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Section 1202 Entity Selection Considerations

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QUALIFICATION FOR SECTION 1202 TREATMENT

I. Since qualification for section 1202 treatment can literally make the difference in the “choice of entity” analysis, it makes sense to examine the section 1202 requirements in detail. There are numerous requirements that must be satisfied by a corporation in order to qualify, some of which only apply at issuance and others of which must be satisfied “during substantially all of” the shareholder’s holding period for the stock, as well as redemption restrictions during two-year and four-year periods surrounding the issuance. In addition, there are some requirements applicable at the shareholder level, and the exclusion itself is subject to certain limits. See Slide N. For taxpayers who manage to wend their way through this morass of requirements, a 100% exclusion is currently available at the federal level. ¹

II. C Corporation Status

A. Section 1202 requires the entity issuing qualified small business stock to be a C corporation. This requirement is set forth in no less than three provisions within the statute.

1. Section 1202(c)(1)(A) provides that “as of the date of issuance” the corporation must be a “qualified small business,” one of the requirements for which is that the corporation be a C corporation. ²

2. Section 1202(c)(2)(A) provides that the entity must be a C corporation “during substantially all of the taxpayer’s holding period of such stock.”

3. Section 1202(c)(1) provides that qualified small business stock must be “stock in a C corporation.” Query: Should this provision be interpreted to require C corporation status on the date of sale?

¹ I.R.C. § 1202(a)(1), (a)(4)(A), (c). Many states also recognize this exclusion simply by adopting the Code on a rolling basis and not otherwise rendering it inapplicable. See, e.g., Minn. Stat. § 290.01(31); N.D. Cent. Code § 57-38-01(13) (defining “taxable income” in the same manner as the Code); 35 Ill. Comp. Stat. 5/102 (defined terms, including “taxable income,” have the same meaning in Illinois as they do under the Code unless an exclusion applies). The Tax Foundation recently identified 20 states as conforming to the Internal Revenue Code on a static basis and 18 states as conforming on a rolling basis. TAX FOUNDATION, https://taxfoundation.org/state-individual-income-tax-code-conform-federal-tax-code/ (last accessed June 17, 2018). There are some states that do not follow section 1202 in its current form. See, e.g., Cal. Rev. & Tax. Code § 18152(a) (no recognition at state level); Wis. Stat. § 71.98(5) (adopting section 1202 only as amended through December 31, 2012, which applied a 50% exclusion). However, Wisconsin has a separate exclusion, applicable to “qualified Wisconsin businesses,” which could provide a 100% exclusion if the corporation is qualified and makes certain required filings. Wis. Stat. § 71.05(25).

² I.R.C. § 1202(d)(1).
4. The juxtaposition of these three provisions creates some confusion regarding when the (c)(2)(A) “substantially all” language could ever mean anything less than the entire holding period.

a) If the two (c)(1) requirements are read to require C corporation status both at issuance and at sale, then the only situation where there could be an “insubstantial” S corporation period would have to be in between those two dates.

b) Alternatively, the (c)(2)(A) “substantially all” language could be interpreted to override the two other requirements, because section 1202(c)(1) begins with the words “[e]xcept as otherwise provided in this section.” This could be important in acquisitions involving foreign or other ineligible shareholders where, for one reason or another, temporary disqualifying ownership might be necessary.

B. This doesn’t mean that all hope is lost for corporations that have previously elected S corporation status. They can engage in drop-down transactions, whereby the business is “dropped down” to a C corporation subsidiary.

1. Provided all of the qualified small business stock requirements described below are met at the time of such transaction, the section 1202 gain exclusion may still be available through the S corporation to its shareholders. However, as explained below, the five-year holding period requirement (also explained below) must thereafter be met at both the corporate and shareholder level. As you would expect, the new subsidiary C corporation must meet the ongoing requirements for section 1202 treatment (also explained below).

2. However, for purposes of section 1202, the basis of the new stock is treated as being no less than the fair market value of the property exchanged. This rule for appreciated property has two significant impacts, one favorable and one unfavorable.

   a) The gain inherent in the contributed property will not be eligible to be treated as excludable section 1202 gain upon the eventual disposition of the stock.

   b) However, the additional amount treated as basis for section 1202 purposes could add to the potentially excluded gain under the ten times

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3 I.R.C. § 1202(g).
4 I.R.C. § 1202(i)(1)(B).
5 Presumably, this calculation is done on an aggregate basis, i.e., it is only the net appreciation that is taken into account, and there is no item-by-item calculation.
aggregate adjusted basis prong of the gain exclusion limitation described below.

C. It is also worth noting that entities treated as partnerships and sole proprietorship disregarded entities electing to be treated as corporations under the check-the-box regulations can also qualify for section 1202 treatment. However, they are subject to the same rules described above with respect to appreciated property as are applied to corporate drop-down transactions.

III. Requirements at Issuance

A. The stock must be issued after August 10, 1993.

B. The corporation issuing the stock must be a “qualified small business.”

1. As noted above, one of the requirements for this status is that the entity be a “C corporation.”

2. In addition, the entity must also be a “domestic corporation.” Presumably, the corporate aspect of both of these requirements can be satisfied by electing such status under the check-the-box regulations.

3. The “aggregate gross assets” of both the corporation and its predecessors must, at all times since August 10, 1993, and up until the date of issuance and immediately thereafter, not exceed $50,000,000.

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6 Treas. Reg. §301.7701-1(g)(1) (providing that, upon conversion to a C corporation, a partnership is treated as first contributing all of its assets and liabilities to the corporation in exchange for the corporation’s stock and then distributing that stock out to its partners). Without a specific provision under section 1202, the partnership’s intermediate holding of the C corporation stock would disqualify it for section 1202 purposes. However, section 1202(h) treats a partner receiving stock “from a partnership” as having acquired that stock “in the same manner” as the partnership, i.e. at original issuance. I.R.C. § 1202(h)(1)-(2), (g).

7 I.R.C. § 1202(i)(1)(B).


9 I.R.C. § 1202(d)(1).

10 Id.

11 Cf. I.R.S. Priv. Ltr. Rul. 201636003 (finding that where a corporation converted to an LLC taxable as an association, the shareholders still held qualified small business stock throughout their holding period) (“While ownership of a corporation is normally tied to stock ownership, and under state law LLC owners hold a member interest and not formal stock, the term ‘stock’ for federal tax purposes is not restricted to cases where formal stock certificates have been issued. Rather, it has been consistent Service position that for federal tax purposes stock ownership is a matter of economic substance, i.e., the right to which the owner has in management, profits, and ultimate assets of a corporation. The presence or absence of pieces of paper called ‘stock’ representing that ownership is immaterial.”) (Sept. 2, 2016). The IRS has made several other similar rulings as well. I.R.S. Priv. Ltr. Ruls. 201603010, 201603011, 201603012, 201603013, 201603014 (Jan. 15, 2016).

12 I.R.C. § 1202(d)(1)(A), (B). The onus of proving this test is satisfied is on the taxpayer. Cf. Holmes v. Comm’r, T.C. Memo. 2012-251, at 1752 (finding that aggregate gross assets test not met when petitioner did not introduce balance sheets and other documentation into evidence to prove qualification under section 1045).
a) The term “predecessor” is not defined, and in many instances should not create a problem, but it could. For example, would a small corporation spun off from a much larger C corporation be permanently ineligible because the C corporation had over $50,000,000 in aggregate gross assets? If a corporation receives assets from another corporation in a taxable acquisition or other transaction, is that other corporation a “predecessor”? What if the corporation acquires assets from a partnership in a taxable or tax-free transaction?

b) The term “aggregate gross assets” is defined as “the amount of cash and the aggregate adjusted bases of other property held by the corporation.”

