover under section 1045, the taxpayer must have held the QSBS for more than six months before the sale. The code provides two modifications: (1) the

[10] Section 1045(a)(2).

[11] *See* reg. section 1.1012-1(c).

[12] Reg. section 1.1012-1(c)(1)(i). The election to use the average basis method is likely unavailable to shareholders of a QSBS because the regulations provide that it applies only to identical shares of stock (requiring a Committee on Uniform Security Identification Procedures number or other security identifier number as permitted in published guidance of general applicability, like a private placement number) deposited with a custodian in connection with a dividend reinvestment plan. *See* reg. section 1.1012-1(e).

[13] Section 1045(b)(3).

[14] *Id.*

taxpayer's holding period for that stock is determined without regard to section 1223; and (2) only the first six months of the taxpayer's holding period in the stock is taken into account in applying section 1202(c)(2). To the extent gain from the sale of QSBS is rolled over under section 1045, for the holding period of the replacement QSBS, the code provides:

> In determining the period for which the taxpayer has held property the acquisition of which resulted under section 1045 . . . in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period for which such other property has been held as of the date of such sale.[15]

5. Rollover election (other than a partnership).

To get the rollover benefits, the taxpayer must make an election on or before the due date (including extensions) for filing the income tax return for the tax year in which the QSBS is sold.[16] A taxpayer must report the sale on Form 8949, "Sales and Other Dispositions of Capital Assets," as if the taxpayer is not making the rollover election. The taxpayer must then file Schedule D accordingly. The instructions for Schedule D provide that if a rollover election is made, the taxpayer should "enter the amount of postponed gained as a negative number" in column (g).[17] A taxpayer who has more than one sale of QSBS in a tax year may make a rollover election for any or all of the sales.[18] The election is revocable only with the prior written consent of the IRS, which a taxpayer must obtain by submitting a request for a private letter ruling.[19]

6. Partnership regulations.

a. Generally.

As mentioned, final regulations were issued on the availability of the section 1045 rollover election to partnerships and their eligible partners.[20] These regulations use particular terms that should be noted. It refers to QSBS as "QSB stock" and clarifies that it "does not include an interest in a partnership that purchases or holds QSB stock."[21] The term "replacement QSB stock" is any QSBS purchased within 60 days beginning on the date of a sale of QSBS.[22] An "eligible partner" is a "taxpayer other than a C corporation that holds an interest in a partnership on the date the partnership acquires the QSB stock and at all times thereafter for more than 6 months until the partnership sells or distributes the QSB stock."[23] For purposes of the foregoing, a taxpayer "who acquires from a partner (other than a C corporation) by gift or at death an interest in a partnership that holds QSB stock is treated as having held the acquired interest in the partnership during the period the partner (other than a C corporation) held the interest in the partnership."[24] The regulations provide that these terms apply for purposes of section 1045, but the terms "by gift" and "at death" are likely references to transfers under section 1202(h)(2)(A) and (B). A "purchasing partnership" is a partnership, different from the partnership selling the QSBS (1) that purchases replacement QSBS and (2) in which the taxpayer is "partner (directly or through an upper-tier partnership) on the date on which the partnership acquires the replacement QSB stock."[25] A "selling partnership" is a partnership that sells QSBS.

Under the regulations, if a partnership is involved in the purchase or sale of QSBS, there are three options under which a taxpayer can get the benefits of rollover under section 1045:

1. "a partnership that holds QSB stock . . . for more than 6 months, sells such QSB stock, and purchases replacement QSB stock may elect to apply section 1045;"[26]

[15] Section 1223(13).

[16] Rev. Proc. 98-48, 1998-2 C.B. 367, section 3.01.

[17] *See* 2017 Instructions for Schedule D, "Capital Gains and Losses," and 2017 Instructions for Form 8949.

[18] Rev. Proc. 98-48, section 3.03.

[19] *See* Rev. Proc. 98-1, 1998-1 C.B. 7, and Rev. Proc. 2018-1, 2018-1 IRB 1 (the current version of the revenue procedure).

[20] T.D. 9353.

[21] Reg. section 1.1045-1(g)(1).

[22] Reg. section 1.1045-1(g)(2).

[23] Reg. section 1.1045-1(g)(3)(i). The regulations also provide rules for tiered partnerships under which the upper-tier (parent) partnership is disregarded and the partners of the upper-tier partnership are treated as owning an interest in the lower-tier partnership directly. *See* reg. section 1.1045-1(g)(3)(iii) and (iv).

[24] Reg. section 1.1045-1(g)(3)(ii).

[25] Reg. section 1.1045-1(c)(1)(i).

[26] Reg. section 1.1045-1(a).

2. "an eligible partner . . . of a partnership that sells QSB Stock may elect to apply section 1045 if the eligible partner purchases replacement QSB stock directly or through a purchasing partnership;"[27] and
3. "a taxpayer (other than a C corporation) that holds QSB stock for more than 6 months, sells such QSB stock, and purchases replacement QSB stock through a purchasing partnership, may elect to apply section 1045."[28]

The section 1045 election, whether made by a partnership, eligible partner, or taxpayer, is revocable only with the prior written consent of the IRS, which the person who made the election must obtain by submitting a request for a private letter ruling.[29]

b. Partnership section 1045 election.

If a partnership elects to apply section 1045 (the first option noted above), each eligible partner will not recognize its distributive share of any partnership section 1045 gain.[30] Partnership section 1045 gain is equal to the partnership's gain from the sale of the QSB stock reduced by the greater of (1) any amount of gain from the sale of the QSBS that is treated as ordinary income;[31] or (2) the excess of the amount realized by the partnership on the sale over the total cost of all replacement QSBS purchased by the partnership (excluding the cost of any replacement QSBS purchased by the partnership that is otherwise taken into account under section 1045).[32]

A partner's distributive share of the partnership section 1045 gain "shall be in the same proportion as the partner's distributive share of the partnership's gain from the sale of the QSB stock."[33] These amounts are determined without regard to basis adjustments under section 743(b) (inside basis adjustments upon the sale of a partnership interest or the death of a partner) and reductions in the basis of replacement QSBS, discussed later.[34] An inside basis adjustment under section 743(b) is inappropriate in the context of QSBS because allowable transfers during lifetime must be by gift, and although transfers at death are permissible, basis adjustments under section 1014 (or any adjustments after original issuance) are ignored for section 1202 purposes.[35]

The regulations provide that the adjusted basis of an eligible partner's interest in the partnership (outside basis) will not be increased under section 705(a)(1) by gain from a partnership's sale of QSBS that is not recognized by the partner as the result of a partnership election under section 1045.[36] This is appropriate because if the entire amount realized on the sale of QSBS stock is rolled over to replacement QSBS, no gain will be recognized and, by definition, no sale proceeds would be available for distribution to the partner. In contrast, if a partnership sells QSBS for cash and all the gain is eligible for a 100 percent exclusion under section 1202(a)(4), the excluded gain will result in an increase in outside basis under section 705(a)(1)(B) (increase in outside basis for partner's distributive share of partnership income exempt from tax).

