QUALIFIED SMALL BUSINESS STOCK:
THE QUEST FOR QUANTUM EXCLUSIONS
(QUERIES, QUALMS, QUALIFICATIONS & QOZ)

Paul S. Lee, J.D., LL.M.
Chief Tax Strategist
The Northern Trust Company
New York, NY
Email: PSL6@ntrs.com

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statements made in the materials and during the presentation before applying them to a particular fact pattern, and should determine independently the tax and other consequences of using any particular device, technique or suggestion before recommending it to a client or implementing it for a client.

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Paul S. Lee, J.D., LL.M.
Chief Tax Strategist
The Northern Trust Company
New York, NY
Email: PSL6@ntrs.com

I. QUALIFIED SMALL BUSINESS STOCK: THE NEXT BIG BANG?

A. Introduction

1. The exclusion for gain on "Qualified Small Business Stock" (hereinafter, "QSBS") as set out in section 1202 of the Internal Revenue Code of 1986, as amended, (hereinafter, the "Code") has been available to taxpayers for over 25 years. However, for a variety of historical and structural reasons, the exclusion was not particularly popular with investors and owners of small businesses, with the notable exception of emerging technology companies. Since its inception in 1993,[2] a number of legislative changes to section 1202 of the Code have occurred and with the enactment of the "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018"[3] act, more commonly known as the "Tax Cuts and Jobs Act" ("TCJA"), we expect QSBS to become a mainstream planning option for owners of new and pre-existing businesses, particularly those that are currently structured as pass-through entities (e.g., entities taxed as partnerships, disregarded entities, and S corporations).

2. The benefits of QSBS treatment are significant: (i) 100% exclusion of gain; (ii) option to rollover and defer taxable gain by reinvesting in other QSBS companies; and (iii) ability to "multiply" the exclusion through gifts, transfers at death, and careful pre-issuance planning. The qualifications for QSBS treatment are deceptively straightforward. Unfortunately, section 1202 has a number of internal inconsistencies and very little case law and IRS administrative guidance on QSBS has been issued. Furthermore, as discussed in more detail in these materials, because of the way QSBS qualification is structured, there are many ways to inadvertently lose QSBS status or otherwise reduce the potential benefit of the exclusion. As such, there are many unanswered questions and potential pitfalls in the quest for QSBS benefits.

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[1] Portions of these materials were originally prepared for the 53rd Annual Heckerling Institute on Estate Planning (2019), published by LexisNexis Matthew Bender, and are reprinted with the permission of the Heckerling Institute and the University of Miami. *See also* Paul S. Lee, L. Joseph Comeau, Julie Miraglia Kwon, and Syida C. Long, *Qualified Small Business Stock: Quest For Quantum Exclusions, Part 1*, Tax Notes Federal (Jul. 6, 2020), p. 15, *Part 2*, Tax Notes Federal (Jul. 13, 2020), p. 217, and *Part 3*, Tax Notes Federal (Jul. 20, 2020), p. 410.

[2] Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, more commonly referred to as the "Revenue Reconciliation Act of 1993."

[3] P.L. 115-97. The Senate parliamentarian removed the short title "Tax Cuts and Jobs Act" as extraneous. Hereinafter, P.L. 115-97 will nonetheless be referred to as the "Tax Cuts and Jobs Act" or "TCJA."

3. These materials will explain how the planning landscape has changed and make a case why today is the time to seriously consider QSBS for new and preexisting closely-held businesses. It will then discuss the basic elements and qualifications of QSBS under sections 1202 and 1045 of the Code. Importantly, in the third section of these materials, I discuss the many unresolved questions and issues surrounding QSBS planning, providing practical answers and guidance on those issues, and the planning opportunities that maximize the QSBS exclusion, along with the common mistakes made by practitioners in this area.

B. QSBS: Why Now?

1. TCJA: Paving the Way for QSBS

a. By definition, QSBS is stock originally issued by a C corporation. As such, prior to the enactment of TCJA, many businesses did not consider QSBS as a viable planning option because it would have required them to do business as a C corporation which was subject to tax at the entity level at 35% percent (for a minimum of 5 years due to the 5-year holding period requirement to get the benefit of the QSBS exclusion). Effective for tax years starting after December 31, 2017, TCJA permanently reduces the corporate tax rate to 21%,[4] so the "penalty" of doing business as a C corporation has been greatly reduced, particularly for those businesses that do not anticipate making significant dividend distributions in the near future (thereby deferring the shareholder level tax).

b. TCJA adds new section 199A[5] of the Code (Qualified Business Income) for the benefit of any "taxpayer other than a corporation."[6] As such, this provision applies to sole proprietors, independent contractors, disregarded entities, partnership, and S corporations. In short and in great simplification, section 199A of the Code provides a temporary 20% deduction on the "qualified business income" from a "qualified trade or business," which generally means any trade or business other than a "specified service trade or business" or the trade or business of "performing services as an employee" (other than those taxpayers who do not exceed a certain threshold amount[7] in taxable income). At the same time, TCJA also temporarily reduces the highest marginal income tax bracket on individual taxpayers from 39.6% to 37%.[8] These two combined provisions would tend to favor doing business through a pass-through entity because if the entire 20% deduction is available to the taxpayer/owner, then, at most, the income would be taxed at an effective rate of 29.6% (80% of 37%), which is a lower overall effective rate than if that income is taxed at a flat C corporate rate of 21% and then taxed again at the individual shareholder level as a qualified dividend.

c. Unfortunately, most pass-through businesses will not get the full benefit of the 20% deduction. Generally, for taxpayers whose taxable income exceeds the threshold amounts the section 199A deduction will be limited based, in whole or in part, on: (i) the type of

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[4] § 13001 of TCJA and § 11 of the Internal Revenue Code of 1986, as amended (the "Code"). Hereinafter, all section references denoted by the symbol § shall refer to the Code, unless otherwise noted.

[5] § 11011 of TCJA and § 199A.

[6] § 199A(a).

[7] The "threshold amount" is $157,500 for each taxpayer (twice the amount in the case of a joint return). *See* § 199A(e)(2)(A).

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

trade or business engaged in by the taxpayer; (ii) the amount of W-2 wages paid with respect to the trade or business; and (iii) the unadjusted basis immediately after acquisition of qualified property held for use in the trade or business. The latter two limitations are often referred to as the "wages and basis" limitations, and these limitations can significantly limit the deduction under section 199A of the Code. As such, many individual owners of pass-through businesses will continue to be taxed at 37% or at a slightly lower rate. In addition, although TCJA temporarily reduces the highest marginal income tax bracket on individual taxpayers to 37%, it also severely limits an individual's ability to deduct state and local sales, income, and property taxes.[9] In contrast, if those state and local taxes were imposed on a C corporation (rather than being passed through to the owners as partners or shareholders of an S corporation, for example), they would be fully deductible at the entity level as an ordinary and necessary business expense. More importantly, the section 199A deduction expires on January 1, 2026,[10] whereas the rate reduction for C corporations is permanent. Thus, even pass-through entities that are getting a significant benefit under section 199A might look to convert to a C corporation as 2026 approaches.

d. Interestingly, most businesses that would qualify for the section 199A deduction will also qualify for QSBS treatment if they were formed or converted to a C corporation. This is not a coincidence because section 199A of the Code specifically refers to section 1202 of the Code in defining a "qualified trade or business" for purposes of the deduction.

(1) Under section 199A, "qualified business income"[11] is the net amount of "qualified items" with respect to any "qualified trade or business" of the taxpayer but does not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly-traded partnership income (such items of income are separately afforded a deduction under section 199A of the Code).

(2) For section 199A purposes, a "qualified trade or business" means any trade or business other than a "specified service trade or business," or the "trade or business of performing services as an employee."[12]

(3) "Specified service trade or business"[13] includes:

(a) Services that are excluded from the definition of "qualified trade or business" under section 1202(e)(3)(A) of the Code, but engineering and architecture services are carved out for these purposes,[14] leaving services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners; and

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

[10] § 199A(i).

[11] § 199A(c)(3)(A).

[12] § 199A(d)(1).

[13] The foregoing exclusion from the definition of a qualified business for specified service trades or businesses phases in for a taxpayer with taxable income in excess of a "threshold amount" and becomes fully effective once taxable income exceeds the threshold amount by $50,000 ($100,000 in the case of a joint return).

[14] § 199A(d)(2)(A).

(b) Services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.[15]

(4) As discussed later in these materials, the definition of a "qualified trade or business" for QSBS purposes is defined in a way that the universe of QSBS businesses is smaller than the universe of section 199A businesses but there is substantial overlap. Significantly, on February 8, 2019, the Treasury Department issued final Treasury Regulations under section 199A[16] (the "199A Final Regulations") that included important guidance on certain definitional items that are contained in section 1202 but where no regulatory guidance had been issued. Of course, it could be held that the guidance under the 199A Final Regulations are not applicable to QSBS planning, but sections 199A and 1202 (through deduction, on one hand, and gain exclusion, on the other) are intended to incentivize the same type of activity (that is to say, active trades or businesses). So, it is reasonable to conclude that the 199A Final Regulations give important, albeit implicit, guidance on QSBS issues.

e. The exclusion benefit for QSBS requires a sale of the stock of the corporation but many buyers prefer a purchase of assets, in large part so that the buyer can succeed to assets with an increased tax basis. One of the business incentives enacted under TCJA is a temporary 100% expensing of certain business assets pursuant to section 168(k) of the Code.[17] The provision allows immediate 100% expensing for "qualified property" placed in service after September 27, 2017, reducing the percentage that may be expensed for property placed in service after January 1, 2023. "Qualified property"[18] that is eligible for bonus depreciation includes tangible personal property with a recovery period of 20 years or less under the modified accelerated cost recovery system,[19] certain depreciable computer software, water utility property, and qualified improvement property,[20] and certain qualified film and television production property. Recapture of this type of "bonus" depreciation property is taxable as ordinary income under section 1245 of the Code.[21] If, by way of example, a pass-through entity elects 100% bonus depreciation on qualified partnership property under section 168(k), a subsequent asset sale of the qualified property will be taxable to the owners at a maximum ordinary income tax rate of 37% (or 39.6% if sold after 2025). The federal income tax rate could be even higher if the owner of the pass-through entity is not actively participating in the business, thus requiring the owner to pay an additional 3.8% excise tax under section 1411 of the Code.[22]

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[15] § 199A(d)(2)(B).

[16] T.D. 9847, 84 Fed. Reg. 2952 (2-8-19) (collectively referred to as the "199A Final Regulations").

[17] § 13201 of TCJA and § 162(k).

[18] § 168(k)(2)(A)(i).

[19] § 168(k)(2)(A)(i)(I).

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

[21] *See* § 1245(a)(3).

[22] § 1411(c). The excise tax is on "net investment income," which includes gross income derived from a trade or business that is a "passive activity (within the meaning of section 469) with respect to the taxpayer." § 1411(c)(2)(A). If an individual or trust owns an interest in a trade or business through a partnership or S corporation, the determination of whether the income is derived in an active or passive trade or business is made at the interest-holder level. *See* Treas. Reg. § 1.1411-4(b)(2)(i).

f. If the pass-through entity converts to a C corporation, and the asset sale occurs thereafter, the maximum tax rate for the entity is 21% and the subsequent distribution of the sale proceeds would typically incur an additional 23.8% (resulting in an overall tax burden of 39.8%). However, taking advantage of QSBS can significantly reduce the overall tax burden. As a first step, the conversion to a C corporation would need to qualify for nonrecognition treatment under section 351 of the Code. There seems to be no provision that would trigger recapture on the contribution (or deemed contribution) of the qualified property to the corporation assuming all of the other requirements for nonrecognition under section 351 of the Code are met (e.g., property is contributed to a controlled corporation solely in exchange for the corporation's stock).[23] If the transferor receives money, nonqualified preferred stock, or other property (commonly referred to as "boot"), then gain is triggered to the extent of the boot under section 351(b) of the Code.[24] The Treasury Regulations provide that if property subject to recapture under section 1245 of the Code is contributed to a corporation and there is partial nonrecognition, the allocation of gain across all of the contributed assets is based on relative fair market values.[25]

g. Assuming there is no recognition of gain upon conversion to a C corporation, the sale of the bonus depreciation assets will be subject to a preferential 21% rate. More importantly, if the shares of the corporation are QSBS and the shareholders have satisfied the 5-year holding period requirement, then the proceeds of the sale can be distributed to the shareholders upon liquidation of the corporation, and the gain on the sale will likely qualify for the 100% exclusion on gain under section 1202 (thereby eliminating taxation at the shareholder level). Thus, the owners of the business could significantly benefit under section 1202, even in an asset sale (saving on the rate differential between 37%/39.6% and 21%).