1. Thus, it is the depreciated adjusted basis as of the date of issuance that counts.

2. There is a special rule requiring that the basis of carryover “property contributed to the corporation . . . be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value.”

   (a) Thus, both appreciated and depreciated property are written up or down to their respective fair market values.

   (b) The above language clearly seems to suggest that such special section 1202 basis should continue to be depreciated for purposes of determining the corporation’s “aggregate adjusted bases” at any future point in time.

c) With respect to “[s]tock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, . . . [t]he determination [of] whether the gross assets test is met is made at the time of exercise or conversion.”

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14 I.R.C. § 1202(d)(2)(B). This is in contrast to the special rule described below with respect to the determination of basis at the shareholder level, which only applies to appreciated property.
15 H.R. Rep. No. 103-213, 526 (Aug. 4, 1993). In Natkunanathan v. Comm’r, T.C. Memo. 2010-15, a taxpayer was denied gain exclusion under section 1202 on the sale of his Intel stock he received after exercising certain stock options. The taxpayer had received stock options in Cognet Microsystems as compensation for services rendered to that company, but did not exercise those options until after Intel acquired Cognet Microsystems in a merger. Natkunanathan, T.C. Memo. 2010-15. The court held that the appropriate time of reference in determining whether the taxpayer received qualified small business stock at original issue is upon the exercise of a stock option. Id. At exercise, the taxpayer acquired stock in Intel at original issue, which was clearly not a qualified small business at
d) Significantly, “[a]ll corporations which are members of the same parent-subsidiary controlled group shall be treated as 1 corporation for purposes of this subsection.” For this purpose, the “at least 80 percent” vote and value ownership requirements under section 1563(a)(1) of the Code are lowered to “more than 50 percent,” and insurance companies are included.17

(1) Note that partnership, sole proprietorship, individual and other assets held outside of corporate solution should not be taken into account.

(2) Most brother-sister corporations should not be grouped together for this purpose since section 1563(d)(1)(B) only triggers attribution to a brother-sister “parent” from options, partnerships and trusts. Notably, there is no attribution “to” a corporation from, say, the corporation’s 100% shareholder like there would be if the rule under section 318(a)(3)(C) were applicable.

e) Also significantly, unless the “aggregate gross assets” test is re-applied as described for certain transfers or transactions discussed below, any subsequent increase in the aggregate adjusted bases of the corporation’s property should not disqualify the stock from section 1202 treatment.

4. The “corporation agrees to submit such reports to the Secretary and to shareholders as the Secretary may be require to carry out the purposes of” section 1202 of the Code. However, to date, the Secretary has not required anything.

C. Subject to the limited exceptions described below, the stock must be “acquired by the taxpayer at its original issue . . . in exchange for money or other property (not including stock), or . . . as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).”20

1. There are things at the margins that practitioners need to be concerned with. For example, would stock received in consideration for guaranteeing debts of the

that time. Id. (“[T]he aggregate gross assets of Intel on the date of exercise would have to have been less than or equal to $50 million. Petitioner makes no such claims with respect to Intel’s aggregate gross assets.”).

18 Under section 1563, in determining whether a corporation is part of a parent-subsidiary controlled group, only the attribution rules under “paragraphs (1), (2), and (3) of subsection (e)” apply. I.R.C. § 1563(d)(1)(B). Those paragraphs provide attribution to a person who “has an option to acquire stock,” who has a 5% or greater interest in the capital or profits of a partnership, who is treated as the substantial owner of a grantor trust or who is a beneficiary of a trust or estate and possesses a 5% or greater actuarial interest in such trust or estate. I.R.C. § 1563(e)(1)-(3).
corporation qualify? Would the grant of a 10% ownership interest in a limited liability company that was treated as a partnership that is now electing to be treated as a corporation in order to qualify for section 1202 in return for services be disqualified, in whole or in part, if some of those services were provided to the predecessor partnership, rather than “provided to such corporation”? If the stock is acquired by an S corporation or a partnership under the special rules described below, must the services be provided by the S corporation or partnership, or the shareholder or partner? Does it even matter who provides the services as long as they are “provided to such corporation”?

2. There are also several exceptions to this original issue requirement. For example, transferees acquiring stock in the following manner are treated as “having acquired such stock in the same manner as the transferor.”

   a) Any transfer by gift or at death

   b) A transfer “from a partnership to a partner,” as long as “requirements similar to the requirements of subsection (g) are met at the time of the transfer (without regard to the 5-year holding period requirement).” Subsection (g), which allows pass-thru entity owners to exclude section 1202 gain under certain circumstances and is discussed below, specifies the following requirements:

      (1) The gain must be attributable to “qualified small business stock in the hands of such entity (determined by treating such entity as an individual).” Application of this requirement at the time of the transfer “from the partnership” seems relatively straightforward.

      (2) The gain must also be “includable in the gross income of the taxpayer 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 by such pass-thru entity.” Application of this requirement to transfers “from a partnership” is more uncertain. If a 50% partner receives all of a partnership’s section 1202 stock, does only half the stock

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23 I.R.C. § 1202(h)(1)(A), (h)(2)(C). This is the provision that allows for the conversion of a tax “partnership” under the check-the-box rules into a corporation whose stock is eligible for section 1202 treatment despite the taxpayer technically receiving such stock from the partnership as part of its liquidation. See supra note 35 and accompanying text.
24 I.R.C. § 1202(g).
qualify? Presumably, if the section 1202 stock is distributed pro rata to two 50% partners, it all qualifies. What happens if the 50% interest of one of the partners is completely retired?

(3) Note that this provision would not appear to apply to a contribution of qualified small business stock into a partnership, or to or from an S corporation for that matter.

3. Aside from the original issue limitation, probably the most significant aspect of this limitation is the exclusion of stock acquired “in exchange for . . . stock.”25

   a) There is, for this purpose, a statutory exception for “stock in a corporation . . . acquired solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer.”26

   (1) Conversion of preferred qualified small business stock of a corporation into common stock of that same corporation pursuant to a convertibility feature should clearly qualify.

   (2) Query: Would the “exchange” of common stock for common stock (or preferred stock for preferred stock) of the same corporation tax-free under section 1036 of the Code be a qualified “conversion” under this rule? What if the “exchange” was not tax-free, e.g., common stock for preferred stock or vice versa? How about an “exchange” between shareholders?

   (3) The use of the word “solely” in the statutory provision suggests that taxpayers would be well advised to bifurcate any transaction that only partially qualifies as such a conversion, presumably by having the corporation issue two certificated or uncertificated securities, one for the stock received upon the qualifying conversion and the other one for other stock received in the transaction. The “solely” requirement could be interpreted to preclude, for example, the payment of additional consideration in order to round out the conversion so as to acquire a whole number of shares. Query: That doesn’t mean that the payment of cash for fractional shares might somehow taint the conversion, does it? A careful analysis of this “solely” language, as well as the bifurcation rules promulgated under the section 1244(d)(2) exception described below, would not seem to preclude this.27

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26 I.R.C. § 1202(f).
27 See Treas. Reg. § 1.1244(d)-3(b)(2).
Another exception to the “in exchange for . . . stock” prohibition is for stock received as a stock dividend on qualified small business stock, or in exchange for qualified small business stock in connection with a recapitalization or a mere change in identity, form or place of organization under sections 368(a)(1)(E) and (F) of the Code.\textsuperscript{28}

(1) Section 1202(h)(3) merely provides that “[r]ules similar to the rules of section 1244(d)(2) shall apply for purposes of this section.” Section 1244(d)(2) covers all stock “the basis of which (in the hands of the taxpayer) is determined in whole or in part by reference to the basis in his hands of” stock qualifying under that section, as well as such stock received in a reorganization described in section 368(a)(1)(F) of the Code, but only “[t]o the extent provided in regulations prescribed by the Secretary.” However, the regulations are explicit. They note that “section 1244(d)(2) authorizes exceptions to” the stock-for-stock exclusion, and that “[t]he exceptions may apply in three situations,” namely the ones listed above.\textsuperscript{29}

(2) Section 1244(d)(2) contains the following provision relating to qualification that appears to raise some questions regarding its incorporation into the section 1202 rules: “For purposes of paragraph . . . 3(A) of subsection (c) [the $1 million overall limitation on capital contributions that applies for purposes of section 1244 qualification], a successor corporation in a reorganization described in section 368(a)(1)(F) shall be treated as the same corporation as its predecessor.”