For purposes of determining the partnership's basis in replacement QSBS, the regulations provide that the basis is "reduced (in the order acquired) by the amount of gain from the partnership's sale of QSB stock that is not recognized by an eligible partner as a result of the partnership's election under section 1045."[37] This rule mirrors the same rule provided in section 1045(b)(3), discussed earlier. However, the regulations clarify that this basis reduction in the replacement QSBS is "with respect to that partner

[27] *Id.*

[28] *Id.*

[29] *Id. See* Rev. Proc. 2007-1, 2007-1 C.B. 1, and Rev. Proc. 2018-1 (the current version of the revenue procedure).

[30] Reg. section 1.1045-1(b)(1).

[31] Reg. section 1.1045-1(b)(1)(i). This provision mirrors the flush language of section 1045(a), which provides that the nonrecognition of gain will not apply to "any gain which is treated as ordinary income for purposes of this title."

[32] Reg. section 1.1045-1(b)(1)(ii). This provision mirrors the calculation in section 1045(a)(1) and (2) if the amount realized exceeds the cost of any QSBS purchased by the taxpayer, reduced by any portion of that cost previously taken into account under the section.

[33] Reg. section 1.1045-1(b)(2).

[34] *Id.*

[35] *See* section 1202(h)(2)(A) and (B); section 1202(b)(1) (flush language); and reg. section 1.1045-1(g)(3)(ii).

[36] Reg. section 1.1045-1(b)(3)(i).

[37] Reg. section 1.1045-1(b)(3)(ii)(A).

only"[38] under the modified principles set forth in reg. section 1.743-1(g), (h), and (j).

As mentioned, inside basis adjustments under section 743(b) relate to a sale of a partnership interest or the death of a partner that results in a disparity between the outside basis of the transferee and the transferee's share of the partnership's basis in its assets (inside basis). Under both circumstances, the transferee receives an outside basis equal to the cost of the purchase or equal to the fair market value of the partnership interest.[39] When a section 754 election is in effect, section 743(b) adjusts for those disparities by making notional adjustments in the transferee partner's share of partnership property. These adjustments are applicable only to the transferee. As such, inside basis adjustments under section 743(b) do not change or affect capital accounts,[40] and because the adjustments apply only to the transferee, they are not made to the common basis of the partnership.[41] The partnership will compute its taxable income, gain, loss, and deduction without regard to the inside basis adjustments under section 743(b), and then allocate these amounts among all the partners under the principles of section 704(b). At this point, the inside basis adjustments then come into consideration. The partnership will adjust the transferee partner's distributive share of income, gain, loss, and deduction to reflect the adjustments.

For example, if the partnership sells an asset that has an inside basis adjustment, the amount of the adjustment will reduce or increase the transferee's distributive share of the gain or loss from the sale of the asset.[42] Also, if a positive adjustment is made to depreciable (or amortizable) property, the adjustment will increase the transferee's share of depreciation (or amortization) from that property. In effect, the transferee is treated as if he or she purchased new property for a price equal to the adjustment.[43]

With these principles in mind, the regulations provide that the basis adjustment that carries over to the replacement QSBS will be reduced (but not below zero) by the eligible partner's distributive share of the excess, if any, of the greater of the reductions to QSBS basis, mentioned earlier, over the partnership's gain from the sale of the QSBS (determined without regard to basis adjustments under section 743 or reductions in the basis of replacement QSBS).[44] This excess amount that reduces the basis adjustment will be accounted for as gain in accordance with reg. section 1.743-1(j)(3).[45]

The regulations provide a detailed example that is worth reproducing because it shows how the inside and outside basis adjustments would work with both eligible and non-eligible partners[46]:

> Partnership sale of QSB stock and purchase and sale of replacement QSB stock. (i) On January 1, 2008, A, an individual, X, a C corporation, and Y, a C corporation, form PRS, a partnership. A, X, and Y each contribute $250 to PRS and agree to share all partnership items equally. PRS purchases QSB stock for $750 on February 1, 2008. On November 3, 2008, PRS sells the QSB stock for $1,500. PRS realizes $750 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates $250 of gain to each of A, X, and Y. PRS purchases replacement QSB stock (replacement QSB1 stock) for $1,350 on December 15, 2008. On its timely filed return for the taxable year during which the sale of the QSB stock occurs, PRS makes an election

[38] *Id.*

[39] "The basis of a partnership interest acquired from a decedent is the [FMV] of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of section 1.706-1 and paragraph (b) of section 1.753-1) under section 691." Reg. section 1.742-1.

[40] Reg. section 1.704-1(b)(2)(iv)(m).

[41] Reg. section 1.743-1(j)(1). There is a limited exception for specified distributions to a transferee partner. *See* reg. section 1.734-2(b)(1).

[42] Reg. section 1.743-1(j)(3).

[43] Reg. section 1.743-1(j)(4).

[44] Reg. section 1.1045-1(b)(3)(ii)(A).

[45] "The amount of a transferee's income, gain, or loss from the sale or exchange of a partnership asset in which the transferee has a basis adjustment is equal to the transferee's share of the partnership's gain or loss from the sale of the asset . . . minus the amount of the transferee's positive basis adjustment for the partnership asset . . . or plus the amount of the transferee's negative basis adjustment for the partnership asset." Reg. section 1.743-1(j)(3).

[46] Reg. section 1.1045-1(i), Example 5.

to apply section 1045. A does not make an election to apply section 1045 with respect to the November 3, 2008, sale of QSB stock. PRS knows that X and Y are C corporations. On March 30, 2009, PRS sells replacement QSB1 stock for $1,650. PRS realizes $300 of gain from the sale of replacement QSB1 stock (none of which is treated as ordinary income) and allocates $100 of gain to each of A, X, and Y. A does not make an election to apply section 1045 with respect to the March 30, 2009, sale of replacement QSB1 stock.

(ii) Under paragraph (b)(1) of this section, the partnership section 1045 gain from the November 3, 2008, sale of QSB stock is $600 ($750 gain less $150 ($1,500 amount realized on the sale of QSB stock less $1,350 cost of replacement QSB1 stock)). This amount must be allocated among the partners in the same proportions as the entire gain from the sale of QSB stock is allocated to the partners, ⅓ ($200) to A, ⅓ ($200) to X, and ⅓ ($200) to Y.

(iii) Because neither X nor Y is an eligible partner under paragraph (g)(3) of this section, X and Y must each recognize its $250 distributive share of partnership gain from the sale of QSB stock. Because A is an eligible partner under paragraph (g)(3) of this section, A may defer recognition of A's $200 distributive share of partnership section 1045 gain. A is not required to separately elect to apply section 1045. A must recognize A's remaining $50 distributive share of the partnership's gain from the sale of QSB stock.

(iv) Under section 705(a)(1), the adjusted bases of X's and Y's interests in PRS are each increased by $250. Under section 705(a)(1) and paragraph (b)(3)(i) of this section, the adjusted basis of A's interest in PRS is not increased by the $200 of partnership section 1045 gain that was not recognized by A, but is increased by A's remaining $50 distributive share of gain.