2. The COVID-19 Pandemic

a. As of the last update of these materials, global economies are struggling as a result of the COVID-19 pandemic, forcing most businesses to close to slow the progression of the deadly virus. Many small businesses in the United States are struggling to survive, and although the U.S. government has already passed economic relief programs—for example, by enacting the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"),[26] which includes the Paycheck Protection Program and Economic Injury Disaster Loans—it is anticipated that more

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

[24] *See* Treas. Reg. § 1.351-2. If two or more items of property are contributed to a controlled corporation, the amount and character of the gain and how the boot is apportioned among the assets is determined under two different types of methods, the asset-by-asset method, and the aggregate method. *See* Rev. Rul. 68-55, 1968-1 C.B. 130, *amplified by* Rev. Rul. 85-164, 1985-2 C.B. 117.

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

[26] P.L. 116-136 (Mar. 27, 2020).

relief and economic stimulus will be needed. To date, the CARES Act, and other relief legislation,[27] will cost $2.7 trillion, and President-Elect Biden has proposed an additional $1.9 trillion stimulus proposal. To offset the resulting budget deficit, it is speculated that income tax rates will need to be increased, which will increase the economic burden on taxpayers.

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

c. Unfortunately, as discuss later, QSBS planning is hampered by a number of practical and structural issues. First, very little guidance has been issued by the IRS on several important aspects of QSBS (for example, the "at all times" qualification of the "Aggregate Gross Asset Requirement," as defined and discussed later), many of which we highlight and for which we offer practical solutions. Second, if the U.S. government wants to provide significant incentives to investors in small businesses, section 1202 needs to be updated to reflect today's economics. By way of example, the Aggregate Gross Asset Requirement is capped at $50 million, and that figure has never been increased or even indexed for inflation. A significant increase of the $50 million limit would greatly increase the number of corporations that could qualify for QSBS treatment. Ironically, the recent economic downturn may have caused many corporations that were above the $50 million upper limit to fall below it, and despite that fact, these corporations may be unable to qualify for QSBS treatment because of the vagaries of the "at all times" requirement.

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

[27] Families First Coronavirus Response Act, P.L. 116-127 (Mar. 18, 2020) and Consolidated Appropriations Act, 2021, P.L. 116-260 (Dec. 21, 2020).

3. Evolution of QSBS

a. Enactment in 1993

(1) Section 1202 of the Code was enacted in 1993.[28] As originally enacted, section 1202 provided for a 50% exclusion from the sale of QSBS owned by non-corporate shareholders for more than five years.[29] The amount of the exclusion is limited to the greater of $10 million per taxpayer or 10 times the taxpayer's adjusted basis in the corporation. As discussed in more detail later in these materials, these limitations are subject to interpretation and are not as straightforward as they might seem. In any case, since the issuance date of the stock would have to occur after August 10, 1993 (date of enactment),[30] the earliest a taxpayer would have gotten the benefit of the exclusion was 1998.

(2) In addition, since 2003,[31] 7% of the excluded gain was also considered a preference item for alternative minimum tax (AMT) purposes.[32] Thus, if a taxpayer was subject to AMT and the taxpayer sold QSBS stock, then 50% of the taxable gain plus 7% of the excluded gain (50%) was subject to the maximum AMT tax rate of 28%, resulting in an effective tax rate on the gain from the sale of QSBS at 14.98%.[33] As discussed later in these materials, the taxable portion of gain from the sale or exchange of QSBS is subject to a maximum tax rate of 28%, not the maximum long-term capital gain tax rate of 20%, which was in effect from 1998 until May 2003. Thus, for a taxpayer that was not in AMT, the maximum effective rate for the sale of QSBS was 14% (50% of 28%), and if the taxpayer was in AMT, the maximum effective rate was 14.98%. Thus, while exclusion of gain for QSBS provided some benefit, the net benefit saved was relatively small (5.02%-6%, the difference between a 20% capital gain tax on 100% of the gain vs. the QSBS rate, depending on whether the taxpayer was subject to AMT). From May 2003 through 2012, the maximum long-term capital gain tax rate was 15%. So, the savings from QSBS sales was even smaller for those taxpayers who were subject to AMT.

b. Increased Exclusion in 2009

(1) In 2009, in the midst of the global financial recession, section 1202 was amended[34] to provide a 75% exclusion on gain for QSBS stock issued after February 17, 2009,

[28] Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, more commonly referred to as the "Revenue Reconciliation Act of 1993."

[29] § 1202(a)(1).

[30] § 1202(c)(1).

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

[32] *See* §§ 1(h)(7) and 57(a)(7).

[33] [50% taxable gain + (7% x 50% of excluded gain)] x 28% AMT rate = 53.5% gain x 28% rate = 14.98%.

[34] American Recovery & Reinvestment Act of 2009, P.L. 111-5, § 1241, 123 Stat. 115 (2009) (hereinafter, "ARRA").

but before January 1, 2011.[35] Subsequently in 2010, Congress amended the time period so that the 75% exclusion applied to stock issued before September 27, 2010.[36] Due to the 5-year holding period requirement, the earliest time a taxpayer would have been entitled to the 75% exclusion was February 18, 2014. In 2013, the maximum long-term capital gain tax rate was increased to 20%, and the 3.8% excise tax on net investment income under section 1411 of the Code became effective.[37] However, as mentioned, the taxable gain on the sale of QSBS is taxed at a maximum rate of 28%, plus the 3.8% excise tax. Assuming a taxpayer sells QSBS, which is entitled to a 75% exclusion, and the taxpayer is not subject to AMT, then the effective tax rate is 7.95% (25% x 31.3%).

(2) If, on the other hand, the taxpayer had been subject to AMT, and the taxable event had occurred prior to amendments in 2010 (as discussed below), then 25% of the taxable gain plus 7% of the excluded gain (75%) would have been taxed at the maximum 28% AMT rate. The result is that the effective tax rate on the sale would have been 8.47%.[38]

c. 100% Exclusion in 2010 and Permanence in 2015

(1) In 2010, section 1202 was again amended[39] to provide for a 100% exclusion on gain for QSBS stock issued after September 27, 2010, but before January 1, 2011.[40] In addition, the 2010 tax act eliminated the AMT preference on the excluded gain.[41] As a result, with the 5-year holding requirement, for stock issued during this short period of time, the earliest QSBS shareholders would be entitled to the 100% exclusion was September 28, 2015.

(2) Each year, until the amendment in 2015, the 100% exclusion was subject to sunset, which would have caused the exclusion to revert to 50%. There were extensions in subsequent years, and ultimately the reversion never occurred. In 2015, the 100% exclusion[42] and the elimination of the AMT preference,[43] were made permanent for all stock issued after September 27, 2010.[44]

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[35] *See* § 1241 of ARRA.

[36] *See* § 1202(a)(3).

[37] *See* American Taxpayer Relief Act of 2012, P.L. 112-240, 126 Stat. 2313 (2013), Health Care and Education Reconciliation Act of 2010, P.L. 111–152, 124 Stat. 1029 (2010), and Patient Protection and Affordable Care Act, P.L. 111-148, 124 Stat. 119 (2010).

[38] [25% taxable gain + (7% x 75% of excluded gain)] x 28% AMT rate = 30.25% gain x 28% rate = 8.47%.

[39] Small Business Jobs Act of 2010, P.L. 111-240, § 2011, 124 Stat. 2504 (2010) (hereinafter, "Small Business Jobs Act").

[40] § 2011 of the Small Business Jobs Act.

[41] *See* § 1202(a)(4)(C).

[42] § 1202(a)(4)(A).

[43] § 1202(a)(4)(C).

[44] Protecting Americans from Tax Hikes Act, P.L. 114-113, 129 Stat. 2242, and Consolidated Appropriations Act of 2016, P.L. 114-113, division Q, section 126(a), struck out "and before January 1, 2015" following "Creating Small Business Jobs Act of 2010" and in the paragraph heading struck out "2011, 2012, 2013, and 2014" and inserted "and thereafter."

4. Boom in Private Equity, Venture Capital, and SPACs

a. Coinciding with the enactment and evolution of section 1202, investments in private equity and venture capital have been booming. By definition, private equity and venture capital investing involves direct investment in private companies. According to one report, in 2000, there were approximately 1,608 private equity and venture capital firms with assets under management of $577 billion. By 2017, those numbers had grown to 4,719 firms with $2.5 trillion under management.[45]

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

c. At the time of the last update of these materials, Special Purpose Acquisitions Companies (SPACs) mergers with private businesses have been booming. SPACs are publicly-traded shell companies, holding essentially only cash, that are designed to take private companies public without going the typical initial public offering (IPO) process. In order for a company to do a traditional IPO, in addition to the required regulatory filings and disclosures, the company typically must show a history of profitability and cash flow, which often can take many years. In addition, the IPO process often includes a lengthy "roadshow" to "sell" the shares to the underwriters who then sell them to the public in the IPO. SPAC mergers circumvent the IPO process because the SPAC goes public first, with the sole intent to acquire (merge with) a private company within a short period of time (typically 2 years). Many SPAC acquisitions involve private companies that do not have a long history of profitability or revenue, and may only have innovative technology and proof of concept. In 2020, SPAC issuances were greater than $68 billion (2019 was less than $14 billion), and the number of SPAC mergers was 81 (2019 was 23) with an average deal size of $1.7 billion.[46] Many of the private companies that were acquired by SPACs were QSB corporations at some point or even at the time of the acquisition. Because, as discussed later in these materials, QSBS maintains its qualified status even after a merger with a publicly-traded company in a tax free exchange of shares, the boom in SPAC mergers has made QSBS even more relevant today.

C. Proposed Limits to QSBS Benefits of High Income Taxpayers, Trusts, and Estates

1. On November 13, 2021, the U.S. House of Representatives passed H.R. 5376, the Build Back Better Act, which includes an amendment to section 1202 that would significantly limit QSBS exclusion benefits for many QSBS shareholders. The act amends section 1202(a) of the Code (adding a new section 1202(a)(5) of the Code) in such a manner that makes the 75% and

[45] The Boston Consulting Group, *Capitalizing on the New Gold Age in Private Equity*, (March 7, 2017). which can be found: https://www.bcg.com/publications/2017/value-creation-strategy-capitalizing-on-new-golden-age-private-equity.aspx.

[46] Based on company filings with Securities and Exchange Commission.

100% exclusion rates[47] for certain QSBS investments unavailable to trusts, estates, and taxpayers with adjusted gross income (AGI) equal to or exceeding $400,000. AGI is calculated without regard to sections 1202 (QSBS exclusions), 911 (exclusion from income certain foreign earned income), 931 (exclusion from income from sources within Guam, American Samoa, or the Northern Mariana Islands), and 933 of the Code (exclusion of income from sources within Puerto Rico). The original 50% exclusion in section 1202(a)(1) would remain available for all other taxpayers. These limitations would apply to sales and exchanges after September 13, 2021, subject to a binding contract exception.