(a) Section 1244(c)(1)(A) provides that the $1 million limitation applies “at the time such stock is issued,” and section 1244(c)(3)(A) itself reiterates that this determination “shall be made as of the time of the issuance of the stock in question.” One possible implication of the above provision, which only applies to section 368(a)(1)(F) changes in identity, etc., is that the $1 million limitation is re-applied at the time of a stock dividend and/or section 368(a)(1)(E) recapitalization. Otherwise, why would this provision be necessary? Alternatively, the same “grandfathering” concept could be found to also apply to recapitalizations, which, while being referenced in the heading to subparagraph (2) of

\textsuperscript{28} I.R.C §§ 1202(h)(3), 1244(d)(2); Treas. Reg. § 1.1244(d)-3.

\textsuperscript{29} Treas. Reg. § 1.1244(d)-3(a).
subsection (d), are not specifically referred to in the body of the statute itself, unlike transactions involving a change in identity, etc. under section 368(a)(1)(F).

(b) Notably, under section 1244(d)(2), it is only the underlying pre-transaction stock that must “meet[] the requirements of subsection (c)(1) [other than the section 1244(d)(2) requirement relating to investment income during the five years preceding disposition],” and that stock, by definition, must have met the $1 million limitation at the relevant time of issuance.\(^{30}\)

(c) This technicality could be important for section 1202 qualification if the requirement that “[r]ules similar to the rules of section 1244(d)(2) shall apply” is interpreted to mean that the $50 million “aggregate gross asset” requirement described above, which is similar to the $1 million “aggregate amount of money and property” requirement under section 1244(c)(3)(A), must be reapplied as of the date of the stock dividend, recapitalization or change in identity, etc.\(^{31}\)

(3) Unlike the conversion exception described above, which provides that it will only apply to stock “acquired solely through the conversion” (emphasis added) of qualified small business stock, there is no “solely” requirement contained in these provisions. In fact, the regulations under section 1244(d)(2) specifically call for bifurcation of stock dividends and stock received in recapitalizations into separate blocks in order to allow for partial continued qualification when some, but not all, of the underlying stock qualifies.\(^{31}\)

(a) The section 1244 regulations and examples go further, indicating, with respect to stock dividends, that such qualification should be pro rata when “all the shares with respect to which the dividend is received have equal rights to dividends.”\(^{32}\) This suggests that differences with respect to voting and other matters should have no impact upon the allocation. Query: what if all of the stock with respect to which the stock dividend is

\(^{30}\) Treas. Reg. § 1.1244(d)-3(b)(1).

\(^{31}\) Treas. Reg. § 1.1244(d)-3(b)(2), (c)(2).

\(^{32}\) Treas. Reg. § 1.1244(d)-3(b)(2), (b)(3) ex. (2).
declared have exactly the same rights with respect to dividends, but differing rights with respect to liquidation? Also, what do you do when there are differing rights with respect to dividends? Does the rule described below with respect to recapitalizations apply?

(b) The regulations with respect to recapitalizations and mere change in identity, etc. also answer some questions, but raise others. They provide that, with respect to such transactions in which only part of the underlying stock qualifies, the portion of the shares issued in the transaction which qualifies for section 1244 treatment “is the number of shares which bears the same ratio to the total number of shares of common stock so received as the basis of the shares transferred which meet such requirements bears to the basis of all shares transferred for such common stock.”33 Thus, unlike with respect to stock dividends under the above-described rule, identical blocks of underlying stock could give rise to differing amounts of qualifying and nonqualifying stock issued in the recapitalization if, for example, the blocks were acquired at different prices.

c) There is a third “transaction” exception to the “in exchange for . . . stock” prohibition that applies to tax-free incorporation and reorganization transactions described in sections 351 and 368, respectively, the scope of which overlaps the recapitalization and change in identity, etc. exceptions described above, and may very well turn out to overlap the conversion exception also, depending upon how broadly it is interpreted.

(1) Unlike the conversion provision, which requires that the newly acquired stock be “acquired solely through the conversion” (emphasis added) of qualifying stock, this provision states that it applies only if qualifying stock “is exchanged for other stock.”34 The net effect of this language may turn out to be pretty much the same. Moreover, the rules with respect to allocating the newly issued stock on a pro rata basis or in proportion to prior stock adjusted basis in accordance with the rules for stock dividends, recapitalizations and changes in identity, etc. could be relevant.

33 Treas. Reg. § 1.1244(d)-3(c)(2), (c)(3) ex. (4), (d)(1).
34 I.R.C. § 1202(b)(4)(A).
There does not appear to be any requirement that the new stock must have been received on a tax-free basis, as long as the reorganization transaction itself falls within the ambit of section 351 or 368 of the Code.\(^{35}\)

However, section 1202(h)(4)(D) does impose an additional requirement with respect to section 351 incorporation transactions. The corporation issuing the new stock intended to qualify must directly or indirectly own stock representing control of the corporation that originally issued the qualifying stock exchanged. This will, of course, have no impact on the fairly common transaction whereby all of the stock of Oldco. is contributed to Newco. However, it does mean that shareholders cannot collectively retain more than 20% of the vote or value of the predecessor corporation’s stock.\(^{36}\)

Unlike the stock dividend, recapitalization, mere change in identity, etc. exception described above, the section 351 or 368 exception does not incorporate any provisions from section 1244 of the Code, which means that the $50 million aggregate gross asset and other qualified small business requirements should not need to be reapplied.

(a) However, if the issuing corporation does not so qualify, the potentially excludable gain is capped at the appreciation at the time of the incorporation or reorganization transaction.\(^{37}\)

(b) Moreover, this excludable gain limitation is applied on the first incorporation/reorganization transaction, and not reapplied if there is another one.\(^{38}\) This could be a favorable or unfavorable provision, depending upon whether the stock appreciates or depreciates in value between the two transactions.

The overlapping scope and slightly differing requirements of these transactional exceptions unavoidably raise the question of what happens when a single transaction qualifies under more

\(^{35}\) I.R.C. § 1202(h)(4)(A) (applying to a “transaction described in section 351 or a reorganization described in section 368”).

\(^{36}\) See I.R.C. § 368(c).

\(^{37}\) I.R.C. § 1202(h)(4)(B).

\(^{38}\) I.R.C. § 1202(h)(4)(C).
than one exception. It looks like the conversion, stock dividend, recapitalization, change in identity, etc. exceptions would be applied first, because the incorporation/reorganization exception only applies to “stock which would not qualify as qualified small business stock but for this subparagraph.”

IV. Ongoing Requirements

A. As noted above, in order for stock of a corporation owned by a taxpayer to qualify for section 1202 treatment, the corporation must be a C corporation “during substantially all of the taxpayer’s holding period for such stock.”

B. Active Business Requirements

1. This is a multifaceted requirement that also must be satisfied “during substantially all of the taxpayer’s holding period for such stock.”

2. Qualified Trade or Business

   a) During such period, “at least 80 percent (by value) of the assets” of the issuing corporation must be “used by such corporation in the active conduct of 1 or more qualified trades or businesses.”

   (1) Note that, unlike the $50 million “aggregate gross asset” test described above, this percentage requirement is based upon “value,” not adjusted basis. This unavoidably introduces an element of subjectivity.