(v) PRS must decrease its basis in the replacement QSB1 stock by the $200 of partnership section 1045 gain that was allocated to A. This basis reduction is a reduction with respect to A only. PRS then adjusts A's distributive share of gain from the sale of replacement QSB1 stock to reflect the effect of A's basis adjustment under paragraph (b)(3)(ii) of this section. In accordance with the principles of [reg.] section 1.743-1(j)(3), the amount of A's gain from the March 30, 2009, sale of replacement QSB1 stock in which A has a $200 negative basis adjustment equals $300 (A's share of PRS' gain from the sale of replacement QSB1 stock ($100), increased by the amount of A's negative basis adjustment for replacement QSB1 stock ($200)). Accordingly, upon the sale of replacement QSB1 stock, A recognizes $300 of gain, and X and Y each recognize $100 of gain.

(vi) Assume the same facts as in paragraph (i) of this Example 5, except that PRS purchases replacement QSB stock (replacement QSB2 stock) on April 15, 2009, for $1,150 and PRS makes an election to apply section 1045 with respect to the March 30, 2009, sale of replacement QSB1 stock. Under paragraph (b)(3)(ii)(A) of this section, PRS' $200 basis adjustment in QSB1 stock relating to the November 3, 2008, sale of QSB stock carries over to the basis adjustment for QSB2 stock. This basis adjustment is an adjustment with respect to A only. The $200 basis adjustment is reduced by A's distributive share of the excess of $500 (the greater of the amount determined under paragraph (b)(1)(i), $0, or (ii) of this section, $500 ($1,650 amount realized on the sale of QSB1 stock less $1,150 cost of replacement QSB2 stock)) over $300 (PRS' gain from the sale of QSB1 stock), or $67 ($200 ($500 minus $300) divided by 3). Under paragraph (b)(3)(ii)(A), A must account for the $67 excess amount that reduces PRS' basis adjustment in QSB2 stock as gain in accordance with [reg.] section 1.743-1(j)(3). Therefore, A now has a $133 negative basis adjustment with respect to replacement QSB2 stock (($200) negative basis adjustment from the November 3, 2008, sale of QSB stock plus $67 positive basis adjustment from the March 30, 2009, sale of QSB1 stock). A also recognizes the $100 of gain allocated by PRS to A from the March 30, 2009, sale of replacement QSB1 stock for total gain recognition of $167 ($100 plus $67).

As the foregoing example points out, eligible partners and non-eligible partners are treated very differently. To that end, the regulations provide: "A partnership must presume that a partner did not recognize that partner's distributive share of the partnership section 1045 gain as a result of the partnership's section 1045 election unless the partner notifies the partnership to the contrary."[47] If a partnership knows that a particular partner is classified as a C corporation for federal tax purposes, the partnership may presume that the partner did not defer recognition of its distributive share of the partnership section 1045 gain, even in the absence of notification by the partner.[48] If a partnership makes an election under section 1045, but an eligible partner opts out of the election and provides notification to the partnership, no basis adjustments are required for that partner.[49]

If a partnership makes any adjustments for replacement QSBS, it must attach a statement to the partnership tax return setting forth the computation of the adjustment, the replacement QSBS to which the adjustment is made, the date on which the QSBS was acquired by the partnership, and the amount of the adjustment that is allocated to each partner.[50] Further, a partnership that makes a section 1045 election must notify all its partners of the election and of the purchase of replacement QSBS "in accordance with the applicable forms and instructions, and separately state each partner's distributive share of partnership section 1045 gain from the sale of QSB stock under section 702."[51] Each partner is required to determine whether it is an eligible partner and report its distributive share of partnership section 1045 gain, including gain not recognized.[52] Any partner that must recognize all or any part of the partner's distributive share of partnership section 1045 gain "must notify the partnership, in writing, of the amount of partnership section 1045 gain that is recognized by the partner."[53]

An eligible partner may opt out of a partnership section 1045 election "either by recognizing the partner's distributive share of the partnership section 1045 gain, or by making a partner section 1045 election"[54] (discussed later). If an eligible partner opts out, it is required to notify the partnership, in writing, that it is opting out.[55]

c. Partner section 1045 elections.

A partner can elect to apply section 1045 in three specified circumstances[56]:

1. an eligible partner of a selling partnership may elect to apply section 1045 if the eligible partner directly purchases replacement QSBS;
2. an eligible partner of a selling partnership may elect to apply section 1045 if replacement QSBS is purchased through a purchasing partnership; and
3. a taxpayer other than a C corporation that sells QSBS held for more than six months at the time of the sale may elect to apply section 1045 if replacement QSBS is purchased by a purchasing partnership (including a selling partnership).

Subject to the nonrecognition limitation, defined later, if an eligible partner of a selling partnership elects to apply section 1045 to a direct purchase of replacement QSBS, the eligible partner must recognize its distributive share of gain from the sale of QSBS by the selling partnership only to the extent of the greater of (1) the amount of the eligible partner's distributive share of the selling partnership's gain from the sale of the QSBS that is treated as ordinary income; or (2) the "excess of the eligible partner's

[47] Reg. section 1.1045-1(b)(3)(ii)(A).

[48] *Id.*

[49] *Id.* The regulations also provide rules for tiered partnerships that require the basis adjustments to be segregated and allocated to the eligible partner. *See* reg. section 1.1045-1(b)(3)(ii)(B).

[50] Reg. section 1.1045-1(b)(3)(ii)(C).

[51] Reg. section 1.1045-1(b)(5)(i).

[52] *Id.*

[53] Reg. section 1.1045-1(b)(5)(ii).

[54] Reg. section 1.1045-1(b)(4).

[55] Reg. section 1.1045-1(b)(5)(ii).

[56] Reg. section 1.1045-1(c)(1).

share of the selling partnership's amount realized on that partnership's sale of the QSB stock (excluding the cost of any replacement QSB stock purchased by the selling partnership) over the cost of any replacement QSB stock purchased by the eligible partner (excluding the cost of any replacement QSB stock that is otherwise taken into account under section 1045)."[57]

The eligible partner's share of the amount realized by the selling partnership on the sale of QSBS (excluding the cost of any replacement QSBS otherwise taken into account under section 1045) is equal to the partnership's amount realized multiplied by a fraction, the numerator of which is the eligible partner's distributive share of the partnership's realized gain from the sale of the QSBS, and the denominator of which is the partnership's realized gain on the sale of the QSBS.[58] The regulations also provide a modification of the foregoing if the purchasing partnership does not realize a gain or realizes a loss from the subsequent sale of replacement QSBS and if the eligible partner's interest in the purchasing partnership is reduced after the sale of QSBS and the purchasing partnership realizes a gain from the sale of replacement QSBS.[59]

Subject to the nonrecognition limitation, if an eligible partner elects to apply section 1045 to replacement QSBS purchased by a purchasing partnership, the eligible partner must recognize its distributive share of gain from the selling partnership's sale of QSBS (and gain from the subsequent sale of replacement QSBS)[60] only to the extent of the greater of (1) the amount of the eligible partner's distributive share of the selling partnership's gain from the sale of the QSBS that is treated as ordinary income; or (2) the excess of the eligible partner's share of the selling partnership's amount realized on its sale of the QSBS (excluding the cost of any replacement QSBS purchased by the selling partnership) over the cost of any replacement QSBS purchased by the eligible partner (excluding the cost of any replacement QSBS otherwise taken into account under section 1045).[61]