2. The proposed section 1202(a)(5) is ill-conceived from a tax policy standpoint and possibly invalid on constitutional grounds. As discussed above, section 1202 is unique in that it incentivizes investment in small businesses (in certain industries), and it rewards such investment based upon the date that such investment is made. In the wake of the global financial crisis of 2007 to 2009, Congress amended section 1202(a) of the Code in 2009 and 2010 to grant the 75% and 100% exclusions to taxpayers who were willing to make qualifying investments in (including compensation for services provided to) these businesses. Since that time many taxpayers have, in fact, made those investments with the hope and anticipation that they would reap the economic benefits of the higher exclusions. The proposed section 1202(a)(5), after the fact and retroactively, takes a significant portion of those benefits away for the vast majority of these taxpayers. As noted, the limitation applies to all trusts, estates, and individual taxpayers with adjusted gross income of $400,000 or more. AGI, for this purpose, is calculated without taking into account any QSBS exclusion, which means an individual taxpayer who has $400,000 of eligible gain in QSBS (regardless of the exclusion percentage) and who has no other AGI would nonetheless be subject to the 50% exclusion on a sale of such QSBS. It effectively means the vast majority of individual taxpayers with QSBS will be subject to this limitation. In addition, perhaps an unintended result of section 135810 is that a portion of the exclusion will be considered an AMT preference item. By making section 1202(a)(4) (the 100% exclusion) inapplicable to most QSBS taxpayers, section 1202(a)(4)(C) of the Code also does not apply. Section 1202(a)(4)(C) provides that section 57(a)(7) of the Code (7% of the QSBS exclusion is an AMT preference item) does not apply.

3. QSBS benefits are based upon the timing of the qualifying investment, and if this investment (services, funds, and property) has already occurred, this proposal, which is applied prospectively, would nevertheless retroactively take an already vested exclusion benefit of the taxpayer (provided the other shareholder and corporate level qualifications are met, as discussed in these materials). As such, it is possible that this provision violates the Due Process Clause. The U.S. Supreme Court ruling in *United States v. Carlton*[48] is often cited to support the application of retroactive tax legislation. However, the situation in *Carlton* is distinguishable in a number of important ways.

4. The law in question in *Carlton* was the retroactive application of an amendment to section 2057 of the Code, originally enacted in 1986. Section 2057 granted an estate tax deduction equal to 50% of proceeds of "any sale of employer securities by the executor of an estate"

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[47] *See* §§ 1202(a)(3) and (4). The provision would create a new § 1202(a)(5) that would provide, “In the case of the sale or exchange of qualified small business stock after September 13, 2021, paragraphs (3) and (4) shall not apply to any taxpayer if—(A) the adjusted gross income of such taxpayer (determined without regard to this section and sections 911, 931, and 933) equals or exceeds $400,000, or (B) such taxpayer is a trust or estate.

[48] *United States v. Carlton*, 512 U.S. 26 (1994).

to "an employee stock ownership plan" (ESOP).[49] That same year, the taxpayer/estate (Carlton, as executor of an estate) purchased a large amount of shares of a corporation, sold those shares to the corporation's ESOP, and then claimed the estate tax deduction. In 1987, Congress retroactively amended section 2057 (effective to original enactment) so the deduction only applies to securities "directly owned" by the decedent "immediately before death." The taxpayer asserted that the retroactive application of the amendment violated the Due Process Clause and thus invalid. As such, the *Carlton* amendment, unlike the proposed section 1202(a)(5), was a curative measure to curb an abuse and obvious misuse of the Code section. As the *Carlton* opinion points out:[50]

> It seems clear that Congress did not contemplate such broad applicability of the deduction when it originally adopted § 2057. That provision was intended to create an "incentive for stockholders to sell their companies to their employees who helped them build the company rather than liquidate, sell to outsiders or have the corporation redeem their shares on behalf of existing shareholders." Joint Committee on Taxation, Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs), 99th Cong., 2d Sess., 37 (Joint Comm. Print 1985); *see also* 132 Cong. Rec. 14507 (1986) (statement of Sen. Long) (§ 2057 "allow[s] . . . an executor to reduce taxes on an estate by one-half by selling the decedent's company to an ESOP"). When Congress initially enacted § 2057, it estimated a revenue loss from the deduction of approximately $300 million over a 5-year period. *See* 133 Cong. Rec. 4145 (1987) (statement of Rep. Rostenkowski); *id.*, at 4293 (statement of Sen. Bentsen). It became evident shortly after passage of the 1986 Act, however, that the expected revenue loss under § 2057 could be as much as $7 billion--over 20 times greater than anticipated--because the deduction was not limited to situations in which the decedent owned the securities immediately before death. *Ibid.* In introducing the amendment in February 1987, Senator Bentsen observed: "Congress did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP . . . and Congress certainly did not anticipate a $7 billion revenue loss." *Id.*, at 4294. Without the amendment, Senator Bentsen stated, "taxpayers could qualify for the deductions by engaging in essentially sham transactions." *Ibid.*

The proposed section 1202(a)(5) is essentially the opposite situation. The 75% and 100% exclusion provisions of section 1202 incentivized and created the intended taxpayer behavior (investment in small businesses in certain industries). Section 138150 significantly curtails those benefits, after the intended investment has already occurred.

5. In support of its decision in *Carlton*, the Supreme Court points favorably the amendment's "modest period of retroactivity"[51] (just over 1 year). Section 138150 applies to tax benefits that could have been acquired as early as early as February 18, 2009 (the effective date for the 75% QSBS exclusion).

6. Notwithstanding the foregoing differences, the Supreme Court in *Carlton* set a very high bar to invalidating the retroactive nature of tax legislation. The taxpayer in *Carlton*

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[49] § 2057.

[50] *Id.* at 31-32.

[51] *Id.* at 32.

argued the amendment violated due process because he detrimentally relied upon the Code, and the Supreme Court did not contest his reliance. However, according to the Supreme Court, "reliance alone is insufficient to establish a constitutional violation. Tax legislation is not a promise, and a taxpayer has no vested right in the Internal Revenue Code. "[52] Notably, the Supreme Court goes on to provide, "the detrimental reliance principle is not limited to retroactive legislation. An entirely prospective change in the law may disturb the relied-upon expectations of individuals, but such a change would not be deemed therefore to be violative of due process."[53]

7. Even if proposed section 1202(a)(5) does not violate the Due Process Clause, it is detrimental from a tax policy standpoint. Eliminating an expected benefit that arises due to an investment that was specifically encouraged will have the unintended consequence of limiting Congress' ability to incentivize other investments in the future (like those related to climate change). Consider the public outcry if the HWM Budget Proposal eliminated, effective immediately, all of the tax benefits of qualified opportunity zone investments (deferral of gain, tax free rollover, increases in tax basis, and elimination of capital gain on appreciation) since enactment under TCJA? The proposed section 1202(a)(5) is akin to that. How eager will taxpayers be to make these encouraged investments if the benefits can be taken away without notice in the future? This is not to say that the exclusion benefits of section 1202 should not be reduced as part of this budget plan, but they can be reduced in a more precise and honest manner. For example, the amendment could simply provide that all issuances of QSBS after September 13, 2021, will carry a 50% exclusion.

II. SHAREHOLDER AND CORPORATE LEVEL QSBS QUALIFICATIONS

A. Percentage Exclusion of Gain and QSBS Rate

1. As mentioned above, section 1202 of the Code excludes a percentage of gain (50%, 75%, or 100%) on the sale or exchange of QSBS held for more than five years, and the percentage of exclusion (hereinafter referred to as the "Exclusion Percentage") depends on the date on which the QSBS was acquired. Although a certain percentage of gain is excluded, the non-excluded gain, defined in the Code as "section 1202 gain," is taxed at a maximum 28% rate,[54] not the 20% preferential long-term capital gain rate. Section 1202 gain is defined as the excess of "the gain which would be excluded from gross income under section 1202 but for the percentage limitation in section 1202(a)," over "the gain excluded from gross income under section 1202"[55] (hereinafter referred to as, "Section 1202 Gain"). With the addition of the 3.8% excise tax on net investment income, the following chart sets out the maximum effective tax rates and exclusions, depending on whether the taxpayer is subject to AMT:[56]

[52] *Id.* at 33.

[53] *Id.* at 33-34.

[54] *See* §§ 1(h)(1)(F) and 1(h)(4)(A)(ii).

[55] § 1(h)(7).

[56] The chart excludes the 60% exclusion with respect to QSBS of certain empowerment zone businesses acquired after December 21, 2000 since the enactment of the 75% and 100% exclusions have made the 60% exclusion of no value to taxpayers. *See* §§ 1202(a)(2) and 1397C(b).

Acquisition Date	Exclusion Percentage	Maximum QSBS Rate	Maximum QSBS AMT Rate[57]	Maximum Rate (No QSBS)
Aug. 11, 1993 to Feb. 17, 2009	50%[58]	15.90%	16.88%	23.80%
Feb. 18, 2009 to Sep. 27, 2010	75%[59]	7.95%	9.42%	23.80%
After Sep. 27, 2010	**100%[60]**	**0.00%**	**0.00%**	**23.80%**

2. As one can see, the maximum tax savings from QSBS comes from stock acquired after September 27, 2010. One might also note that under some circumstances, the sale of QSBS stock might be subject to a higher rate than if section 1202 did not apply (e.g., stock entitled to a 50% exclusion under section 1202 sold during a time when the taxpayer's highest tax bracket is 15%). It's important to note that section 1202 is not elective. Under such circumstances, the taxpayer would have been better off intentionally losing QSBS status by, for example, failing the 5-year holding requirement or making a disqualifying transfer, as discussed in more detail below.

3. In calculating any tax liability associated with the sale of QSBS, it is important to make a distinction between Section 1202 Gain (as defined above), gain that is excluded under section 1202(a) of the Code (hereinafter, the "Excluded Section 1202 Gain"), and the taxable gain that is not subject to section 1202 (hereinafter, "Non-Section 1202 Gain"). As noted above, Section 1202 Gain is taxed at a maximum rate of 28% (31.8%) and is carefully defined in terms of gain that would be excluded but for the percentage limitations noted above. By consequence, Section 1202 Gain is also limited by the "Per-Issuer Limitation," discussed below, which limits the total amount of gain that is subject to the percentage exclusions. Any other gain, namely Non-Section 1202 Gain is taxed at the preferential 20% (23.8%) long-term capital gain tax rate.

4. For example, A has an adjusted tax basis in QSBS of $5 million that is worth $100 million. Assume that A acquired the QSBS at such a time that the 50% percentage limitation

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

[58] § 1202(a)(1).

[59] § 1202(a)(3).

[60] § 1202(a)(4).

applies, the Per-Issuer Limitation is $50 million, and all other conditions are met to qualify under section 1202. If A sells the stock for $100 million, assuming A is not in AMT, the resulting tax liability is calculated, as follows:[61]

Category Of Gain	**Amount Of Gain**	**Maximum Tax Rate**	**Federal Tax Liability**
Excluded Section 1202 Gain	$25 Million	0.00%	$0.00
Section 1202 Gain	$25 Million	31.80%	$7.95 Million
Non-Section 1202 Gain	$45 Million	23.80%	$10.71 Million
TOTALS	**$95 Million**	**N/A**	**$18.66 Million**

5. Non-Section 1202 Gain can include the unrecognized gain inherent in appreciated assets contributed to the corporation in exchange for stock in the corporation under section 351 of the Code. Under section 358 of the Code, the stock received in the corporation will receive a carryover basis, but for purposes of the Per-Issuer Limitation, discussed below, the fair market value of the contributed property is used in calculating the tenfold multiplier.