   (2) Note also that this requirement is based on the gross value of all assets, without any reduction for corresponding liabilities. Query: Could $2,000,000 held in escrow to fund a future redemption obligation somehow cause a corporation to run afoul of this requirement?

   b) The definition of “qualified trade or business” excludes the following extensive and disparate categories of activities (See Slide O):

      (1) “the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, 

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40 I.R.C. § 1202(c)(2)(A).
41 I.R.C. § 1202(c)(2)(A). The active business requirement does not apply when the corporation is an "eligible corporation" (defined below) that is "licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993)." I.R.C. § 1202(c)(2)(B).
42 I.R.C. § 1202(c)(1)(A).
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.  

(a) Significantly, the categories of “engineering” and “architecture” are specifically not included in the corresponding listing of “specified service trade or business” exclusion for purposes of the new 20% deduction under section 199A of the Code.

(b) Although there are no regulations under section 1202 relating to these “disqualified” categories, the first eight service professions listed above, health through consulting, are also listed in the provisions of the Code relating to the cash basis method of accounting. Therefore, the regulations, case law and rulings under that provision may be relevant here.

(c) The “performance of services” phrase in the statutory language quoted above could very well have substantive impact.

i. For example, in one private letter ruling, the IRS determined that a pharmaceutical company was

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43 I.R.C. § 1202(e)(3)(A). In Owen v. Comm’r, T.C. Memo. 2012-21, the court, analyzing this language under section 1202, determined that a company that “sold prepaid legal service policies, including estate planning services” and that, together with an affiliated company, had around 150 employees and 350 sales agents was a business for which the “reputation or skill of one or more of its employees” was not its principal asset because “[w]hile [there was] no doubt that the success of the Family First Companies [wa]s properly attributable to Mr. Owen and Mr. Michaels, the principal asset of the companies was the training and organizational structure; after all it was the independent contractors, including Mr. Owen and Mr. Michaels in their commission sales hats, who sold the policies that earned the premiums . . . .” Owen, T.C. Memo. 2012-21.


46 Treas. Reg. § 1.448-1T(e)(4) discusses the meaning of services performed in health, performing arts and consulting. For example, services performed in the field of health means “the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals,” but “does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient.” Treas. Reg. § 1.448-1T(e)(4)(ii). Similarly, the performance of services in the performing arts “means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists,” but “does not include the provisions of services by persons who themselves are not performing artists.” Treas. Reg. § 1.448-1T(e)(4)(iii). Lastly, the performance of consulting services “means the provision of advice and counsel,” but “does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services,” though “brokerage services” are explicitly included in the section 1202 list of excluded businesses. Treas. Reg. § 1.448-1T(e)(4)(iv).
not disqualified because it was not itself in the “business of offering service[s] in the form of individual expertise” and because, while noting that the pharmaceutical industry was “certainly a component of the health industry,” it reasoned that “Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry” and therefore did “not perform services in the health industry within the meaning of § 1202(e)(3).”\(^{47}\)

ii. Similarly, the IRS separately determined that a company that developed a tool to make certain medical determinations did not perform services in the health industry, despite the facts that the company was the only person legally allowed to perform certain tests related to such determination and that the lab director was required to hold an M.D., D.O. or Ph. D. In reaching this determination, the IRS noted that “[a]lthough Company’s laboratory reports provide valuable information to healthcare providers, Company does not provide healthcare professionals with diagnosis or treatment recommendations for treating a healthcare professional’s patients nor is Company aware of the healthcare provider’s diagnosis or treatment of the healthcare provider’s patients.”\(^{48}\)

(d) There is obviously significant potential overlap between the “financial services” and “brokerage services” categories listed above and the “banking, insurance, financing, leasing, investing, or similar business” category discussed below.

(e) The category of “trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees” has been the subject of a fair amount of controversy, especially as it relates to the new section 199A deduction. However, such examples as architects with an excellent reputation and

the celebrity chef are not all that relevant for purposes of section 1202, because architectural services are still excluded for this purpose under the above provision and restaurants are also excluded in one of the exceptions noted below.

(2) “any banking, insurance, financing, leasing, investing, or similar business”

(a) Banking and insurance businesses should be relatively easy to identify because they are typically subject to either state or federal regulation. Query: What does “financing” cover that is not already covered by the “banking category? Would the financing arm of a car dealership be precluded from section 1202 treatment?

(b) Leasing is a category that is more likely to catch taxpayers by surprise. This is discussed further in connection with the additional statutory prohibition relating to 10% real estate rental assets described below.

(c) As noted above, the “investing” and “similar business” categories certainly appear to overlap with the “financial services” and “brokerage services” categories included in the above listing. These new terms seem to make it clear that, for example, a venture fund or hedge fund should not qualify. Query: how about an investment advisor?

(3) “any farming business (including the business of raising or harvesting trees)”

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50 I.R.C. § 1202(e)(3)(C). Section 263A(e)(4) of the Code defines a farming business as “the trade or business of farming,” which includes “operating a nursery or sod farm” and “the raising or harvesting of trees bearing fruits, nuts, or other crops, or ornamental trees.”
“any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A”

“any business of operating a hotel, motel, restaurant, or similar business” Presumably, a franchisor of such businesses would not be disqualified.

c) The term “active conduct” contained in the 80% test also creates some hurdles to section 1202 qualification.

(1) The term is not specifically defined in the statute or the regulations.

(2) However, the statute specifies that the following activities qualify as long as they are “in connection with any future qualified trade or business,” “without regard to whether a corporation has any gross income from such activities at the time of the determination”:

(a) “investigating the creation or acquisition of an active trade or business,” “creating an active trade or business” and “any activity engaged in for profit and for the production of income before the date on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.”

(b) Activities resulting in research and experimental expenditures.

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51 I.R.C. § 1202(e)(3)(D).
53 The active conduct test under section 355, which may apply by analogy, is fact-intensive. See Treas. Reg. § 1.355-3 ("[T]he determination of whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions.").
54 I.R.C. § 1202(e)(2).
56 I.R.C. §§ 1202(e)(2)(B), 174. Treas. Reg. § 1.174-2(a)(1), which has not been amended to reflect any changes made by the TCJA, defines research or experimental expenditures as “expenditures incurred in connection with the taxpayer’s trade or business which represent research and development costs in the experimental or laboratory sense.” The regulation goes on to state that this includes “costs incident to the development or improvement of a product” and “costs of obtaining a patent.” Also, “[e]xpenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.”
(c) In-house research activities as long as “the principal purpose of the taxpayer . . . is to use the results of the research in the active conduct of a future trade or business” of itself or another member of its controlled group.57

(d) The above exceptions seem to cover some of the more obvious situations where taxpayers might otherwise inadvertently fail to qualify under the “active conduct” text. Moreover, section 1202 contains specific provisions dealing with the “active conduct” requirement in the context of software development and real estate businesses, which are discussed below.58 However, as always, there will unavoidably be some issues at the margins.

i. Startup activities are specifically covered, but what happens when the business is winding down, either after a sale or when the business no longer has ongoing viability? Perhaps this is one of those situations where the “substantially all of the taxpayer’s holding period for such stock” language comes into play.

ii. There is also the issue of when investing and other financial activities rise to the level of an actual “trade or business.”59 However, here the financial services, brokerage services, banking, financing, investing or “similar business” exceptions discussed above may very well come into play.