Subject to the nonrecognition limitation, if a taxpayer other than a C corporation elects to apply section 1045 to replacement QSBS purchased by a purchasing partnership, the taxpayer must recognize gain only to the extent of the greater of (1) the amount of gain from the sale of the QSBS that is treated as ordinary income; or (2) the excess of the amount realized by the taxpayer on the sale of the QSBS over the partner's share of the purchasing partnership's cost of the replacement QSBS (excluding the cost of any QSBS otherwise taken into account under section 1045).[62] For purposes of the foregoing, a partner's share of the cost of replacement QSBS purchased by a purchasing partnership is the percentage of the partnership's future income and gain, if any, "that is reasonably expected to be allocated to the partner (determined without regard to any adjustment under section 1045) with respect to the replacement QSB stock that was purchased by the partnership, multiplied by the cost of that replacement QSB stock."[63]

The amount of gain that an eligible partner does not recognize cannot exceed the nonrecognition limitation.[64] The nonrecognition limitation is equal to the product of (1) the partnership's realized gain from the sale of the QSBS, determined without regard to any basis adjustment under section 734(b) or 743(b)[65] (other than the inside basis adjustments described earlier); and (2) the eligible partner's "smallest percentage interest in partnership capital."[66] The latter is the partner's percentage share of capital determined at the time of the acquisition of the QSBS as adjusted before the QSBS is sold to reflect any reduction in the capital of the eligible partner, "including a reduction as a result of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the eligible partner or the transfer of an interest

[57] Reg. section 1.1045-1(c)(1)(ii)(B).

[58] Reg. section 1.1045-1(c)(2)(i).

[59] *See* reg. section 1.1045-1(c)(2)(ii) and (iii).

[60] *See* reg. section 1.1045-1(c)(5).

[61] Reg. section 1.1045-1(c)(1)(iii)(A)(2).

[62] Reg. section 1.1045-1(c)(1)(iii)(B)(2).

[63] Reg. section 1.1045-1(c)(3).

[64] Reg. section 1.1045-1(d)(1).

[65] Reg. section 1.1045-1(d)(1)(i).

[66] Reg. section 1.1045-1(d)(1)(ii).

by the eligible partner, but excluding income and loss allocations."[67]

The regulations provide that the outside basis of an eligible partner's interest in a selling partnership is increased by the partner's distributive share of gain.[68] If the selling partnership is also a purchasing partnership, the eligible partner's outside basis may be reduced.[69] Under reg. section 1.1045-1(c)(4)(ii), a partner's basis in any replacement QSBS that is purchased by the partner, as well as the adjusted basis of any replacement QSBS that is purchased by the purchasing partnership, must be reduced (in the order acquired) by the partner's distributive share of the gain on the sale of the selling partnership's QSBS that is not recognized by the partner, or by the gain on a sale of QSBS by the partner that is not recognized under section 1045, as applicable. If the purchasing partnership purchases replacement QSBS, that partnership maintains its adjusted basis in the replacement QSBS, but the eligible partner (in computing its distributive share of income, gain, loss, and deduction for the replacement QSBS) must take into account the variation between the adjusted basis in the QSBS (reduced as described previously) and the adjusted basis determined without the reduction.[70]

A partner that treats its interest in QSBS purchased by a purchasing partnership as the partner's replacement QSBS must reduce (in the order acquired) the adjusted basis of the partner's outside basis in the purchasing partnership by the partner's distributive share of the gain on the sale of the selling partnership's QSBS that the partner defers, or by the gain on a sale of QSBS by the partner that the partner defers under section 1045, as applicable.[71] The regulations provide that if the partner or the purchasing partnership sells or exchanges replacement QSBS, the amount recognized by the partner is determined by taking into account the basis adjustments described in reg. section 1.1045-1(c)(4)(ii).[72]

A partner making an election under section 1045 must do so on the partner's timely filed (including extensions) federal income tax return for the tax year during which the partner takes into account the partner's distributive share of the partnership's gain from the sale of the QSBS under section 706. Also, a partner making an election under section 1045 must do so in accordance with the applicable forms and instructions.[73]

J. C Corporation Formation or Conversion

1. Generally.

As noted, by definition, QSB and QSBS status require that the issuer of the stock be a C corporation. Further, QSBS must be acquired at its original issuance either in exchange for money or other property (other than stock) or as compensation for services provided to the corporation. When property is transferred to a C corporation in exchange for stock in the corporation, gain or loss is generally recognized by the contributing shareholder. The notable exception to this rule is outlined in section 351, generally describing transfers to controlled corporations.

QSBS companies are sometimes initially formed as C corporations, and the initial shareholders look to section 351 to avoid recognition of gain if appreciated property is contributed to the corporation in exchange for shares of its stock. More often than not, however, companies that eventually become QSBS companies start as limited liability companies, partnerships, or other business entities that are either taxed as partnerships or treated as disregarded entities for federal income tax purposes. These passthrough entities will often, for several business and tax reasons, eventually convert to C corporations. The owners of the passthrough entity also hope that the conversion

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[67] Reg. section 1.1045-1(d)(2). The regulations also provide that if an eligible partner owns an interest in a tired partnership, the eligible partner's percentage interest in the purchasing partnership must be proportionately adjusted to reflect the eligible partner's percentage interest in the upper-tier partnership. *See* reg. section 1.1045-1(d)(3).

[68] Reg. section 1.1045-1(c)(4)(i).

[69] *See* reg. section 1.1045-1(c)(4)(iii).

[70] *Id.*

[71] Reg. section 1.1045-1(c)(4)(iii).

[72] Reg. section 1.1045-1(c)(5). Also, a partner in an upper-tier partnership that owns an interest in a lower-tier partnership that holds replacement QSBS must take into account the same basis adjustments in determining the amount recognized by the partner on a sale of the interest in the lower-tier partnership by the upper-tier partnership or the partner's distributive share of gain from the upper-tier partnership.

[73] Reg. section 1.1045-1(h)(1).

itself will not be considered a recognition event for income tax purposes, often relying on section 351. A direct contribution of property to a C corporation in exchange for shares of stock and a conversion have many similarities, but there are some differences that should be noted.

2. Section 351.

Under section 351(a), no gain or loss is recognized by a transferor of property to a corporation solely in exchange for stock of the corporation (other than nonqualified preferred stock)[74] if immediately after the transfer, the transferor and all other persons who transfer property to the corporation are in control of the corporation. 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."[75]

If section 351(a) would apply but for the transferor's receipt of consideration (including nonqualified preferred stock) other than qualified stock of the transferee corporation, the transferor recognizes any gain realized up to the FMV of that other consideration (boot) but does not recognize any loss realized.[76] If a transferor transfers multiple properties and receives boot, the boot and the qualifying stock must be allocated pro rata among the different types of property transferred, and loss realized on the transfer of one property may not be offset against gain realized on the transfer of another property.[77]

If a shareholder transfers property that has a relatively small value compared with the value of the stock the shareholder already owns in the transferee corporation, that shareholder is not to be included in the group of transferors if the primary purpose of that shareholder's transfer of property is to qualify exchanges of property by other persons for stock in the corporation under section 351.[78] The IRS has ruled that it will not treat property as being relatively small in value compared with the value of the stock already owned if the FMV of the property transferred is at least 10 percent of the FMV of the stock already owned.[79]