B. Per-Issuer Limitation ($10 Million or 10 Times Basis)

1. The Code provides a "Per-Issuer Limitation," which prescribes the maximum gain that can be excluded under section 1202(a) of the Code. Section 1202(b)(1) of the Code provides, "If the taxpayer has eligible gain for the taxable year from 1 or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation which may be taken into account … for the taxable year shall not exceed the greater of—"[62]

[61] *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, p. 49, fn. 75, which provides the following example: "For example, assume an individual has $300,000 gain from the sale of qualified stock in a small business corporation and $120,000 of the gain (50 percent of $240,000) is excluded from gross income under section 1202, as limited by section 1202(b). The entire $180,000 of gain included in gross income is included in the computation of net capital gain and $120,000 of that gain will be taken into account in computing 28-percent rate gain. The combination of the 50-percent exclusion and the 28-percent maximum rate will result in a maximum effective regular tax rate of 14 percent on the $240,000 gain from the sale of the small business stock to which the 50-percent section 1202 exclusion applies, and the maximum rate on the remaining $60,000 of gain is 20 percent." Please note that the highest long-term capital gain tax rate in 1997 was 20%.

[62] § 1202(b)(1).

a. "$10,000,000 reduced by the aggregate amount of eligible gain taken into account by the taxpayer . . . for prior taxable years and attributable to dispositions of stock issued by such corporation" (hereinafter, referred to as the "$10 Million Per Taxpayer Limitation"),[63] or

b. "10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year" (hereinafter referred to as the "10 Times Basis Limitation").[64]

2. As discussed later in these materials, the foregoing provision is not a model of clarity, but it does provide some interesting opportunities to possibly multiply and maximize the amount of gain exclusion by taking advantage of multiple taxpayers and engaging in careful tax basis management prior to the time of QSBS share issuance. In determining the applicability of the Per-Issuer Limitation, it's important to note that it is based on a per-issuer (per corporation), per taxpayer basis. Further, the $10 Million Per Taxpayer Limitation is reduced by recognized gains in previous taxable years, whereas the 10 Times Basis Limitation is not. The 10 Times Basis Limitation, in contrast, is taken into account only for the taxable year in question.

3. For married[65] individuals filing separate returns, the $10 Million Per Taxpayer Limitation is reduced to $5 million per taxpayer[66] (but the 10 Times Basis Limitation remains unadjusted). Section 1202(b)(3)(A) states the $5 million reduction applies "in the case of a separate return by a married individual,"[67] with no mention of married taxpayers filing a joint return. However, the Code goes on to provide in section 1202(b)(3)(B), "In the case of any joint return, the amount of eligible gain taken into account shall be allocated equally between the spouses for purposes of applying this subsection to subsequent taxable years."[68] In the absence of some clarification, a strict reading of section 1202 would imply one rule with respect to the availability of the QSBS exclusion that only applies to married taxpayers filing separately and another rule with respect to how gain is allocated that only applies to married taxpayers filing jointly. As discussed later, the section 1202 exclusion is afforded to each and every taxpayer who acquires QSBS by Original Issuance (defined later) or who receive such stock through a permissible transfer. To that end, the separate taxpayer distinction is critical.

4. This seemingly disparate treatment of exclusion benefits, on one hand, and how gain or income is allocated, on the other hand, is not in conflict with the Treasury Regulation, which provides, "Although there are two taxpayers on a joint return, there is only one taxable income."[69] Indeed, the Tax Court has held "it is a long recognized legal maxim that a husband and

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[63] § 1202(b)(1)(A).

[64] § 1202(b)(1)(B).

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

[66] § 1202(b)(3)(A).

[67] *Id.*

[68] § 1202(b)(3)(B).

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

wife are separate and distinct taxpayers notwithstanding the fact that they have filed joint Federal income tax returns."[70] Moreover, the IRS has ruled, for purposes of the $5 million limitation of section 453A, that the taxpayer and his spouse are not considered a single taxpayer. In coming to that conclusion, the IRS stated, "In particular, if Congress had intended that married individuals be treated as one taxpayer for purposes of apply the $5,000,000 limitation…, it could have easily provided for this attribution in express terms… Where Congress is silent on this point, as in section 453A, we do not believe that an allocation between married individuals can be implied."[71]

5. Thus, absent other guidance or changes to section 1202, married individuals filing jointly are entitled to each claim up to $10 million of exclusion against eligible gain, but any such gain is allocated equally between the spouses in determining the $10-million-per-taxpayer limitation for subsequent tax years, regardless of which spouse sells QSBS in any tax year.[72]

6. For purposes of the 10 Times Basis Limitation, the Code provides that the "adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued."[73] As such, if a taxpayer dies with QSBS and such stock receives a "step-up" in basis to fair market value on the date of the taxpayer's death under section 1014(a) of the Code, then the increased basis may not be used in calculating the 10 times basis limitation. In contrast, since the Code only refers to "any addition to basis," if the value of the QSBS is less than the adjusted basis at the time of death, the stock will receive a "step-down" in basis, and the lower basis would seemingly apply for calculating the 10 Times Basis Limitation. As discussed later in these materials, however, the "step-up" in basis may be beneficial depending on the stock's applicable Exclusion Percentage, unrealized Section 1202 Gain, and unrealized Non-Section 1202 Gain at the time of death. Furthermore, if the QSBS is acquired by a partnership, the limitation on "any addition to basis" would also apply to any increases in tax basis resulting from a liquidating distribution[74] to a partner or inside basis adjustments to QSBS held by the partnership under sections 734(b) of the Code, if the partnership has a section 754 election in place.[75] These

[70] *Nell v. Commissioner*, T.C. Memo. 1982-228, 43 T.C.M. (CCH) 1236, 1237. *But see*, *Voss v. Commissioner*, 796 F.3d 1051 (9th Cir. 2015) (Unmarried domestic partners, each filing separately may not apply section 163(h)(3)'s debt limitation (for the deduction of qualified residence interest) separately despite being separate taxpayers.

[71] TAM 9853002.

[72] It's unclear how and to what extent married taxpayers (filing jointly) can "split" or "share" each of their $10 million of exclusion. For example, if joint filing spouse 1 sells QSBS with $20 million of eligible gain but spouse 2 does not own any QSBS, does section 1202(b)(3)(B) of the Code allow the spouses to share and exclude the entire $20 million of gain? Section 1202(b)(3)(B) mandates an equal sharing of eligible gain between spouses and there doesn't seem to be a requirement that each spouse must have eligible gain in that same taxable year.

[73] § 1202(b)(1), flush language.

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

[75] This can occur when higher basis partnership property is distributed to a partner with a lower outside basis, resulting in a reduction of basis on the distributed property. With a section 754 election, the partnership is allowed replace the lost basis by increasing the basis of partnership property. This is sometimes referred to as a basis "strip" and "shift." *See* Paul S. Lee, Ellen K. Harrison, and Turney P. Berry, *Putting It On & Taking It Off: Managing Tax Basis Today (for Tomorrow)*, 52nd Annual Heckerling Institute on Estate Planning (2018), Chapter 2, ¶ 204.15-204.17. An addition to basis could occur under section 743(b) of the Code upon a taxable sale of a partnership interest, which would generally disqualify QSBS treatment with

additions to basis are ignored only for purposes of the 10 Times Basis Limitation, so they can reduce any unrealized Section 1202 Gain and Non-Section 1202 Gain.

7. If a taxpayer contributes property (other than money or stock) to a qualified small business corporation in exchange for stock in the corporation, such stock "shall be treated as having been acquired by the taxpayer on the date of such exchange,"[76] and the "basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged."[77] These special rules apply only for section 1202 purposes (and section 1045 purposes, as discussed later). Thus, notwithstanding that a nonrecognition contribution of property to a controlled corporation under section 351 of the Code provides for a tacking of holding period to the exchanged stock, for section 1202 purposes, the required 5-year holding period is deemed to start on the date of exchange.[78] More importantly, for purposes of the 10 Times Basis Limitation, the taxpayer is able to use the fair market value of appreciated property at the time of the exchange in that calculation.

8. The foregoing limitations on any "addition to basis after the date on which such stock was originally issued" and on the use of the fair market value for appreciated property contributed for purposes of the Per-Issuer Limitation were enacted so that "only gains that accrue after the transfers are eligible for the exclusion."[79] However, without any explanation, section 1202(i)(2) provides, "If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution."[80] As such, this subsection seems to imply that basis can be nonetheless increased for purposes of the 10 Times Basis Limitation, but it's difficult to envision a scenario in which a shareholder would contribute capital to a corporation that would not be treated as an additional acquisition of shares, thereby requiring such acquisition to satisfy all of the other requirements of QSBS.

9. Some debate exists around the order in which the Per-Issuer Limitation and the Exclusion Percentage are applied in arriving at the Excluded Section 1202 Gain. We believe the Per-Issuer Limitation is applied against eligible gain first, followed by the application of the Exclusion Percentage. The reason for this interpretation is section 1202(b)(1) mandates that the amount of eligible gain "which may be taken into account under subsection (a)" (the Exclusion Percentage) shall not exceed the Per-Issuer Limitation. Assume, A sells QSBS for $15 million of eligible gain, which qualifies for a 50% Exclusion Percentage, and the Per-Issuer Limitation is $10 million. Based on our interpretation, of the $15 million of eligible gain, $10 million "may be taken into account under subsection (a)" (i.e., the 50% exclusion), and the remaining $5 million of eligible gain is considered Non-Section 1202 Gain. The result is $5 million of Excluded Section 1202 Gain, $5 million of Section 1202 Gain, and $5 million of Non-Section 1202 Gain.

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respect to such interest, or upon the death of a partner due to a "step-up" in basis on the partnership interest, which is discussed later in these materials.

[76] § 1202(i)(1)(A).

[77] § 1202(i)(1)(B).

[78] There is a discussion later in these materials regarding the interplay between the acquisition date for QSBS purposes on formation of the corporation or conversion from a partnership to a C corporation.

[79] Conference Report (H. Rept. 103-213) on Omnibus Budget Reconciliation Act of 1993, p. 526.

[80] § 1202(i)(2).

10. Some have argued that the Exclusion Percentage should be applied against all of the eligible gain, and then the Per-Issuer Limitation is applied. Under that interpretation, in the foregoing example, 50% of the $15 million of eligible gain ($7.5 million) would be Excluded Section 1202 Gain, and since $7.5 million is less than the Per-Issuer Limitation of $10 million, $7.5 million of the eligible gain is Excluded Section 1202 Gain. We respectfully do not believe this is the correct result, although it would be better for the taxpayer. Further, it is unclear, based on this interpretation, whether the remaining gain is considered Non-Section 1202 Gain or a combination of Section 1202 Gain and Non-Section 1202 Gain.

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

C. Qualified QSBS Shareholders

1. The percentage exclusion on gain under section 1202 is available to "a taxpayer other than a corporation."[81] This includes individuals, trusts, and estates (collectively, hereinafter referred to as "Qualified QSBS Shareholders").[82] The foregoing taxpayers may be entitled to the exclusion even if the stock is held by certain pass-through entities (spelled "pass-thru" in section 1202), as long as some additional requirements are met. These pass-thru entities are not per se Qualified QSBS Shareholders, but they are eligible holders of QSBS for the benefit of the owners of the pass-thru entity who are Qualified QSBS Shareholders.[83]

2. The term "pass-thru entity"[84] means a:

a. Partnership,

b. S corporation,

c. Regulated investment company, and

d. Common trust fund.

[81] § 1202(a)(1).