(3) “[R]ights to computer software which produces active business computer software royalties (within the meaning of section 543(d)(1))” are also specifically included in the category of assets used in the active conduct of business.60 However, the

58 I.R.C. § 1202(e)(7)-(8).
59 See e.g. Higgins v. Commissioner, 312 U.S. 212 (1941) (holding that a taxpayer who spent time overseeing his investments and hired others to help with this were not deductible as expenses incurred in carrying on a trade or business); Whipple v. Commissioner, 373 U.S. 193 (1963) (holding that taxpayer’s debts from acting merely as an investor could not be deducted because the debts were not related to a trade or business).
60 I.R.C. § 1202(e)(8).
personal holding company “active business computer software royalties” category incorporated into this provision contains the following significant limitations.61

(a) The issuing corporation must still be “engaged in the active conduct of a trade or business of developing, manufacturing, or producing computer software,” and the royalties must be attributable to computer software which was either “developed, manufactured, or produced by such corporation (or its predecessor) in connection with” such trade or business or “directly related to such trade or business.”62

(b) Such royalties must constitute at least 50% of the ordinary gross income of the issuing corporation.63

(c) Deductions allowable to the issuing corporation under sections 162, 174 and 195 of the Code for ordinary and necessary, research and experimental and start up expenditures of its active business computer software business (exclusive of compensation paid to the five largest shareholders) must collectively amount to at least 25% of its overall ordinary gross income, either during the current taxable year or during the five-taxable-year period ending with that year.64

(d) Other personal holding company income must be distributed to the extent that it exceeds 10% of the issuing corporation’s ordinary gross income each year.65

(e) This provision and the cross-reference to the specific personal holding company rules unavoidably will raise the question as to whether other software development businesses that do not meet all of the above requirements might possibly qualify. Would a “troll” software company that actively acquires and licenses software developed by others qualify? How about an issuing corporation that has other active businesses and so does

61 I.R.C. § 543(d).
63 I.R.C. § 543(d)(3).
64 I.R.C. § 543(d)(4)(A).
65 I.R.C. § 543(d)(5).
not meet the 50% ordinary gross income requirement above?

(4) In contrast, the provision relating to the real estate industry specifies when a particular corporation flunks, rather than passes, the “active conduct” test. In particular, it provides that an issuing corporation will not qualify if “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,” and specifically provides that “the ownership of, dealing in, or renting of real property shall not be treated as the active conduct a qualified trade or business.”

(a) The intent seems to be to prevent real estate rental businesses from taking advantage of the section 1202 exclusion. This would appear to be the case even for activities that qualify as a “trade or business” under the case law. However, as noted above, “leasing” is already excluded from qualified trades or businesses eligible for section 1202 treatment.

(b) The net effect of this provision seems to be that it creates a separate 10% cap on investment and rental real estate, in addition to the 20% overall cap on all non-trade or business assets under the 80% “active conduct” rule.

(c) Both this provision and the overall 80% “active conduct” requirement probably preclude the real estate company in the commonplace brother-sister real estate company/operating company structure from qualifying for section 1202 treatment.

(d) Another issue that is inherent in both this 10% disqualifying rule, as well as the 80% qualification requirement, is whether real estate purchased for future use in the business, or previously so used and now held for sale, should be treated as satisfying the “used in the active conduct of a qualified trade or business” and

66 I.R.C. § 1202(e)(7).
67 See, e.g., Taiyo Hawaii Co. v. Comm’r, 108 T.C. 590, 611 (1997) (holding that “where a taxpayer buys and sells real property, collects rents, pays operating expenses, taxes, and mortgage interest, makes alterations and repairs, employs labor, purchases materials, and makes contracts over a period of years, there is obvious evidence of a U.S. trade or business.”) (citing Pinchot v. Commissioner, 113 F.2d 718 (2d Cir. 1940)).
“used . . . in the active conduct of 1 or more qualified trades or businesses” elements of such tests, respectively.\textsuperscript{68} One would hope so.

(5) There is a similar provision relating to portfolio stock or securities. This provision provides that a corporation would not satisfy the “active conduct” requirement for any period where “more than 10 percent of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations.”\textsuperscript{69} Stock and debt of subsidiaries are disregarded under the subsidiary rules described below, and assets qualifying as working capital are also excluded under the working capital rules described below.

(a) Note that this 10% test is based on “assets (in excess of liabilities).” That 10% net asset figure could be a lot smaller than the 10% gross asset figure for real estate assets.

(b) Although “securities” are also covered, only securities “in other corporations” count. Thus, securities issued, for example, by hedge funds might not trigger this 10% net assets rule, though they would still be subject to the 20% gross assets test of the “active conduct” requirement.

(c) Many corporations flunking this test would already be excluded under the “financial services,” “brokerage services,” “financing,” “investing” or related “similar business” tests.

(d) The net effect of this requirement seems to be quite similar to the 10% non-trade or business real estate test in that it essentially creates an additional separate 10% subtest for non-subsidiary, non-working capital corporate stock and securities, on top of the 20% cap on all non-“active conduct” assets.

d) Subsidiaries

(1) For purposes of the 80 percent “active conduct” requirement, “stock and debt in any subsidiary corporation shall be

\textsuperscript{68} I.R.C. § 1202(e)(8), (1)(A) (emphasis added).

\textsuperscript{69} I.R.C. § 1202(e)(5)(B).
disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary’s assets, and to conduct its ratable share of the subsidiary’s activities.”

(2) It seems reasonable to conclude that the slightly different phraseology for the 10 percent cap on non-subsidiary, non-working capital “stock or securities” (emphasis added) on the one hand and the look-thru rule providing that “stock and debt” (emphasis added) of a subsidiary on the other was not intended to create any slippage between these two provisions, whereby, for example, some non-debt securities of the subsidiary might still be counted for the 10 percent “stock or securities” cap.

(3) For both the 10 percent cap and subsidiary look-thru rules, a corporation is a subsidiary of another corporation if that other corporation 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 the subsidiary. Thus, either “vote” or “value” is enough, but ownership of “more than” 50 percent, presumably without the application of any constructive ownership rules, is required.

(4) The disregarding of “stock and debt in any subsidiary corporation” and the application of the above look-thru rule should be pretty straightforward in the case of 100% owned subsidiaries, at least if the subsidiary has no debt to outside parties. However, determining the parent corporation’s “ratable share” of the subsidiary’s assets and activities in other situations could become problematic.

(a) For example, what does it mean to “disregard” the “debt” of the subsidiary? Does that simply mean that subsidiary debt held by the parent is excluded from the numerator and denominator in applying the 80% “active conduct” test? Is such debt taken into account for purposes of determining the parent’s “ratable share” of subsidiary assets and activities?

(b) How do you determine the parent’s ratable share if its “vote” percentage is different than its “value”

70 I.R.C. § 1202(e)(5)(A).
71 I.R.C. § 1202(e)(5)(C) (emphasis added).
percentage? Does the latter count for more in making this determination?

e) Working Capital

(1) The statute provides a fairly generous rule stating that any assets which are either “held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation” or “held for 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” will be treated as used in the active conduct of a qualified trade or business. However, even this provision could present problems. For example, the accumulation of a reserve to redeem a controlling shareholder upon his or her retirement within the next several years would not appear to qualify.

(2) Moreover, the statute specifically provides that, after a corporation has been in existence for at least two years, no more than 50 percent of its assets may “qualify as used in active conduct of a qualified trade or business by reason of this paragraph.” This provision appears to apply to both the “reasonably required working capital needs” and the “reasonably expected to be used within 2 years” prongs of the above-quoted safe harbor.

(a) This 50 percent cap on working capital after two years puts a fair amount pressure on the term “working capital.” If the term is interpreted to mean cash and marketable securities held to provide liquidity, the 50 percent cap should generally not present a problem.

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72 I.R.C. § 1202(e)(6). In Owen v. Comm’r, cited above, the court held that stock in a jewelry company intended to be the rollover recipient of a section 1045 deferral transaction was not qualified small business stock because the company did not pass the active business requirement. Owen, T.C. Memo 2012-21. In that case, 92% of the company’s assets were held in cash, in excess of the 50% working capital limitation under section 1202(e)(6). Id. (“We recognize that section 1202(e)(6) apparently contemplates that even after 2 years up to 50 percent of a corporation’s assets might in some circumstances be held as part of the reasonably required working capital needs of the business. But we leave for another day what amount of cash on hand can be considered actively used in a trade or business under section 1045 that has been in existence for less than 2 years.”).