If the issuing corporation assumes a liability of the transferor, the assumption generally is not treated as boot. For this purpose, taking property subject to a liability generally is treated as an assumption of the liability.[80] If, however, the amount of liabilities assumed exceeds the transferor's basis in the property transferred to the transferee corporation, the transferor generally must recognize gain equal to the excess of the liabilities assumed over the basis of the property.[81] For this purpose, the amount of liabilities assumed generally does not include a liability whose payment would be deductible or would be a distribution in liquidation of a partnership interest, unless the incurrence of a liability created or increased the basis of any property of the transferor.[82] If the transferor's principal purpose regarding the assumption of any liability either was to avoid federal income tax on the transfer or was not a bona fide business purpose, the total amount of the transferor's liabilities assumed is treated as boot.[83]

A transferor's basis in stock of the transferee corporation received by the transferor in a section 351 transaction generally is the same as the transferor's basis in the property or properties transferred to the corporation, reduced by (1) the amount of money received as boot; (2) the amount of liabilities assumed by the transferee corporation, excluding any liabilities not taken into account for purposes of applying section

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[74] *See* section 351(g)(2). Nonqualified preferred stock is stock that is (1) limited and preferred as to dividends; (2) does not participate in corporate growth to any significant extent; and (3) either (a) can be put to the issuer or a related person, (b) must be purchased by the issuer or a related person, (c) is callable by the issuer or a related person (and it is more likely than not on the issue date that the call will be exercised); or (d) has a dividend rate that varies with reference to interest rates, commodity prices, or other similar indices. The put, mandatory purchase obligation, or call will not cause stock to be considered nonqualified preferred stock if the right or obligation may not be exercised within 20 years after the issue date or is subject to a contingency that makes exercise a remote possibility. Section 351(g)(2)(A) and (B).

[75] *See* sections 351(a) and 368(c).

[76] Section 351(b).

[77] Rev. Rul. 68-55, 1968-1 C.B. 140.

[78] Reg section 1.351-1(a)(1)(ii).

[79] Rev. Proc. 77-37, 1977-2 C.B. 568.

[80] Section 357(a) and (d).

[81] Section 357(c).

[82] Section 357(c)(3).

[83] Section 357(b) and reg. section 1.357-1(c).

357(c), as discussed in the previous paragraph; and (3) the FMV of any other boot received, and increased by the amount of any gain recognized by the transferor.[84]

Section 358(h) provides that if, after applying the basis rules above, the basis of the stock received exceeds its FMV because, for example, the transferee corporation has assumed or otherwise has contingent liabilities not taken into account for federal income tax purposes, the basis of the stock received can be further reduced (but not below its FMV) to take into account contingent liabilities of the transferor assumed in the transaction.[85] This reduction, however, does not apply if the business (or substantially all the assets) with which the contingent liability is associated are transferred to the corporation.[86]

The corporation's basis in the property contributed by the transferor in a section 351 transaction is generally the same as the transferor's basis, increased by the amount of gain recognized by the transferor.[87] However, if the transferor recognizes gain as a result of the assumption of a liability, the transferee corporation's increase to the basis of the property to account for the gain recognized as a result of the liability assumption may not cause the corporation's basis to exceed the property's FMV.[88] Also, if the aggregate FMV of the property transferred by a transferor is less than the aggregate basis of the property, the transferee corporation's basis in the transferred property is limited to the property's aggregate FMV immediately after the transaction, unless both the transferor and the transferee corporation elect for the transferor's basis in the stock received in the transaction to be limited to its FMV.[89] This last provision is intended to prevent the transferee corporation and the transferor from both obtaining a deduction for the same built-in loss upon subsequent dispositions of the property transferred and the stock received in the section 351 transaction. Note that under section 1202(d), the aggregate gross asset requirement is based generally on the adjusted bases of corporate property, and if property is contributed to the corporation, for purposes of this requirement, that property will be deemed to have a basis equal to its FMV at the time of the contribution.[90] Thus, it seems that the foregoing election would not be required, by way of example, if the corporation's shareholders desired QSBS status but the corporation was at risk of violating the aggregate gross asset requirement because of excess basis above the FMV of contributed assets.

A transferor's holding period for stock received in a section 351 transaction is the same as the transferor's holding period for the property exchanged for the stock, if the property was a capital asset or section 1231 property (for example, real property and depreciable property used in a trade or business in the transferor's hands and held for more than one year).[91] The holding period for stock received for property that is not a capital asset or section 1231 property does not include the holding period of the transferred property. As a result, when a transferor transfers some property that is a capital asset or section 1231 property and other property that is not, the stock received will have a split holding period.[92] The transferee corporation's holding period for property received in a section 351 transaction includes the transferor's holding period for the property, because the corporation's basis in the property is determined by reference to the transferor's basis.[93] As discussed later, section 1223(1) (tacking of holding periods) should not apply in determining the acquisition date for QSBS purposes and does not apply for purposes of the five-year holding requirement.

The depreciation recapture rules of sections 1245 and 1250 do not require the recognition of gain in a section 351 transaction when the property is contributed to the corporation.[94] In contrast, the transfer of a debt instrument

[84] Section 358(a)-(d).

[85] Section 358(h).

[86] Section 358(h)(2).

[87] Section 362(a).

[88] Section 362(d).

[89] Section 362(e)(2).

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

[91] Section 1223(1).

[92] Rev. Rul. 85-164, 1985-2 C.B. 117.

[93] Section 1223(2).

[94] Sections 1245(b)(3) and 1250(d)(3); and reg. sections 1.1245-4(c) and 1.1250-3(c).

acquired at a market discount will cause taxation of the accrued but previously unrecognized market discount.[95]

A taxpayer who contributes multiple properties with different tax bases in a section 351 transaction will not be able to claim separate lot accounting on adequately identified blocks of stocks in the corporation. Separate lot accounting applies to stock that the taxpayer purchased or acquired on different dates or at different prices.[96] In a section 351 transaction, the IRS ruled, a taxpayer may not select specific items to be exchanged for particular stock or securities in order to allocate the high bases of specific assets to the securities received and the low bases of other assets to the stock received. The taxpayer must use the general rule of allocating according to relative FMVs.[97] This rule applies even if the transfers are made at different times, as long as they were part of a single integrated transaction. Exchanging for different classes of stock does not apparently change this rule. The regulations provide that if a transferor receives stock of more than one class, the basis of the property transferred to the corporation is allocated among all of the classes of stock received in proportion to the FMV of the stock of each class.[98] However, separate lot accounting is available over different rounds of funding, which would presumably be at different times (and not part of an integrated plan) and at different prices. Separate lot account or tracing (as it is sometimes coined) is available in some section 351 transactions, but only when stock is contributed to the issuing corporation.[99] By definition, however, QSBS status is available to stock in an original issuance in exchange for money or property, other than stock,[100] so these tracing rules are not available.

3. Conversion of passthrough entity.

a. Generally.