[82] Similarly, the recently enacted the Qualified Business Income Deduction under section 199A of the Code is allowed to a taxpayer "other than a corporation." § 199A(a). The legislative history provides that this includes individual taxpayers, as well as trusts and estates. Joint Explanatory Statement of the Committee of Conference on H.R. 1, 115th Cong. 1st Sess. (2017), p. 27 and 40.

[83] The Qualified Business Income Deduction under section 199A is not taken at the pass-thru entity level, rather the deduction is taken at the partner or shareholder level. *See* § 199A(f)(1)(A).

[84] § 1202(g)(4).

3. A partner, shareholder, or owner of a "pass-thru entity" who is a Qualified QSBS Shareholder will be entitled to section 1202 exclusion on gain allocated to such owner,[85] as long as such gain is:

a. Attributable to a sale or exchange by the pass-thru entity of stock which is "qualified small business stock in the hands of such entity (determined by treating such entity as an individual) and which was held by such entity for more than 5 years,"[86] and

b. Includible in the gross income of the owner "by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-thru entity acquired such stock and at all times thereafter before the disposition of such stock."[87]

4. In such instance, for purposes of applying the Per-Issuer Limitation (specifically, the 10 Times Basis Limitation) to the Qualified QSBS Shareholder, the Code provides "the taxpayer's proportionate share of the adjusted basis of the pass-thru entity in such stock shall be taken into account."[88]

5. In addition, the amount of the preferential gain exclusion allocated to the taxpayer is limited by reference to the interest held by the taxpayer in the pass-thru entity on the date the qualified small business was acquired. The Code provides, in pertinent part, the allocated gain subject to a partial or complete exclusion "shall not apply to any amount to the extent such amount exceeds the amount…which…would have applied if such amount were determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired."[89]

6. With respect to regulated investment companies, IRS Notice 97-64[90] provides temporary Treasury Regulations will be issued on how regulated investment companies[91] may designate dividends as section 1202 distributions. These yet to be issued temporary regulations are expected to provide (i) section 1202 gain distributions will need to be designated separately for each issuer of QSBS; (ii) the exclusion under section 1202(a) will be determined at the shareholder level; and (iii) the maximum distributable section 1202 gain for each issuer will be calculated separately from limitations on all other classes of capital gain dividends but in the aggregate may not exceed the regulated investment company's net capital gain.[92]

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[85] § 1202(g)(1)(A).

[86] § 1202(g)(2)(A).

[87] § 1202(g)(2)(B).

[88] § 1202(g)(1)(B).

[89] § 1202(g)(3).

[90] Notice 97-64, 1997-47 I.R.B. 7.

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

[92] Notice 97-64, 1997-47 I.R.B. 7, § 8.

D. Eligible Gain (5-Year Holding Period)

1. Generally

a. The Per-Issuer Limitation is applied against "eligible gain," which is defined as "any gain from the sale or exchange of qualified small business stock held for more than 5 years."[93] As such, "eligible gain" has two definitional requirements: (i) gain must be from the sale of QSBS (as defined and discussed below), and (ii) the taxpayer must have held the stock for more than 5 years.

b. For purpose of the foregoing, stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue. The determination whether the gross assets test is met is made at the time of exercise or conversion, and the holding period of such stock is treated as beginning at that time.[94] In the case of convertible preferred stock, the gross assets determination is made at the time the convertible stock is issued, and the holding period of the convertible stock is added to that of the common stock acquired upon conversion.[95] Stock received by a taxpayer in connection with the performance of services is treated as issued when the resulting compensation income is included in the taxpayer's income pursuant to section 83 of the Code. Thus, the 5-year holding period is deemed to start (i) at issuance where the stock is subject to a substantial risk of forfeiture or other vesting condition, but the taxpayer makes a section 83(b) election, or (ii) at the expiration of the substantial risk of forfeiture or the satisfaction of the vesting condition, if the taxpayer did not make a section 83(b) election.[96]

2. Tacking and Permissible Transfers

a. The Code provides if a transferee receives stock in certain types of transfers, then the transferee will be deemed to have "acquired such stock in the same manner as the transferor,"[97] and "held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under [section 1202(h)]) by the transferor."[98] As discussed in more detail below, such a transfer is defined as any transfer:

(1) "by gift,"[99]

(2) "at death,"[100]

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[93] § 1202(b)(2). Subsection (a) of section 1202 sets out the percentage exclusion available on the sale of stock by a taxpayer other than a corporation and mirrors, but does not reference, the definition of "eligible gain" (any gain from the sale or exchange of qualified small business stock held for more than 5 years).

[94] Conference Report (H. Rept. 103-213) on Omnibus Budget Reconciliation Act of 1993, p. 526.

[95] *Id.*

[96] *Id.*

[97] § 1202(h)(1)(A).

[98] § 1202(h)(1)(B).

[99] § 1202(h)(2)(A).

[100] § 1202(h)(2)(B).

(3) "from a partnership to a partner,"[101] if the stock received from the partnership otherwise meet the requirements of section 1202(g) discussed above (e.g., limited to such shareholder's interest at the time the QSBS was acquired by the partnership) other than the 5-year holding requirement.

b. In addition to the foregoing, holding periods will tack in the following situations:

(1) Taxpayer acquires stock "solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer;"[102]

(2) The exchange of QSBS for stock in another corporation in a transaction described in section 351 of the Code or reorganization described in section 368 of the Code (as discussed in more detail below);[103] and

(3) The purchase of QSBS with proceeds from a qualifying rollover under section 1045 of the Code (as discussed below).[104]

c. It's because of the foregoing provisions that if shares of a QSB are "sold" in a tax free exchange of shares with a publicly-traded company, the publicly-traded shares will qualify for the QSBS exclusion under section 1202(a), provided the shares are sold after the required, but cumulatively calculated, 5-year holding period.

3. Disqualifying Hedging Transactions

a. Certain hedging transactions can disqualify QSBS. If a taxpayer (or related party[105]) has an "offsetting short position" on any QSBS, the gain will not qualify for partial or complete exclusion unless (i) the QSBS was held by the taxpayer for more than 5 years as of the first day on which there was a short position,[106] and (ii) the taxpayer elects to recognize gain as if such stock were sold on such first day for its fair market value.[107] An "offsetting short position" includes:[108]

(1) A "short sale of substantially identical property,"

(2) An "option to sell substantially identical property at a fixed price," or

[101] § 1202(h)(2)(C).

[102] § 1202(f).

[103] § 1202(h)(4).

[104] *See* 1223(13)

[105] § 1202(j)(2) [flush language], taxpayer includes any person who is related as defined in sections 267(b) or 707(b) of the Code.

[106] § 1202(j)(1)(A).

[107] § 1202(j)(1)(B).

[108] § 1202(j)(2).

(3) To the extent provided in the Treasury Regulations, "any other transaction which substantially reduces the risk of loss from holding such qualified small business stock."

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

E. QSBS: Original Issuance Requirement

1. Generally

a. In order for stock to be considered QSBS, it must be:

(1) Stock in a C corporation;[109]

(2) Originally issued after August 10, 1993 (date of enactment of the Revenue Reconciliation Act of 1993);[110]

(3) On the date of issuance, issued by a corporation that is a "qualified small business," as defined below;[111] and

(4) Except for certain exceptions noted below, "acquired by the taxpayer at its original issue,"[112] in exchange for money or other property (not including stock),[113] or as compensation for services provided to such corporation.[114]

b. The foregoing is often referred to as the "Original Issue" or "Original Issuance" requirement. The term "Original Issue" refers to an issuance of stock directly from the corporation to a Qualified QSBS Shareholder, as opposed to, for example, an acquisition of such stock on a secondary market or acquisition from another person. It does not refer to the timing of the issuance of stock. In other words, it should not be interpreted to mean that only the first issuance of stock from a corporation will be considered QSBS.

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[109] § 1202(c)(1).

[110] *Id.*

[111] § 1202(c)(1)(A).

[112] § 1202(c)(1)(B).

[113] § 1202(c)(1)(B)(i).

[114] § 1202(c)(1)(B)(ii).

2. Permissible Transfers

a. The Original Issuance requirement is not violated if a taxpayer receives the stock "by gift"[115] or "at death."[116] Thus, if the transferred stock satisfied the Original Issuance requirement in the previous owner's hands, it continues to satisfy that requirement. However, as discussed later in these materials, it is unclear the breadth of transfers that would be considered "by gift" and "at death." Because section 1202 is an income tax section, it is reasonable to conclude that transfers "by gift" and "at death" are defined as they would be under Chapter 1 of Title 26 of the United States Code (e.g., transferee basis would be determined under sections 1015 and 1014 of the Code), rather than as these transfers would be defined under Chapters 11 and 12 (estate and gift tax).

b. In addition, the Original Issuance requirement is not violated if a taxpayer receives the stock in a transfer "from a partnership to a partner,"[117] provided the stock received from the partnership otherwise meet the requirements of section 1202(g) discussed above (e.g., limited to such shareholder's interest at the time the QSBS was acquired by the partnership) other than the 5-year holding requirement. This exception applies only to partnerships and apparently does not apply to distributions from other types of pass-thru entities (as defined in section 1202(g)(4) of the Code), like S corporations, although they are eligible holders of QSBS. Notably, what is not included is a transfer from a partner to a partnership. Whether a contribution of QSBS stock to a partnership (typically a non-taxable event) automatically disqualifies QSBS is discussed in detail later in these materials.

c. The Original Issuance requirement is also met if a pre-existing business that is a sole proprietorship, disregarded entity, or partnership for Federal income tax purposes converts to a C corporation and as part of that conversion issues shares to the owners of the business. While section 1202 contains an aggregate gross asset limitation, there is no time frame by which a preexisting trade or business must convert to a C corporation, so even businesses that have been in existence for a long period of time could become QSBS companies. As mentioned above, in the wake of the enactment of TCJA, the ability to convert preexisting businesses to C corporations and qualify them for QSBS is an important planning option to consider. This is discussed in greater detail later in these materials.

d. Given the Aggregate Gross Asset Requirement (discussed below), it remains to be seen if a preexisting business can divide its business to meet the gross asset test at the time of original issuance. To that end, the Code provides, "The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including regulations to prevent the avoidance of the purposes of this section through split-ups, shell corporations, partnerships, or otherwise."[118]

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115 § 1202(h)(2)(A).

116 § 1202(h)(2)(B).

117 § 1202(h)(2)(C).

118 § 1202(k).

3. Disqualifying Redemptions and Purchases

a. As discussed in more detail below, in order to prevent a possible abuse surrounding the Original Issuance requirement, the QSBS exclusion is not available if the issuing corporation redeems or otherwise purchases its stock within a period of time surrounding the issuance of the stock.[119] Presumably, these rules are to ensure that taxpayers do not convert non-QSBS stock to QSBS or to give QSBS status to investments that are essentially replacements of previous investments.

b. Stock will lose QSBS status if the issuing corporation "at any time during the 4-year period beginning on the date 2 years before the issuance of such stock … purchased (directly or indirectly) any of its stock from the taxpayer or from a person related … to the taxpayer."[120] The disqualification applies only to stock "acquired by the taxpayer,"[121] not to other stock held by other shareholders. A person is deemed related under sections 267(b) or 707(b) of the Code. As such, the family of an individual includes his or her "brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."[122] The Treasury Regulations provide that QSBS status is retained if the purchase or redemption from the taxpayer or related party is limited to a de minimis amount.[123] For this purpose, a de minimis amount is exceeded if (i) the aggregate amount paid for the stock exceeds $10,000, and (ii) more than two percent of the stock held by the taxpayer and related person is acquired.[124]

c. Stock will lose QSBS status if the issuing corporation "during the 2-year period beginning on the date 1 year before the issuance of such stock … made 1 or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of such 2-year period."[125] Unlike a related party redemption above, this disqualification applies to all stock "issued by a corporation."[126] For purposes of this rule, the Treasury Regulations provide that QSBS status is retained if the purchase or redemption is limited to a de minimis amount.[127] For this purpose, a de minimis amount is exceeded if (i) the aggregate amount paid for the stock exceeds $10,000, and

[119] *See* Conference Report (H. Rept. 103-213) on Omnibus Budget Reconciliation Act of 1993, p. 523. The Conference Report provides the redemption rules are "to prevent evasion of the requirement that the stock be newly issued."