73 I.R.C. § 1202(e)(6).

74 Cf. Treas. Reg. § 1.469-2T(c)(3)(ii). See also section 7 of the Preamble to the December 5, 2012 proposed regulations under section 1411 of the Code (the net investment income tax). 77 F.R. 72626 (“The term working
(b) However, the most common accounting definition of working capital is the excess of current assets over current liabilities. If this were to be the definition adopted for this purpose, many car dealers and other retail merchants could easily run afoul of this 50 percent working capital limitation, since a very substantial portion of the assets of such enterprises consists of inventory and accounts receivable.

3. Eligible Corporations

a) In addition to the 80 percent and two 10 percent active conduct assets requirements described above, an issuing entity must also be an “eligible corporation” in order to satisfy the active business requirement “during substantially all of the taxpayer’s holding period.”

b) However, this requirement should not cause too much of a problem for most closely held businesses.

(1) It does require that the issuing corporation, which must be domestic at the time of issuing section 1202 stock, continue to be a domestic corporation during the requisite holding period.

(2) In addition, the corporation may not be any of the following:

(a) DISC or former DISC

(b) regulated investment company, real estate investment trust or REMIC

(c) cooperative

C. In addition to the C corporation and active business requirements noted above, a corporation must also not engage in certain redemption transactions if it wants its stock to be qualified under section 1202.

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capital is not defined in either section 469 or section 1411, but it generally refers to capital set aside for use in and the future needs of a trade or business.”) (emphasis added).

75 Restatement and Revision of Accounting Research Bulletins, Accounting Research Bulletin No. 43, Ch. 3A, paragraph 3 (FASB Original Pronouncements, As Amended 1953).

76 I.R.C. § 1202(c)(2)(A), (e)(1)(B).

77 I.R.C. § 1202(e)(4).

78 I.R.C. § 1202(e)(4). This list was recently amended to remove “a corporation with respect to which an election under section 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect.” Pub. L. No. 115-141, § 401(d)(1)(D)(xv).
1. Section 1202(c)(3) contains two separate redemptions tests which prevent stock issued within 4- or 2-year periods surrounding issuance from being treated as qualified small business stock.\textsuperscript{79}

   a) Congress, in enacting these rules, intended them to “prevent evasion of the requirement that the stock be newly issued.”\textsuperscript{80}

   b) For purposes of these rules, an acquisition of a shareholder’s stock by a corporation controlled in part by such shareholder who also controls, at least in part, the issuing corporation will be treated as a purchase by the issuing corporation of its stock from the shareholder.\textsuperscript{81}

   c) Also, an acquisition of a shareholder’s stock by a corporation that is a subsidiary with respect to the issuing corporation will be treated as a purchase by the issuing corporation of its stock from the shareholder.\textsuperscript{82}

2. The first of these tests provides that stock will not be qualified small business stock if, within the 4-year period surrounding issuance, the corporation purchases “(directly or indirectly) any of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b)) to the taxpayer.”\textsuperscript{83}

   a) Here, depending on whether the taxpayer is an individual or a pass-thru entity, different persons might be treated as related to the taxpayer under these rules.

   (1) For example, where the taxpayer is an individual, the taxpayer will be viewed as related to, under section 267(b), (i) the members of his or her family (siblings, spouse and lineal descendants), (ii) a corporation more than 50 percent owned by the taxpayer, (iii) an exempt organization controlled by the taxpayer, (iv) certain responsible persons of related trusts or estates and (v) under section 707(b), a partnership in which he or she owns (directly or indirectly) more than 50% of the capital or profits.\textsuperscript{84} Since the taxpayer is an individual, the provisions

\textsuperscript{79} I.R.C. § 1202(c)(3)(A)-(B).
\textsuperscript{80} H.R. Rep. No. 103-213, 523 (Aug. 4, 1993). The original House bill provided that purchases by persons related to the corporation would be treated as purchases by the corporation for purposes of these redemption rules. Id. That rule was replaced in the Conference Agreement with the current rule that simply treats redemptions under section 103(a) as purchases by the corporation. Id. at 527; I.R.C. § 1202(c)(3)(C). Unlike the rule in section 1.83-6(d)(1) of the Treasury Regulations, a transfer of stock by a shareholder to an employee or independent contractor of the corporation will not be treated as a purchase by the corporation of that stock. Treas. Reg. § 1.1202-2(c).

\textsuperscript{81} I.R.C. § 1202(c)(3)(C); I.R.C. § 304(a)(1).
\textsuperscript{82} I.R.C. § 1202(c)(3)(C); I.R.C. § 304(a)(2).
\textsuperscript{83} I.R.C. § 1202(c)(3)(A).
\textsuperscript{84} I.R.C. §§ 267(b)(1)-(2), (4)-(9), (13), 707(b)(1)(A).
under section 267(b)(3), (10)-(12) or under section 707(b)(1)(B) should not be applicable.  

(2) Turning to the situation where a pass-thru entity owns the stock, in order for an individual holding an interest in the pass-thru entity to be entitled to exclude gain from the sale or exchange of that stock, as described below, the stock must be qualified small business stock “in the hands of [the pass-thru] entity (determined by treating such entity as an individual).”

(a) Query: What effect does the parenthetical “(determined by treating such entity as an individual)” have here? The term “individual” is used only three times in the statute, once in the parenthetical above and the other two times to make clear that the gain limitation under subsection (b) for a married individual filing a separate return is halved.

(b) Should this parenthetical apply for purposes of applying the related person rules at the pass-thru entity level?

i. For example, take the situation where a corporation otherwise meeting the requirements under section 1202 issues stock on the same date to partnership AB, which is owned 51% by individual A and 49% by individual B, and partnership AC, which is owned 51% by individual A and 49% by individual C. If, six months after issuance, the corporation redeems some of its stock held by partnership AB, would C be entitled to exclude gain on the sale of partnership AC’s stock even though partnerships AB and AC would otherwise be related under section 707(b)(1)(B)?

ii. Or, do we treat partnership AC as an individual, and thus not as a partnership, while applying the...

85 I.R.C. § 267(b)(3), (10)-(12). Presumably the additional persons treated as being described in subsection (b) by virtue of section 267(e)(1) are not treated as related persons under section 1202 since that provision generally only applies to match a payee’s income with the corresponding deduction and is not contained within subsection (b) itself. See I.R.C. § 267(e)(1).
86 I.R.C. § 1202(g)(2)(A) (emphasis added).
related person rules? If the latter, partnerships AB and AC would not be related since partnership AC would be treated as an individual and could not be one of “two partnerships in which the same persons own . . . more than 50 percent of the capital interests or profits interests,” and C would be able to exclude the gain on the eventual sale or exchange by partnership AC of its stock.  

b) Despite the statute itself providing that a redemption of “any” of its stock from the taxpayer or person related to the taxpayer would result in disqualification, the regulation under section 1202 is more lenient and provides a de minimis rule.

   (1) The regulation provides that “if, in one or more purchases . . . more than a de minimis amount of its stock” is purchased by the issuing corporation from the taxpayer or a related person within 2 years on either side of issuance, the stock issued will not be qualified small business stock.

   (2) For this purpose, more than a de minimis amount of stock is purchased only if (i) the amount paid exceeds $10,000 and (ii) “more than 2 percent of the stock held by the taxpayer and related persons is acquired.”