A C corporation conversion of an entity taxable as a partnership,[101] regardless of entity form, can be accomplished with a check-the-box election to be an association taxed as a corporation.[102] The election is considered a transfer of all the partnership's assets to the association (corporation) and a distribution of the corporate stock by the partnership to the partners (in liquidation of the partnership).[103] This, as discussed herein, is an assets-over transaction. When a state law corporation is preferred (for example, Delaware), Rev. Rul. 84-111, 1984 C.B. 88, provides that the taxpayer may choose among three options to effectuate the conversion to a corporation:

1. a transfer of assets by the partnership to the corporation in exchange for stock of the corporation, followed by a partnership liquidation (an assets-over transaction);
2. a liquidation of the partnership followed by a transfer of the assets by the partners to the corporation in exchange for stock of the corporation (an assets-up transaction); or
3. a transfer of all the partnership interests to the corporation followed by a liquidating distribution of the partnership assets to the corporation (an interests-up transaction).[104]

As one can see, each of the options generally involves a contribution of assets to a corporation in exchange for stock in the corporation, and assuming the other requirements are met, section 351 is available. Under most circumstances, the end result is that the original partners receive shares in the new C corporation equal to the

[95] Section 1276(d)(1)(C).

[96] *See* reg. section 1.1012-1(c).

[97] Rev. Rul. 85-164.

[98] Reg. section 1.358-2(b)(2) and prop. reg. section 1.358-1(g) ("the aggregate basis of the property transferred shall be allocated among all of the shares of stock received in proportion to the fair market values of each share of stock").

[99] Prop. reg. section 1.358-2(g)(2), REG-143686-07, 74 F.R. 3509, 3512-3513 (Jan. 21, 2019). The preamble provides that the IRS and Treasury will continue to study the issue of tracing in section 351 exchanges. 74 F.R. at 3512.

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

[101] *See* reg. section 301.7701-3(a) (Unless the unincorporated entity elects otherwise, a domestic eligible entity is a partnership if it has two or more owners or a disregarded entity if it has (or is deemed to have) a single owner.).

[102] *See* reg. section 301.7701-3(b)(1).

[103] Reg. section 301.7701-3(g)(1)(i). A conversion of a disregarded entity to a corporation is treated as if the owner of the disregarded entity contributed all the assets and liabilities of the entity to the association (corporation) in exchange for stock in the corporation. Reg. section 301.7701-3(g)(1)(iv).

[104] For partnership merger or division purposes, interests-up transactions are not valid, but apparently they can be used to convert a partnership to a corporation. *See* T.D. 8925.

inside basis of the assets of the partnership or to the outside basis in their partnership interests (but without credit for partnership liabilities reflected in the outside basis). When the inside basis of the partnership's assets differs from the aggregate outside basis of the partnership interests, the method chosen may affect the corporation's basis in the partnership's assets. Although incorporation of a partnership with liabilities involves either a deemed distribution of each partner's share of the liabilities, or a transfer of that share, the incorporation generally should not result in recognition of ordinary income, regardless of form, unless there is boot or the liabilities exceed the aggregate basis of the assets, as previously mentioned.

As discussed in more detail, each of the conversion options involves a liquidation of the partnership. Generally, in a liquidating distribution, the distributed assets take the outside basis of the partner receiving those assets. The resulting basis of the liquidated assets will have a direct or indirect effect on the tax basis the partner will have in the corporation. A partner has a unitary basis in his or her partnership interest, even if the partner has different classes of partnership interest (general and limited, preferred and common, etc.), and even if the partner acquired the partnership interests in different transactions.[105] This is in contrast to the separate lot rules applicable to shares of corporate stock. Under this unitary basis concept, basis in property is generally allocated in relation to the FMV of different interests when determining if that basis allocation is relevant (for example, the sale of a partnership interest or a distribution of property in redemption of a partnership interest). A partner will have a split holding period in his or her partnership interest if the partner acquires that interest by contributing assets with different holding periods or by subsequent contributions. The split holding periods are allocated generally in proportion to the FMV of the property in question.[106]

Unitary basis is determined on a partnership-by-partnership basis, seemingly even if a partner has an interest in two or more partnerships that are identical in all respects (including the interests of other partners) except perhaps the assets in the partnership. There does not seem to be a statutory rule that the unitary basis of the partner must be aggregated. This may have important planning implications in the QSBS arena because it might make sense for taxpayers to segregate low-basis and high-basis assets into different partnerships in a tax-free partnership division[107] before converting to a C corporation.

In estate planning, it is common for grantors to simultaneously own interests in partnerships individually and deem to own, for income tax purposes, partnership interests in an intentionally defective grantor trust (IDGT) because of grantor trust status. This assumes that grantor trust status equates to the IDGT being disregarded or ignored for income tax purposes, and thus, the grantor will be treated for all income tax purposes as the owner of the trust assets. This apparently is the position of the government. Rev. Rul. 85-13, 1985-1 C.B. 184, provides that a defective grantor trust will be ignored for income tax purposes. Assuming an IDGT is ignored for income tax purposes, because of the unitary basis rule, later contributions of high-basis property by the grantor will result in proportional increases (in a pro rata partnership) to the outside basis of the IDGT partnership interests (or vice versa). This in turn will have a direct effect on the basis in C corporation stock received in a subsequent conversion of the partnership.

Because each conversion transaction involves a contribution of property (assets or partnership interests) to a corporation in exchange for shares in the corporation, advisers should consider whether and to what extent the FMV of the contributed assets should include valuation discounts because of lack of marketability or other factors (for example, an interests-up conversion involves the contribution of partnership interests). Also, consideration should be given to whether value can or should be attributed to the goodwill of the business. As mentioned, FMV, however determined, has a direct effect on how the 10-times-basis limitation and the aggregate gross asset requirement are calculated.

[105] Rev. Rul. 84-53, 1984-1 C.B. 159. *Cf.* LTR 200909001 (the unitary basis rule does not apply to publicly traded partnership interests).

[106] *See* reg. section 1.1223-3.

[107] *See* section 708(b)(2)(B) and T.D. 8925.

b. Assets-over conversion.

Generally, an assets-over transaction involves a transfer of partnership assets to a newly created corporation in exchange for shares of stock in the corporation. If the partnership and the partners are in control of the corporation, the contribution and exchange will qualify for nonrecognition treatment under section 351, except to the extent of boot.[108] If the entire partnership (assets and liabilities) are contributed to the corporation, the transfer of liabilities will be considered only if the aggregate liabilities exceed the aggregate bases of the assets.[109] As noted, under section 362(e), the transferee corporation's tax basis in the contributed assets may be reduced for any built-in net loss in the assets transferred (subject to the election).[110]

As discussed, the transferor partnership's basis in the corporate stock is equal to the inside basis of the assets transferred, reduced by the liabilities transferred, and its holding period is tacked to the extent attributable to capital assets and section 1231 property, but not to the extent attributable to other assets. The partnership's inside basis in the corporate shares becomes the partners' basis in the shares when distributed in liquidation, subject to the effect of each partner's outside basis (as reduced for the deemed distribution from the partner's being relieved of its share of partnership liabilities on the transfer).

Liquidating distributions (whether in one distribution or a series of distributions) terminate the liquidated partner's entire interest in a partnership.[111] Generally neither the partner nor the partnership will recognize any gain or loss upon a distribution of property.[112] The basis of property distributed in a liquidating distribution will be equal to the partner's outside basis (reduced by any money distributed in the transaction, including any change in the partner's share of liabilities as a result of the distribution).[113] The transfer of the liabilities from the partnership to the corporation (before the liquidating distribution) is a deemed distribution by the partnership to its partners, reducing their outside basis. That may result in gain to any partners whose shares of liabilities exceed basis.[114] The holding period of the distributed property (shares in the corporation) includes the holding period of the partnership (which in turn may include the holding period of the contributed assets if the assets are capital assets and section 1231 property).[115] As such, the holding period of the partner's interest in the partnership is generally irrelevant when determining the holding period of distributed property.