[120] § 1202(c)(3)(A).

[121] *Id.*

[122] § 267(c)(1). There is also constructive ownership through trusts, estates, and business entities. *See* §§ 267(b) and 707(b).

[123] Treas. Reg. § 1.1202-2(a)(1). The Treasury Regulation was issued in 1997, but the de minimis exception applies to all stock issued after August 10, 1993. Treas. Reg. § 1.1202-2(e).

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

[125] § 1202(c)(3)(B).

[126] *Id.*

[127] Treas. Reg. § 1.1202-2(b)(1). The Treasury Regulation was issued in 1997, but the de minimis exception applies to all stock issued after August 10, 1993. Treas. Reg. § 1.1202-2(e).

(ii) more than two percent of all of the outstanding stock is purchased.[128] For purposes of the two percent limit, "The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase."[129] Note that the de minimis calculation is determined at the time of the purchase, but the five percent limit described in the Code is determined at the beginning of the two-year period.

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

e. For purposes of (related party and significant) redemptions under section 1202 of the Code, if a distribution is treated under section 304(a) of the Code as a redemption of stock in any corporation, then such corporation shall, for QSBS purposes, be treated as purchasing an amount of stock equal to the value of the amount treated as a redemption under section 304(a).[130] Section 304(a) of the Code generally provides if one or more persons are in control of two corporations, and in return for property, one of the corporations acquires the stock of the other corporation, then the property shall be treated as a distribution in redemption of stock of the corporation acquiring such stock.[131] For this purpose, "control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock."[132] In determining the foregoing, constructive ownership under section 318(a) of the Code applies,[133] except that in determining attribution from or to corporations, 5 percent replaces 50 percent.[134] Under section 318(a), an individual is deemed to own the stocked owned by his or her spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), children, grandchildren, and parents.[135]

f. For purposes of the related party and significant redemptions rules, the following purchases are ignored:

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[128] Treas. Reg. § 1.1202-2(b)(2).

[129] The Treasury Regulations also provide, "The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase." *Id.*

[130] § 1202(c)(3)(C).

[131] *See* § 304(a)(1).

[132] § 304(c)(1).

[133] § 304(c)(3).

[134] § 304(c)(3)(B).

[135] § 318(a)(1)(A).

(1) A transfer of stock by a shareholder to an employee, independent contractor, or beneficiary of either is not treated as a purchase by the issuing corporation, even if the stock is treated as having been transferred to the corporation and then to the recipient under the Treasury Regulations relating to transfers by shareholders to employees or independent contractors being treated as compensation;[136]

(2) A stock purchase in connection with death, disability or mental incompetence, or divorce;[137]

(3) A purchase of stock if the shareholder acquired the stock in connection with the performance of services as an employee or director of the issuing corporation and the stock is purchased from the shareholder incident to the shareholder's retirement or other bona fide termination of services;[138]

(4) A purchase of stock in connection with the death of an individual, if prior the decedent's death, the stock (or an option to acquire the stock) was held by the (i) decedent, decedent's spouse, or both, (ii) the decedent and a joint tenant, or (iii) a trust revocable by the decedent, spouse, or both,[139] and if the stock is purchased:

(a) From the decedent's estate, a beneficiary that receives the stock either by bequest or lifetime gift, heir, surviving joint tenant, surviving spouse, or from a trust established by the decedent or decedent's spouse;[140] and

(b) Within three years and nine months from the date of the decedent's death.[141]

F. QSBS: Active Business Requirement

1. Generally

a. Stock in a corporation will not be considered QSBS unless "during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements" (hereinafter referred to as the "Active Business Requirement") … "and such corporation is a C corporation."[142] "Substantially all" refers to the taxpayer's holding period, and there is no guidance or safe harbor that describes what period of time will be considered sufficient for these purposes. Although two court cases have held that the taxpayers failed to meet

[136] Treas. Reg. §§ 1.1202-2(c) and 1.83-6(d)(1).

[137] Treas. Reg. § 1.1202-2(d).

[138] Treas. Reg. § 1.1202-2(d)(1)(i). Note, the Treasury Regulations reserve a section for the treatment of stock purchases from independent contractors, but to date, such section has not been issued. Treas. Reg. § 1.1202-2(d)(1)(ii).

[139] Treas. Reg. § 1.1202-2(d)(2).

[140] Treas. Reg. § 1.1202-2(d)(2)(i).

[141] Treas. Reg. § 1.1202-2(d)(2)(ii).

[142] § 1202(c)(2)(A).

the Active Business Requirement, the court failed to give guidance on how "substantially all" is to be determined.[143]

b. Under section 1202(e)(1) of the Code, a corporation is deemed to meet the Active Business Requirement for any period if during that time:

(1) At least 80 percent (by value) of the assets of the corporation are used "in the active conduct of 1 or more qualified trades or businesses,"[144] and

(2) The corporation is an "eligible corporation"[145] (any domestic corporation other than a (i) DISC or former DISC, (ii) regulated investment company, real estate investment trust, or REMIC, and (iii) cooperative). [146]

2. Defining "Substantially All"

a. Not only are there questions about how the 80 percent test will be calculated (discussed below), but no guidance has been issued to prescribe how the "substantially all" holding period should be applied in conjunction with the 80 percent test. Recently issued guidance relating to qualified opportunity zones may be helpful in this respect. TCJA enacted new sections 1400Z-1 and 1400Z-2 of the Code (qualified opportunity zone investments or "QOZ" investments through a qualified opportunity fund or "QOF") which provide taxpayers with a number of benefits similar to QSBS, including a deferral and reduction of recognized gains and an abatement of post-investment appreciation, provided the taxpayers meet certain holding company requirements. In fact, section 1400Z-2 refers to the disqualifying redemptions and purchases rule in section 1202(c)(3) in describing qualified opportunity zone stock,[147] and Treasury Regulations impose an original issuance requirement for "qualified opportunity zone stock."[148] Because QSBS and QOZ investments are meant to incentivize certain types of investments (i.e., small business growth with QSBS investments and economic growth in distressed communities with QOZ investments), it is reasonable to look to the recently issued QOZ guidance, which has been rapid and prolific since its enactment, while QSBS guidance continues to be sorely lacking.

b. In January of 2020, the IRS published final Treasury Regulations on investments in QOFs (the "2020 QOZ Final Regulations"),[149] retaining the basic approach and structure of two sets of proposed Treasury Regulations previously issued in 2018[150] and 2019,[151] (each respectively referred to as the "2018 QOZ Proposed Regulations" and the "2019 QOZ

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

[144] § 1202(e)(1)(A).

[145] § 1202(e)(1)(B).

[146] § 1202(e)(4).

[147] § 1400Z-2(d)(2)(B)(ii).

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

[149] T.D. 9889, 85 Fed. Reg. 1866 (01-13-20) (the "2020 QOZ Final Regulations").

[150] REG-115420-18, 83 Fed. Reg. 54279 (10-29-18) (the "2018 QOZ Proposed Regulations").

[151] REG-120186-18 (the "2019 QOZ Proposed Regulations").

Proposed Regulations"). Section 1400Z-2 of the Code imposes a "substantially all" holding period requirement and a "substantially all" test on assets. [152] For example, "The term 'qualified opportunity zone business property' means tangible property used in a trade or business of the qualified opportunity fund if… during substantially all of the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone."[153] For purposes of the foregoing, the 2020 QOZ Final Regulations include four new definitional phrases or terms:

> (1) "*70-percent tangible property standard*. The term 70-percent tangible property standard means the requirement in section 1400Z-2(d)(3)(A)(i) that a qualified opportunity zone business must satisfy with respect to qualified opportunity zone business property (see § 1.1400Z2(d)-2) that the qualified opportunity zone business holds, whether the qualified opportunity zone business property is owned by the qualified opportunity zone business or leased by the qualified opportunity zone business from another person."[154]
>
> (2) "*70-percent use test*. The term 70-percent use test means the test used to determine if a QOF or qualified opportunity zone business satisfies the requirement in sections 1400Z-2(d)(2)(D)(i)(III) and 1400Z-2(d)(3)(A)(i) that substantially all of the use of tangible property was in a qualified opportunity zone."[155]
>
> (3) "*90-percent qualified opportunity zone property holding period.* The term 90-percent qualified opportunity zone property holding period means the minimum portion of a QOF's holding period in stock of a corporation or interests in a partnership, during which the corporation or partnership qualifies as a qualified opportunity zone business in order for the stock or the partnership interests to meet the substantially all requirement under section 1400Z-2(d)(2)(B)(i)(III) to be treated as qualified opportunity zone stock or the substantially all requirement under section 1400Z-2(d)(2)(C)(iii) to be treated as qualified opportunity zone partnership interests, as applicable, held by the QOF."[156]
>
> (4) "*90-percent qualified opportunity zone business property holding period.* The term 90-percent qualified opportunity zone business property holding period means the minimum portion of a QOF's or qualified opportunity zone business's holding period in tangible property during which the 70-percent use test with respect to the tangible property must be satisfied, in order for the tangible property to meet the requirement under section 1400Z-2(d)(2)(D)(i)(III) to be treated as qualified opportunity zone business property held by the QOF or qualified opportunity zone business."[157]

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

[153] § 1400Z-2(d)(3)(A)(i) and (A)(i)(III).

[154] Treas. Reg. § 1.1400Z2(a)-1(b) (2).

[155] Treas. Reg. § 1.1400Z2(a)-1(b)(3).

[156] Treas. Reg. § 1.1400Z2(a)-1(b)(4).

[157] Treas. Reg. § 1.1400Z2(a)-1(b)(5).

c. The 2020 QOZ Final Regulations generally requires that a QOF must apply a holding period and asset use requirement in a compound manner.[158] As the preamble to the 2020 QOZ Final Regulations state, "due to the compound application of the 90-percent threshold, the 70-percent tangible property standard, and the 70-percent use test, the Treasury Department and the IRS sought to ensure that each percentage requirement, when taken together, would remain significant." As previously explained in the preamble to the 2018 QOZ Proposed Regulations,[159] "Several requirements of section 1400Z-2(d) use substantially all multiple times in a row (that is, "substantially all of … substantially all of … substantially all of …"). This compounded use of substantially all must be interpreted in a manner that does not result in a fraction that is too small to implement the intent of Congress." [160] While 90 percent may seem unusually high, the preamble to 2019 QOZ Proposed Regulations explains:

> [T]he Treasury Department and the IRS have determined that a higher threshold is necessary in the holding period context to preserve the integrity of the statute and for the purpose of focusing investment in designated qualified opportunity zones. Thus, the proposed regulations provide that the term substantially all as used in the holding period context in sections 1400Z-2(d)(2)(B)(i)(III), 1400Z-2(d)(2)(C)(iii), and 1400Z-2(d)(2)(D)(i)(III) is defined as 90 percent. Using a percentage threshold that is higher than 70-percent in the holding period context is warranted as taxpayers are more easily able to control and determine the period for which they hold property. In addition, given the lower 70-percent thresholds for testing both the use of tangible property in the qualified opportunity zone and the amount of owned and leased tangible property of a qualified opportunity zone business that must be qualified opportunity zone business property, applying a 70-percent threshold in the holding period context can result in much less than half of a qualified opportunity zone business's tangible property being used in a qualified opportunity zone. Accordingly, the Treasury Department and the IRS have determined that using a threshold lower than 90 percent in the holding period context would reduce the amount of investment in qualified opportunity zones to levels inconsistent with the purposes of section 1400Z-2.

d. Mathematically, when taken together, the compound "substantially all" requirements result in a combined percentage requirement of at least 63 percent (0.9 x 0.7). Assuming a similar rule would be applicable to QSBS, "substantially all" could be interpreted to mean approximately 80% of the holding period. When combined with the 80-percent asset test discussed below, the combined percentage requirement is at least 64% (0.8 x 0.8). Perhaps not coincidentally, the term "substantially all" in other Code sections leads to a general rule, in other contexts, of 80%.[161]

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[158] *See generally* Treas. Reg. § 1.1400Z2(d)-1(b) and -1(c).