   (3) In determining whether “more than 2 percent of the stock held by the taxpayer and related persons [was] acquired,” one must calculate the percentage arrived at by dividing the value of the stock purchased from the taxpayer or a related person in a given transaction by the total value of all stock owned by the taxpayer and related persons immediately prior to such transaction and add each such percentage for each purchase during the 4-year period.

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89 In the preamble to the regulation under section 1202 as originally proposed, the IRS and the Treasury were apparently “concerned that, in many cases, redemptions that have neither the purpose nor the effect of evading the original issue requirement may result in disqualification under these rules.” 61 F.R. 28822 (June 6, 1996).
90 Treas. Reg. § 1.1202-2(a)(1).
91 Treas. Reg. § 1.1202-2(a)(2).
92 Id.
3. Turning to the second redemption test, stock is also disqualified if, within the 2-
year period surrounding issuance, the corporation “purchases . . . 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” determined as of one year prior to
issuance.93

a) First, it is worth pointing out that a series of redemptions violating this
 provision would disqualify all stock issued on the date of issuance. This
is different from the 4-year test which only disqualifies a particular
shareholder’s stock.

b) The regulations contain a similar de minimis rule: a corporation must
not, during the 2-year period surrounding issuance, make one or more
purchases of its stock in “more than a de minimis amount,” and the
aggregate value of such purchases “(as of the time of the respective
purchases)” must not “exceed[,] 5 percent of the aggregate value of [its]
stock as of the beginning of such 2-year period.”94

(1) Query: What happens if a redemption takes place within the first
year after the corporation is formed? Technically, the amount
equal to “5 percent of the aggregate value of all of the issuing
corporation’s stock as of the beginning of such 2-year period”
(emphasis added) would be zero since the corporation obviously
had no value a year before it came into existence.

(2) Until there is guidance on this issue, it makes sense to advise a
company seeking qualification under section 1202 to not
undertake any redemption transactions during its first year of
operations that would total more than $10,000 or 2% of its
outstanding stock (per the de minimis exception listed below).

c) As noted above, a corporation does not purchase more than a de minimis
amount of its stock unless both (i) the aggregate amount paid exceeds
$10,000 and (ii) “more than 2 percent of all outstanding stock is
purchased.”95

d) Similar to the rule above, whether the 2 percent limitation is surpassed is
determined by dividing the value of the stock purchased by the total

93 I.R.C. § 1202(c)(3)(B).
94 Treas. Reg. § 1.1202-2(b)(1).
95 Treas. Reg. § 1.1202-2(b)(2).
value of all outstanding stock for each transaction and summing the resulting amounts.  

4. The regulations provide several exceptions to these rules, which address situations that “are incident to certain events affecting a shareholder . . . [which are] of [an] extraordinary nature . . . and . . . are generally not within the control of the issuing corporation.” Under these exceptions, a stock purchase is “disregarded if the stock is acquired in the following circumstances”:

a) The stock is purchased from an employee or a director of the corporation “incident to the seller’s retirement or other bona fide termination of such services” if the stock was originally acquired by the director or employee “in connection with the performance of services as an employee or director.” While the Treasury Department and IRS anticipated publishing a rule relating to the termination of services by independent contractors, no rule has been published as of yet.

b) The stock is purchased “within 3 years and 9 months from the date of the decedent’s death” from “the decedent’s estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent’s spouse” and “[p]rior to [the] decedent’s death, the stock (or an option to acquire the stock) was held by the decedent or the decedent’s spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent’s spouse (or by both).”

c) The stock is purchased “incident to the disability or mental incompetency of the selling shareholder.”

d) The stock is purchased “incident to divorce (within the meaning of section 1041(c)) of the selling shareholder.”

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96 Id.
97 T.D. 8749, 62 FR 68166 (Dec. 31, 1997). The IRS and the Treasury Department considered whether to adopt a more general exception to these rules for “all redemptions occurring in the ordinary course of business or for legitimate business reasons.” Id. However, such an exception was not adopted because “[t]he IRS and Treasury [we]re concerned . . . that a much broader exception for redemptions that arise out of ordinary business needs and purposes of the issuing corporation . . . would be much more likely to undermine the original issue requirement.” Id.

V. Shareholder Level Requirements

A. The gain exclusion under section 1202 only applies “in the case of a taxpayer other than a corporation.”\textsuperscript{103} However, an “amount included in gross income by reason of holding an interest in a pass-thru entity,” which includes S corporations or partnerships,\textsuperscript{104} can still qualify if it is “attributable to gain on the sale or exchange by the pass-thru entity” of “qualified small business stock in the hands of such entity (determined by treating such entity as an individual)” and the amount does not exceed “the amount to which [this provision] 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,” provided the stock was held by such entity for more than five years and the taxpayer has held the interest to which such amount is attributable during the entire period that the pass-thru entity held such stock.\textsuperscript{105}

1. This provision gives rise to a number of questions relating to tiered structures.

a) One question is why would partnerships\textsuperscript{106} even need to be covered by this provision, given the fact that all taxpayers “other than corporations” are covered to begin with?

b) Also, given the language quoted above, there is a question as to whether a taxpayer holding otherwise qualifying stock indirectly through a multi-tiered structure of pass-thru entities would be eligible to exclude a gain “amount.” It would seem that it should, but query: whether that amount is “included in gross income by reason of holding an interest in a pass-thru entity” and “attributable to gain on the sale or exchange by the pass-through entity”?\textsuperscript{107} Note, however, that the regulation under a related and analogous provision, section 1045 of the Code, which defines when section 1202 stock may be rolled over without the recognition of gain prior to the expiration of the five-year holding period,\textsuperscript{108} clearly applies that provision to tiered structures.\textsuperscript{109} Note also that section 1045 is

\textsuperscript{103} I.R.C. § 1202(a)(1).
\textsuperscript{104} I.R.C. § 1202(g)(1), (4)(A)-(B). This special provision also applies to regulated investment companies and common trust funds, though that technicality is unlikely to be relevant for "choice of entity" decisions for closely held businesses. I.R.C. § 1202(g)(4)(C)-(D).
\textsuperscript{105} I.R.C. § 1202(g)(2)(A)-(B), (3).
\textsuperscript{106} This comment would apply to common trust funds also.
\textsuperscript{107} I.R.C. § 1202(g)(1), (2)(A) (emphasis added).
\textsuperscript{108} Section 1045 provides for nonrecognition of the gain on the “sale of qualified small business stock held . . . for more than 6 months” where new qualified small business stock is “purchased by the taxpayer during the 60-day period beginning on the date of such sale” and an election is made. I.R.C. § 1045(a)(1).
\textsuperscript{109} Treas. Reg. § 1.1045-1(g)(3)(iii).
supposed to apply “rules similar to the rules of subsections (f), (g), (h), (i), (j), and (k) of section 1202.”

2. The provision relating to the amount “determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired” could also give rise to a number of interpretational difficulties. Here again, however, the regulations under section 1045 may be of assistance in fleshing out this requirement. Under those regulations, the amount of realized gain deferred is limited to an amount equal to the product of “[t]he partnership’s realized gain from the sale of the [qualified small business] stock” and the “eligible partner’s smallest percentage interest in partnership capital.”

B. The gain must be “from the sale or exchange of qualified small business stock held for more than 5 years.”

1. This puts renewed emphasis on the whole “sale or exchange” set of issues that are so important for purposes of determining net capital gain.

a) Clearly dividends are not eligible. This is very important for corporations that anticipate making substantial ongoing distributions of profits, as explained in more detail below.

b) However, gain upon distributions qualifying as redemptions for tax purposes should be eligible for exclusion under this provision.

   (1) Thus, substantially disproportionate redemptions, redemptions qualifying as complete terminations of a shareholder’s interest and redemptions that are “not essentially equivalent to a dividend” should be eligible for the exclusion.