When the transfer of partnership assets includes an assumption of a section 358(h) liability, the basis of the stock received is reduced (but not below FMV) by the amount of the liability, and the outside bases of the partners are reduced by the same amount.[116] If the reduction is more than a partner's outside basis, it will result in the partner recognizing gain.[117] The reduction in basis is to the corporate stock only and does not affect the basis of the partnership assets contributed to the corporation (and thus the basis the corporation has in those assets).

c. Assets-up conversion.

Generally, an assets-up conversion involves a distribution of assets to the partners in liquidation, and then a contribution of those assets to a newly created corporation in exchange for shares of the corporation. As just discussed, the basis of assets distributed in a liquidating distribution is determined by the outside basis of the liquidated partner. Effectively, this means that the corporation's basis in the assets is essentially determined by the partners' outside basis in their partnership interests, not the partnership's inside basis in those assets.

[108] Because section 751 (concerning hot or ordinary income assets of the partnership) applies only to transfers of partnership interests and distributions, the partnership's contribution of the assets to the corporation does not implicate section 751, and the general rule of nonrecognition under section 351 applies.

[109] Section 357(c).

[110] *See* reg. section 1.362-4(b).

[111] Section 761(d).

[112] Section 731(a)-(b); and reg. section 1.731-1(a)-(b).

[113] Section 732(b).

[114] Section 752(b).

[115] Section 735(b).

[116] *See* reg. section 1.752-7, which incorporates by reference section 358(h)(3).

[117] *See* reg. section 1.358-7(b) and (e), Example 2.

The distribution of the partners' shares of assets and liabilities is entitled to nonrecognition for both the partnership and the partners. However, the distribution of the assets to the partners may result in gain under the mixing bowl rules or the disguised sale rules if the distributed property includes assets that were contributed within two to seven years of the distribution.[118] The transfer of liabilities will generally be a wash because although the deemed distribution will result in a reduction in the partner's share of partnership liabilities, there is an increase for the deemed contribution as a result of taking on the same liability individually. Assuming that each partner receives a proportionate share of each asset, there are no section 751 implications dealing with disproportionate distributions of hot or ordinary income assets.

The partner's basis in the distributed property is determined by the outside basis of the partnership interest (including the liability share and any gain under the mixing bowl rules), which may differ significantly from the share of inside basis, particularly if there is no section 754 election in place. As noted, the partners' holding period on the property distributed is the same as the partnership's holding period, and the holding period of their partnership interests is irrelevant.

The partners' basis in the corporate shares received upon the contribution of assets to the corporation is determined under section 351, as discussed. When a partner's share of partnership liabilities exceeds outside basis, reflecting a negative capital account (or a purchaser who succeeded to a capital account greater than the net purchase price net of liabilities transferred), there may be gain under section 357(c) (which treats liabilities transferred over the aggregate basis of property transferred as boot). If the assets transferred by a partner have a built-in loss, under section 362(e) the transferee corporation has a downward adjustment to basis for the net built-in loss, unless both the transferor partner and the transferee corporation elect to adjust the basis of the corporate stock. If the transfer of former partnership assets includes the assumption of a section 358(h) liability, the basis of the corporate stock received by the partner is immediately reduced (but not below the FMV of the stock) by the amount of the liability.

d. Interests-up conversion.

Generally, an interests-up conversion involves the transfer of all (or a portion) of the partnership interest to a newly formed corporation in exchange for shares in the corporation. The corporation, now owning all the partnership interests, terminates the partnership, or if it owns less than all of the partnership interests, the partnership subsequently liquidates the corporation's interest in the partnership. It is essentially a mixture of the assets-over and assets-up conversions. The corporation has an exchanged basis in the assets determined by the basis of the partnership interests (not reduced for liabilities) and a tacked holding period based on the partnership assets.

The partners' basis in their corporate shares is measured by their basis in their partnership interests, reduced for liabilities transferred, but there is a split holding period to the extent the partnership interest is attributable to section 751 property (not a capital asset or section 1231 property).[119] The mixing bowl rules do not apply to an interests-up conversion.[120] When a partner's share of liabilities exceeds outside basis in the transferred interest, gain will be recognized, likely under section 357(c) as the receipt of boot.[121] This boot is allocated in proportion to the FMV of the property transferred.[122]

4. Acquisition date for QSBS purposes on formation or conversion.

As mentioned in part 1 of this report, after its initial enactment in 1993, section 1202 was

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[118] *See* sections 707(c)(1)(B) and 737 (the mixing bowl rules) and section 707(a)(2)(B) (the disguised sale provision). A discussion of these rules is beyond the scope of this report.

[119] *See* LTR 9537013.

[120] Reg. sections 1.704-4(c)(5) and 1.737-2(c).

[121] *See* Rev. Rul. 80-323, 1980-2 C.B. 124, and section 752.

[122] *See* Rev. Rul. 68-55 and Rev. Rul. 85-164. When there is boot, section 751(a) treats the gain as ordinary income to the extent allocable to the partner's share of section 751 property, with the balance allocated to the partnership interest, possibly producing generally capital gain but no loss. The allocable share of corporate stock should not, however, result in ordinary income under section 751(a), even though that section provides for ordinary income on receipt of money or property, with no reference to section 351 or any other nonrecognition provision. The nonrecognition provision of section 351 should control.

amended in 2009 and 2010 to increase the exclusion from 50 percent to 75 percent or 100 percent, depending on the acquisition date of the QSBS. After the 75 percent and 100 percent exclusions were enacted, each of the respective subsections was amended in 2012[123] to include the following flush language: "In the case of any stock which would be described in the preceding sentence (but for this sentence), the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223."[124] Section 1223 now has 15 subsections, most of which provide for the tacking of holding periods depending on the transaction in question.

For section 1045 rollover purposes, section 1223(13) provides that in determining the period for which the taxpayer has held property whose acquisition resulted under section 1045 in the nonrecognition of any part of the gain realized on the sale of other property, "there shall be included the period for which such other property has been held as of the date of such sale."[125] For section 351 purposes, section 1223(1) provides:

> In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and, in the case of such exchanges the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231.[126]

Except for section 1223(10), which concerns the holding period of property acquired upon the death of a decedent, all the subsections in section 1223 provide for the inclusion of time before an exchange (or other transaction) and a relation back to a prior ownership. As such, the flush language of section 1202(a)(3) and (4) is broad enough to say that in determining the QSBS acquisition date, section 1223 could predate the creation of the C corporation if properties are contributed under section 351 (including a conversion of a partnership to a C corporation). Thus, if a partnership that purchased property in 2005 converts to a C corporation in 2011, the flush language would imply that for QSBS purposes, a portion of the stock received in the conversion would have an acquisition date of 2005 and, as such, that stock would be entitled to only a 50 percent exclusion, not 100 percent.