[159] Preamble to the 2018 QOZ Proposed Regulations.

[160] Preamble to the 2018 QOZ Proposed Regulations.

[161] *See, e.g.,* Treas. Reg. § 1.41-4(a)(6) and Rev. Proc. 92-33, 1992-1 C.B. 28. *Cf.* Rev. Proc. 77-37, 1977-2 C.B. 568 (for purposes of sections 354(b)(1)(A), 368(a)(1)(C), 368(a)(2)(B)(i), 368(a)(2)(E)(i) of the Code, "substantially all" is satisfied if there is a transfer of assets of at least 90% of the fair market value of the net assets and at least 70% of the fair market value of the gross assets immediately prior to the transfer).

e. It may seem erroneous to combine percentages in this manner, but the preamble to the 2019 QOZ Proposed Regulations does, in fact, do this:

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

3. 80 Percent Test

a. It is unclear whether the 80 percent test should be interpreted to mean that at all times the corporation must use at least 80 percent of assets in the active trade or business, or if during the period in question an average of at least 80 percent will suffice. For purposes of the 80 percent test, there is a look through rule for any subsidiaries of the parent. Pursuant to the rule, the value of any stock and debt in any subsidiary is disregarded, and the parent corporation is "deemed to own its ratable share of the subsidiary's assets, and to conduct its ratable share of the subsidiary's activities."[162] For this purpose, a corporation will be considered a subsidiary if the parent owns more than "50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent in value of all outstanding stock, of such corporation."[163] In addition to the foregoing, a corporation will be deemed to fail the 80 percent test for any period during which "more than 10 percent of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries of such corporation,"[164] other than assets that would be considered "working capital" under section 1202(e)(6) of the Code, as defined below. The latter restriction is intended to ensure that a corporation does not hold a passive portfolio of stock or securities that will not be reasonably used in the conduct of the active trade or business.

b. For purposes of the 80 percent test, any assets that are reasonably required for the working capital needs of the trade or business will be treated as used in the active conduct of a qualified trade or business. These "working capital" assets are described as any assets which are held for (i) "reasonably required working capital needs of a qualified trade or business of the corporation,"[165] or (ii) "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."[166] If the corporation has been in existence for at least 2

[162] § 1202(e)(5)(A).

[163] § 1202(e)(5)(C).

[164] § 1202(e)(5)(B).

[165] § 1202(e)(6)(A).

[166] § 1202(e)(6)(B).

years, no more than 50 percent of the assets of the corporation under this "working capital" safe harbor will be considered used in the active conduce of a qualified trade or business.[167]

c. It should be noted that under certain accounting conventions "working capital" includes inventory because "working capital" could be defined as "the excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin or buffer for meeting obligations within the ordinary operating cycle of the business."[168] Certain active trade or businesses involved in the retail or grocery business often have a very large percentage (70% or more) of their current assets in inventory. Section 1202 was never intended to preclude these types of businesses from the definition of a "qualified trade or business." Thus, it is reasonable to conclude that "working capital" is more narrowly defined. Here again, the guidance surrounding QOZs is instructive. Commentators to the 2019 QOZ Proposed Regulations asserted that "inventory should never be treated as qualified opportunity zone business property because such inventory (i) is a transitory asset, (ii) does not add value to the QOZ, and (iii) does not meet the requirements for either the original use or substantial improvement requirement."[169] Ultimately, the 2020 QOZ Final Regulations provide that for purposes of the 90-percent investment standard and the 70-percent tangible property standard, a QOF may choose to include or exclude the inventory in the calculation, but once a QOF makes such choice it must do so consistently. Furthermore, the QOZ Final Regulations adopt the definition of "working capital" provided in section 1397C(e)(1) of the Code. Section 1397C(e)(1) of the Code excludes from the definition of "nonqualified financial property" reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less.[170]

d. For purposes of the 80 percent test, certain assets used in start-up activities and for research will be deemed to be used in the active conduct of a trade or business. Assets used for (i) "start-up activities described in section 195(c)(1)(A)"[171] of the Code, (ii) "activities resulting in the payment or incurring of expenditures that may be treated as research and experimental expenditures deductible under section 174"[172] of the Code, and (iii) "activities with

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[167] § 1202(e)(6) [flush language].

[168] Accounting Research Bulletin 43 (ARB 43) of the American Institute of Certified Public Accountants, ch. 3, Working Capital, § A-Current Assets and Current Liabilities, ¶3 (codified in FASB Accounting Standards Codification 210-10-05 through 210-10-60, 310-10-45, 340-10-05, 470-10-45 through 470-10-60, and 958-210-60).

[169] Preamble to the 2020 QOZ Final Regulations.

[170] See § 1400Z2(d)-1(d)(3) (reference to § 1397C(b)(8) and Prop. Treas. Reg. § 1.1400Z-2(d)-1(d)(5)(iii)

[171] § 1202(e)(2)(A). Section 195(c)(1)(A) of the Code broadly defines "start-up expenditure" as any amount paid or incurred in connection with (i) "investigating the creation or acquisition of an active trade or business," (ii) "creating an active trade or business," or (iii) "any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business." §195(c)(1)(A)(i)-(iii).

[172] § 1202(e)(2)(B). § 13206(a) of TCJA amended section 174 of the Code, requiring specified research or experimental expenditures, including software development expenditures, to be capitalized and amortized (rather than immediately deductible at the election of the taxpayer), generally, over a 5-year period. The amendment applies to amounts paid or incurred in taxable years beginning after December 31, 2021. It is unclear whether or how this amendment may affect how the 80 percent test is to be applied under section 1202 of the Code.

respect to in-house research expenses described in section 41(b)(4)"[173] of the Code, will be treated as "used in the active conduct of a qualified trade or business," regardless of whether the corporation has "any gross income from such activities at the time of the determination."[174]

e. A corporation will not be treated as meeting the 80 percent test for any period during which "more than 10 percent of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business."[175] For purposes of the foregoing, "the ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business."[176]

f. For purposes of the 80 percent test, certain computer software assets which produce royalties will be deemed to be used in the active conduct of a trade or business. This applies only to "rights to computer software which produces active business computer software royalties (within the meaning of section 543(d)(1))."[177] Generally, active business computer software royalties apply only to corporations that are actively engaged in the computer software business.[178]

4. Qualified Trade or Business Defined

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

(1) "Trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees;"[179]

(2) "Banking, insurance, financing, leasing, investing, or similar business;"[180]

(3) "Farming business (including the business of raising or harvesting trees);"[181]

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[173] § 1202(e)(2)(C). Section 41(b)(4) of the Code provides a taxpayer is treated as meeting the trade or business requirement if "at the time such in-house research expenses are paid or incurred, the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of a future trade or business." § 41(b)(4).

[174] § 1202(e)(2) [flush language].

[175] § 1202(e)(7).

[176] *Id.*

[177] § 1202(e)(8).

[178] *See* § 543(d)(2).

[179] § 1202(e)(3)(A).

[180] § 1202(e)(3)(B).

[181] § 1202(e)(3)(C).

(4) "Business involving the production or extraction of products that would provide depletion deductions under sections 613 and 613A"[182] of the Code (e.g., oil, natural gas, minerals, etc.); and

(5) "Business operating a hotel, motel, restaurant, or other similar businesses."[183]

b. Notwithstanding the exclusion of certain companies performing "services" in certain fields like health, the IRS has ruled that companies that deploy technology, manufacturing assets, or other intellectual property to provide services exclusively to clients in the health care industry would nonetheless qualify for QSBS status:

(1) PLR 201436001 involved a company that worked exclusively with clients in the pharmaceutical industry to commercialize experimental drugs. Specifically, the company's activities included research on drug formation effectiveness, pre-commercial testing procedures, and manufacturing of drugs. The IRS explained, "the thrust of § 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners)."[184] The IRS ruled, "Company is not in the business of offering service in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers. Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, … Company does not perform services in the health industry within the meaning of § 1202(e)(3)."[185]

(2) PLR 201717010 involved a company that was formed to provide more complete and timely information to health care providers. In particular, the company owned and deployed patents and other technology for the detection of "B," pursuant to which it performed "X" testing, analyzed the results of X testing, and prepared laboratory reports for healthcare providers. In ruling that the company qualified for QSBS status, it noted that the company simply provides lab results to health care professionals, does not discuss diagnoses or treatment, does not discuss lab tests to patients, and only has contact with patients for billing purposes. Further, the skills of the company's employees are not useful in preforming the tests, and they are not subject to state licensing requirements as healthcare professionals. Finally, none of the company's revenue is earned in connection with patients' medical care.

(3) PLR 202144026 involved a company that developed software to assist medical providers in providing treatment to patients. The software seeks to make medical treatment more effective by optimizing the patients use of medical treatment or medication. The software is used by the medical provider and patients, and the medical provider makes all the medical decisions. The company does not practice medicine, has no patients, and is not licensed to issue prescriptions. The company does not perform any medical or laboratory tests and does not diagnose or recommend patient treatment. The IRS ruled, "Although the software and applications

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[182] § 1202(e)(3)(D).

[183] § 1202(e)(3)(E).

[184] PLR 201436001.

[185] *Id.*

developed by Company are allied or associated with the healthcare industry, we conclude that for the purposes of § 1202(e)(3), Company is not in the trade or business of performing services in the field of health or where the principal asset of the trade or business is the reputation or skill of one or more of its employees."[186]

(4) It is not clear whether all of the foregoing factors must exist in order for a company that works in excluded service fields to have QSBS status, but it seems important that there must exist a physical asset, process, proprietary methodology, technology, patent, or other intellectual property such that it is not a company where "the principal asset of the trade or business is the reputation or skill of one or more of its employees."[187]

(5) Unlike the previous aforementioned rulings, PLR 202221006 involved a company involved in the retail sale pharmaceuticals. The company did not manufacture them, but it held exclusive distribution arrangements with the manufacturers. Although the business employed licensed pharmacists to fill prescriptions received by physicians, most of the employees were not licensed and provided services like the coordination insurance coverage and following up with the patients to inquire about side effects. None of the employees (including the pharmacists) diagnose, treat or manage any of the patient's care, and their interactions with the patients are limited to filling and the maintenance of prescriptions has ordered by the physicians. The IRS ruled that the business was not in a trade or business involving the performance of services in the field of health or where the principal asset of the trade or business is the reputation and skill of one or more of its employees. To the latter conclusion, the ruling points out that the business' "principal asset is not the reputation or skill of one or more employees, but its exclusive pharmaceutical distribution rights."[188]

c. The IRS has ruled that a company that obtains insurance (property, casualty, surety, worker's compensation, employee benefits, personal and medical, and professional practice insurance) for its customers, as an agent or representative of insurance companies or as an agent appointed with a general wholesale agent, was engaged in a qualified trade or business as defined in section 1202(e)(3) of the Code.[189] Despite the Code excluding "the performance of services in the fields of … brokerage services"[190] and also "insurance … or other similar business,"[191] the IRS ruled that the company's activities fell within the definition of a qualified trade or business. In coming to that conclusion, the IRS reasoned, "Business's role is not that of a mere intermediary. Contracts with insurance companies require Business to perform a number of administrative services beyond those that would be performed by a mere intermediary facilitating a transaction between two parties."[192]

d. In a recently issued legal memorandum,[193] chief counsel concluded that a business that facilitates (through its website) the leasing of property between lessors and lessees

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[186] PLR 202144026.