   (2) Perhaps even more important for the growth-type companies more likely to consider qualifying for section 1202 treatment, partial liquidation distributions should also qualify. Thus, an active venture capital concern should be able to buy and sell businesses, including distributing the proceeds from successful

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110 I.R.C. § 1045(b)(5).
111 I.R.C. § 1202(g)(3).
112 Treas. Reg. § 1.1045-1(d)(1)(i)-(ii). As a consequence, it appears that partners receiving a carried interest in a partnership that owns section 1202 stock would not be able to exclude gain attributable to that interest. T.D. 9353, 2007-40 I.R.B., 723 (“Taxpayers that invest through a partnership acquire the requisite interest for purposes of the continuous economic interest requirement by an investment of capital in the partnership.”).
113 I.R.C. § 1202(a)(1), (b)(2).
114 I.R.C. § 302(b)(1)-(3).
115 I.R.C. § 302(b)(4).
investments, without losing the benefit of section 1202 treatment.

(3) However, note that, as discussed in detail above, redemptions can disqualify the stock of certain, and in some cases all, shareholders of the corporation.

2. The five-year holding period requirement also includes a number of special rules, in addition to those noted above with respect to pass-thru entities.

a) There is tacking of holding periods for stock acquired in the following circumstances under the rules described above with respect to exceptions to the “original issue” requirement: (a) gifts, (b) death, (c) partnership distributions, (d) conversions, (e) Section 1244(d)(2) stock dividends, recapitalizations and changes in identity, etc., (f) Sections 351 and 368 incorporations and reorganizations.116

b) If the taxpayer “has an offsetting short position,” the five-year holding period requirement must have been satisfied before such position was acquired and the taxpayer must elect “to recognize gain as if such stock were sold” as of then.117

(1) The use of the word “has” raises some questions. For example, if the taxpayer “had” an offsetting short position in prior years, but no longer “has” the offsetting short position, does the provision even apply? Conversely, what happens if the taxpayer acquired an offsetting short position after three years, then let it expire, and then continued to own the stock for another three years?

(2) The language requiring the taxpayer “to recognize gain as if such stock were sold” when the offsetting short position was acquired also gives rise to some interpretational difficulties. Does that simply mean that only gain accrued prior to the acquisition of the offsetting short position can be excluded? Can it be interpreted to mean that the taxpayer must elect to recognize gain immediately as soon as the offsetting short positions were acquired?

(3) An offsetting short position is defined in the statute to include both a short sale of substantially identical property, as well as an option to sell substantially identical property at a fixed price.118

116 I.R.C. § 1202(h)(1)-(4).
117 I.R.C. § 1202(j)(1).
Treasury is authorized to issue regulations to cover “any other transaction which substantially reduces the risk of loss,”119 but no such regulations have been issued.

(4) Significantly, offsetting short positions held by related parties under sections 267(b) and 707(b) of the Code count for purposes of this provision.120

c) With respect to stock received “in connection with the performance of services,” the taxpayer’s holding period with respect to such stock begins at the time it is “included in [his or her] gross income in accordance with the rules of section 83.”121 This would, among other things, mean that a taxpayer making an 83(b) election would benefit by starting the clock on the 5-year holding period requirement immediately.

d) Solely to determine the appropriate gain exclusion percentage in situations where a taxpayer would otherwise be treated as having acquired stock during a period of time in which a more than 50% gain exclusion would be applicable, the taxpayer’s holding period is determined by applying the rules of section 1223 of the Code.122

(1) Consider the situation where a partnership contributes commercial real estate, which it had owned since 2008, to a newly formed corporation in a section 351 exchange in which it receives qualified small business stock. If the concluding sentence of (a)(4) did not apply, such stock would “be treated as having been acquired by the [partnership] on the date of such exchange” under section 1202(i)(1)(A) and qualify for 100% gain exclusion.

(2) However, a plain reading of the statute compels a different answer. The concluding sentence of (a)(4) provides that “[i]n the case of any stock which would [have been treated as acquired after September 27, 2010123] (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 Since the stock would

120 I.R.C. § 1202(j)(2).
124 I.R.C. § 1202(a)(4) (emphasis added).
have qualified for the 100% gain exclusion “but for” the concluding sentence of (a)(4), the partnership’s holding period for the stock will include its holding period with respect to the commercial real estate. As a result, the partnership would only be entitled to a 50% gain exclusion since the partnership would be treated as having acquired the stock in 2008.125

(3) There is some support in the legislative history for the position that this concluding sentence was really intended just to prevent taxpayers from engaging in a section 1045 rollover so as to acquire new qualified small business stock after September 27, 2010 and receive a 100% exclusion rate. However, the plain language of the statute contains no such limitation.

C. The amount of the taxpayer’s “eligible gain,” i.e. “gain from the sale or exchange of qualified small business stock held for more than 5 years,”126 that can be excluded under section 1202(a) for a given taxable year is limited to the greater of the following amounts:

1. $10,000,000 less the taxpayer’s total amount of gain previously excluded under section 1202(a)127
   a) This $10,000,000 limitation is reduced only with respect to “dispositions of stock issued by such corporation,” and so a taxpayer can exclude at least $10,000,000 of gain for each corporation in which he or she disposes of qualified small business stock held for over 5 years.128
   b) This $10,000,000 limitation turns into a $5,000,000 limitation for married individuals filing separate returns.129

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125 I.R.C. § 1223(a); I.R.C. § 1202(a)(1). Some have noted that these concluding sentences were intended only to apply to section 1045 rollover stock. Edward Vergara & Reuven Graber, Get a Hold of Your QSBS Holding Period, https://www.arnoldporter.com/en/perspectives/publications/2017/01/get-a-hold-of-your-qbs-holding-period (last accessed June 26, 2018) (citing S. Rept. 112-208, 68 n. 159 (Aug. 28, 2012) (“Under present law, it is unclear whether the tacked-holding period applies for purposes of determining when the replacement stock was acquired for purposes of determining the exclusion percentage. One commentator has suggested ‘it appears that 1223(13)’s tacked-holding-period should apply for this latter purpose [i.e., determining the date the replacement stock was acquired] as well.’ Ginsburg, Levin, and Rocap, Mergers, Acquisitions, and Buyouts, p. 2–399 (Feb. 2012).”)). This issue does not appear to have been decided, but a successful attack would clearly have to attack the plain language of the statute head on.
126 I.R.C. § 1202(b)(2).
128 I.R.C. § 1202(b)(1)(A), (2).
129 I.R.C. § 1202(b)(3)(A). Query: Is an additional $10,000,000 of exclusion worth a friendly divorce?
2. “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.”

   a) Note that this “10 times” limitation simply looks at the adjusted bases of qualified small business stock “disposed of” by the taxpayer during the taxable year. As a consequence, if the taxpayer sells only a portion of his or her qualified small business stock, only the bases with respect to such stock are used to calculate this limitation.

   b) While it is the “adjusted” basis that applies, the statute provides that the adjusted basis is “determined without regard to any addition to basis after the date on which such stock was original issued.” Moreover, in calculating the exclusion, any gain attributable to the contribution of appreciated property is not taken into account (the same as for such contributions upon original issuance). So, if a taxpayer makes additional capital contributions the corporation should issue additional stock if it still qualifies under section 1202.

   c) Where a taxpayer holds an interest in a pass-thru entity that disposes of qualified small business stock, the taxpayer takes his or her “proportionate share of the adjusted basis of the pass-thru entity in such stock” into account in determining this limitation.

   d) For married taxpayers filing a joint return, any gain excluded is “allocated equally between the spouses” when determining these limitations with respect to the taxpayer in subsequent years.

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130 I.R.C. § 1202(b)(1)(B).
132 I.R.C. § 1202(b)(1).
133 I.R.C. § 1202(i)(2).
134 I.R.C. § 1202(g)(1)(B).