Contrary to the foregoing, section 1202(i)(1) provides: "In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation . . . such stock shall be treated as having been acquired by the taxpayer on the date of such exchange."[127] The code makes clear that this rule applies "for purposes of this section"[128] — namely for purposes of section 1202. Section 1202(i) was enacted with the original statute in 1993, and as noted earlier, the 75 percent and 100 percent exclusions were added in 2009 and 2010, respectively, but the flush language was added in 2012.[129] The issue is whether the flush language overrides section 1202(i), which we believe it does not, or whether the flush language applies for some purpose other than for determining the acquisition date of the QSBS.

The authors of an excellent article on QSBS[130] researched the legislative history and have, we believe, rightfully concluded that the flush language applies only for section 1045 rollover purposes (not for section 351 purposes). The authors point to the Senate report,[131] which focused on section 1045 rollovers, and to the Joint Committee on Taxation's report, which includes

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123 American Taxpayer Relief Act of 2012 (ATRA), P.L. 112-240, section 324(b)(1).

124 Sections 1202(a)(3) (flush language) and 1202(a)(4) (flush language).

125 Section 1223(13).

126 Section 1223(1).

127 Section 1202(i)(1) and (1)(A).

128 Section 1202(i).

129 ATRA section 324(b)(1).

130 Janet Andolina and Kelsey Lemaster, "Candy Land or Sorry: Thoughts on Qualified Small Business Stock," *Tax Notes*, Jan. 8, 2018, p. 205.

131 S. Rep. No. 112-208, at 74-76 (Aug. 8, 2012) (the Senate's version of the eventual bill was S. 3521, the Family and Business Tax Cut Certainty Act of 2012).

the following statement: "The provision is not intended to change the acquisition date determined under Section 1202(i)(1)(A) for certain stock exchanged for property."[132] Just as persuasively, the authors point out that if the flush language applied for property contribution purposes (section 351), it would create inconsistent results that were never intended. They write, "Interpreting the flush language to apply to property contributions could lead to inconsistent outcomes for founders and investors. For example, if a founder contributed a patent obtained before September 28, 2010, to a new corporation that is capitalized by an investor, the investor would get the 100 percent exclusion, but the founder would not."[133] Suffice it to say, clear guidance from the IRS on this issue would be greatly appreciated.

K. Reporting Requirements and Statute of Limitations

The reporting requirements for QSBS benefits belie the significant benefits that are available to QSBS shareholders. When a corporation that would qualify as a QSB issues stock to an investor, there is no proactive election required to claim QSBS status upon an eventual sale of the stock. Also, there are no requirements that the corporation inform a shareholder whether the stock issued has been issued by a company that would be considered a QSB. QSBS status is not elective. When a shareholder sells stock in a corporation, the stock either qualifies as eligible gain of a QSB, in whole or in part, or it does not (which is more likely the case). As discussed, given the federal rate applicable to section 1202 gain (31.8 percent) versus other long-term gain (23.8 percent), the difference can be significant for taxpayers.

As discussed earlier, to be considered a QSB, the corporation must agree to "submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes"[134] of section 1202. To date, no guidance has been issued, other than that the reports that may be mandated upon audit of a particular transaction.

A shareholder is required to report the sale of QSBS on Schedule D and Form 8949 like any other capital gain. The amount of the exclusion is shown as a negative number on Form 8949 in column (g),[135] and in completing Schedule D, a taxpayer is instructed to complete the 28 percent rate gain worksheet with the appropriate amount that would be taxable at 28 percent depending on the percentage exclusion.[136]

There are special instructions for reporting gain from an installment sale of QSBS. According to the instructions:

> If all payments aren't received in the year of sale, a sale of QSB stock that isn't traded on an established securities market generally is treated as an installment sale and is reported on Form 6252. . . . Figure the allowable section 1202 exclusion for the year by multiplying the total amount of the exclusion by a fraction, the numerator of which is the amount of eligible gain to be recognized for the tax year and the denominator of which is the total amount of eligible gain.[137]

Under these instructions, a fractional portion of the 28 percent taxable gain would need to be reported each year depending on the percentage exclusion. As will be discussed in part 3 of this report, these instructions may not be appropriate in all circumstances.

Generally, under section 6501(a), the IRS must assess tax within three years after a taxpayer files his or her tax return. Under section 6501(e)(1), that period is extended to six years if the taxpayer omits from gross income an amount exceeding 25 percent of the gross amount of income claimed on the return. In a chief counsel advice memorandum,[138] the IRS ruled that in determining the 25 percent threshold under section 6501(e)(1), the excluded amount under

[132] JCT, "General Explanation of Tax Legislation Enacted in the 112th Congress," JCS-2-13, at 185 n.490 (Feb. 2013).

[133] Andolina and Lemaster, *supra* note 130, at 223.

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

[135] 2019 Instructions for IRS Form 8949, columns (f) and (g).

[136] 2019 Instructions for IRS Schedule D, "Exclusion of Gain on Qualified Small Business (QSB) Stock."

[137] *Id.*

[138] ILM 200609024.

section 1202(a) is not included. The memorandum concludes that gross income "for purposes of section 6501(e) does not include the portion of capital gain excluded by section 1202." The practical effect is that for taxpayers claiming a QSBS exclusion, particularly those who properly claim a 100 percent exclusion, it's likely that the IRS will be limited to the three-year statute of limitations.

L. State Income Tax Treatment

For residents in states that do not impose an individual income tax (for example, Florida, Nevada, Texas, and Washington) or do not impose a capital gains tax (for example, Tennessee), the availability of QSBS status for state income tax purposes is unimportant. Generally, on the sale of stock in a C corporation, jurisdiction and situs for state income tax purposes is based on the residence of the selling shareholder at the time of the sale. However, a large majority of states impose an income tax, and although almost none of them makes any state-level adjustments to federal adjusted gross income or taxable income (thereby allowing the benefit of QSBS exclusion to the taxpayer), some states specifically make adjustments or opt out of the exclusion for state income tax purposes.

Notably, effective January 1, 2013, California — the state with the highest marginal state income tax rate and in which many technology companies have been founded — has disallowed the QSBS exclusion benefit and the section 1045 rollover provisions.[139] Before enacting that complete disallowance, California had, instead of conforming to the federal treatment of QSBS, enacted its own similar (but not identical) requirements for exclusion benefits. The exclusion benefit was applicable only to companies that met specified qualifications, including whether their assets and activities were in California. Ultimately, the California appeals court held that the California statutory provisions for the exclusion or deferral of gain on QSBS were a violation of the U.S. Constitution's commerce clause, because they improperly favored investment in California companies (defined as corporations using 80 percent of their assets in the conduct of business in California and maintaining 80 percent of their payrolls in California) over investments in non-California companies.[140]

Like California, some states (for example, Pennsylvania) completely disallow the QSBS exclusion benefit, while other states (for example, Hawaii, Massachusetts, and New Jersey) make state modifications to the exclusion.[141] That being said, a large proportion of the states follow the federal treatment, so for many taxpayers the QSBS benefits apply in full for state tax purposes. ■

[139] Ca. Rev. & Tax Code section 18152; and California Franchise Tax Board Notice 2012-03.

[140] *Cutler v. Franchise Tax Board*, 208 Cal. App. 4th 1247 (2012).

[141] For a summary of each state's QSBS treatment as of April 15, 2018, see Benetta P. Jenson and Stuart J. Kohn, "Maximize Qualified Small Business Stock Exclusion," 40 *Est. Plan* 3 (Oct. 2018).