[187] PLR 201717010.

[188] PLR 202221006.

[189] PLR 202114002.

[190] § 1202(e)(3)(A).

[191] § 1202(e)(3)(B).

[192] PLR 202114002.

[193] ILM 202204007.

constitutes "brokerage services." Chief counsel concluded, "A broker serves as an intermediary between a buyer and a seller, and Corporation does this."[194] The chief counsel's office added, "Unlike a search engine that provides content to users and also sends targeted advertisements to those users based on their search history, Corporation's website is solely devoted to effectuating agreements between potential lessors and potential lessees of certain property."[195] Most notably in this legal memorandum, chief counsel asserted that "brokerage services," in the context of section 1202, should be interpreted broadly, citing section 6045 which includes any person who regularly acts as a middleman with respect to property or services. This assertion is in contrast to section 199A, discussed below, which defines "brokerage services" narrowly (i.e., securities).

5. Guidance from Section 199A Final Regulations

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

b. Given that the IRS has issued the 199A Final Regulations, practitioners might get some inference as to how these definitions may be interpreted for QSBS purposes. A detailed discussion of the 199A Final Regulations is beyond the scope of these materials, but they provide interesting insights (in many instances drawing upon guidance from section 448(d)(2) of the Code)[196] as to how certain in enumerated personal service fields will be defined.

(1) Trade or Business

(a) Sections 1202 and 199A of the Code apply to trades or businesses but neither provides a definition of the term. The term is defined in a number of different Code sections, but the 199A Final Regulations conclude that section 162 of the Code provides the most appropriate definition of a trade or business. The 199A Final Regulations provide that a trade or business means "a trade or business that is a trade or business under section 162 (a section 162 trade or business) other than the trade or business of performing services as an employee."[197]

(b) The courts have held that under section 162 of the Code a trade or business requires that the taxpayer carry on activities with a good faith intention to make

[194] *Id.*

[195] *Id.*

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

[197] Treas. Reg. § 1.199A-1(b)(14).

a profit or in the belief that a profit can be made from the activity.[198] In addition, the courts have held that the scope of activities should be sufficient to be considered a trade or business, and they have generally held that the offering of goods and services to the public suffices to be considered a trade or business. To that end, in the field of investments (which would be excluded from QSBS consideration under section 1202(3)(B) of the Code), a dealer who purchases and sells securities for the accounts of others is generally considered to be in a trade or business, whereas an investor who trades on his own account is not in a trade or business.[199] Further, whether a trader who manages his or her own account is considered to have a trade or business is based on the amount of activity and whether the activity is considerable, regular, and continuous.[200]

(2) Health

(a) "Performance of services in the field of health" means "the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals performing services in their capacity as such." [201]

(b) The performance of services in the field of health does not include "provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient."[202] For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

(3) Law

(a) "Performance of services in the field of law" means "the performance of services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such." [203]

(b) The performance of services in the field of law does not include "the provision of services that do not require skills unique to the field of law; for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services."[204]

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

[199] *See King v. Commissioner*, 89 T.C. 445 (1987), *Crissey v. Commissioner*, T.C. Summ. Op. 2014-44, and *Kay v. Commissioner*, T.C. Memo. 2011-159.

[200] *See, e.g., Kay v. Commissioner*, T.C. Memo. 2011-159.

[201] Treas. Reg. § 1.199A-5(b)(2)(ii).

[202] *Id.*

[203] Treas. Reg. § 1.199A-5(b)(2)(iii).

[204] *Id.*

(4) Accounting

(a) "Performance of services in the field of accounting" means "the provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such." [205]

(b) The preamble to the 199A proposed treasury regulations[206] (the "199A Proposed Regulations") explained that the provision of services in the field of accounting is not limited to services requiring state licensure as a certified public accountant (CPA). The aim is to capture the common understanding of accounting, which includes tax return and bookkeeping services, even though the provision of such services may not require the same education, training, or mastery of accounting principles as a CPA. As such, the field of accounting does not include payment processing and billing analysis.

(5) Actuarial Science

(a) "Performance of services in the field of actuarial science" means "the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such." [207]

(b) The preamble to the 199A Proposed Regulations explains that the field of actuarial science does not include the provision of services by analysts, economists, mathematicians, and statisticians not engaged in analyzing or assessing the financial costs of risk or uncertainty of events.

(6) Performing Arts

(a) "Performance of services in the field of the performing arts" means "the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such." [208]

(b) The performance of services in the field of performing arts does not include "the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts."[209] In addition, the performance of services in the field of the performing arts does not include "the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public."[210]

[205] Treas. Reg. § 1.199A-5(b)(2)(iv).

[206] REG-107892-18, 83 Fed. Reg. 40884 (8-16-18).

[207] Treas. Reg. § 1.199A-5(b)(2)(v).

[208] Treas. Reg. § 1.199A-5(b)(2)(vi).

[209] *Id.*

[210] *Id.*

(7) Consulting

(a) "Performance of services in the field of consulting" means "the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems." [211] The 199A Final Regulations specifically provide that consulting includes "providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such."[212]

(b) The performance of services in the field of consulting does not include "the performance of services other than advice and counsel, such as sales (or economically similar services) or the provision of training and educational courses."[213] For purposes of the foregoing, "the determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business,"[214] including, "for example, the manner in which the taxpayer is compensated for the services provided."[215]

(c) Consulting does not include "the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services."[216]

(8) Athletics

(a) "Performance of services in the field of athletics" means "the performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing."[217]

(b) The performance of services in the field of athletics does not include "the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events"[218] and does not include "the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public."[219]

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[211] Treas. Reg. § 1.199A-5(b)(2)(vii).

[212] *Id.*

[213] *Id.*

[214] *Id.*

[215] *Id.*

[216] *Id.*

[217] Treas. Reg. § 1.199A-5(b)(2)(viii).

[218] *Id.*

[219] *Id.*

(9) Financial Services

(a) "Performance of services in the field of financial services" means "the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 or similar cases), and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities and similar services."[220] It includes services provided by financial advisors, investment bankers, wealth planners, and retirement advisors and other similar professionals, but does not include taking deposits or making loans, but does include "arranging lending transactions between a lender and borrower."[221]

(b) Section 1202(e)(3)(A) of the Code includes the term financial services, but then separately lists banking in section 1202(e)(3)(B). For that reason, the preamble to the 199A Proposed Regulations points out that the term "financial services" does not include banking services.

(10) Brokerage Services

(a) "Performance of services in the field of brokerage services" includes services in which "a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee." [222] This includes services provided by stock brokers and other similar professionals but specifically does not include services provided by real estate agents and brokers, or insurance agents and brokers.[223]

(b) As noted above, in ILM 202204007, IRS chief counsel asserted that "brokerage services" should be defined broadly, citing section 6045, not narrowly as defined in section 199A (limiting such definition to dealing with securities).

(11) Investing and Investment Management

(a) "Performance of services that consist of investing and investment management" refers to a "trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments." [224] It does not include directly managing real property.

(b) The preamble to the 199A Proposed Regulations state that investing and investment management would include a trade or business that receives a commission, a flat fee, or an investment management fee calculated as a percentage of assets under management.

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[220] Treas. Reg. § 1.199A-5(b)(2)(ix).

[221] *Id.*

[222] Treas. Reg. § 1.199A-5(b)(2)(x).

[223] *Id.*

[224] Treas. Reg. § 1.199A-5(b)(2)(xi).

(12) Reputation or Skill of 1 or more of its employees

(a) "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 … means any trade or business that consists of any of the following (or any combination thereof): (A) A trade or business in which a person receives fees, compensation, or other income for endorsing products or services, (B) A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, (C) Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format." [225]

(b) The 199A Final Regulations provide two examples, one involving a celebrity chef and another involving a well-known actor. In the celebrity chef example,[226] the chef receives and an endorsement fee for the use of the chef's name on a line of cooking utensils and cookware. The 199A Final Regulations conclude that the chef's restaurant business is a trade or business that is not an SSTB, but the chef's endorsement business is an SSTB. In the well-known actor example,[227] the actor enters into a partnership with a shoe company, pursuant to which she contributes her likeness and the use of her name. The 199A Final Regulations conclude that the actor's income from the partnership is an SSTB.

6. Defining "Domestic Corporation" and Non-U.S. Businesses

a. As noted above, the term "qualified small business" means, under section 1202(d)(1), a "domestic corporation" which is also a C corporation that meets, among other things, the Gross Asset Requirement

G. QSB Defined

1. Aggregate Gross Asset Requirement

a. Under section 1202(d) of the Code, a "qualified small business" (hereinafter, referred to as "QSB") is a domestic C corporation[228] that meets the following requirements (hereinafter, collectively referred to as the "Aggregate Gross Asset Requirement"):

(1) The "aggregate gross assets" of such corporation (or any predecessor thereof) "at all times" on or after August 10, 1993, and before the issuance did not exceed $50 million;[229] and

(2) The "aggregate gross assets" of such corporation "immediately after the issuance (determined by taking into account amounts received in the issuance)" do not exceed $50 million.[230]

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[225] Treas. Reg. § 1.199A-5(b)(2)(xiv).

[226] Treas. Reg. § 1.199A-5(b)(3)(xv), *Ex. 15*.

[227] Treas. Reg. § 1.199A-5(b)(3)(xvi), *Ex. 16*.

[228] § 1202(d)(1).

[229] § 1202(d)(1)(A).

[230] § 1202(d)(1)(B).

b. "Aggregate gross assets" means the "amount of cash and the aggregate adjusted bases of other property held by the corporation."[231] However, for this purpose, "the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution."[232]

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

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

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

[231] § 1202(d)(2)(A).

[232] § 1202(d)(2)(B).

on average or at the end of fiscal year in between issuances and at the time of issuances? Again, some IRS guidance would be appreciated.

f. Although the Aggregate Gross Asset Requirement is sometimes interpreted to mean that only corporations that have assets of $50 million in value or less can issue QSBS eligible stock, that is not technically correct. For example, a series of investors contribute $20 million of cash in exchange for shares in a newly formed corporation. The shares received would obviously not violate the Aggregate Gross Asset Requirement. Assume that the cash is invested in property that appreciates to $50 million in value. In a second round of financing, investors contribute an additional $30 million in exchange for additional shares in the corporation. Although the corporation at that time would already have assets valued at $80 million after this issuance, the shares received in the second round would still be eligible for QSBS status. The appreciation occurring within the corporation is ignored for purposes of the calculation.

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

h. For purposes of determining whether a corporation is a QSB, all corporations that are part of the same "parent-subsidiary controlled group" as defined in section 1563(a)(1) of the Code are treated as one corporation, except that "more than 50 percent" is substituted for the "at least 80 percent" requirement in such Code section.[233] As such, a parent-subsidiary controlled group means one or more corporations connected through stock ownership with a common parent if:

(1) Stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote (or more than 50% of the total value of shares of all classes of stock of each of the corporations), except the common parent corporation, is owned by one or more of the other corporations; and

(2) The common parent corporation owns stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote (or more than 50% of the total value of shares of all classes of stock of at least one of the other corporations), excluding, in computing such voting power or value, stock owned directly by such other corporations.[234]

[233] § 1202(d)(3)(B).

[234] In applying these tests, stock ownership includes constructive ownership under section 1563(d)(1) of the Code (constructive ownership from options and attribution from partnerships, estates, and trusts). *See* §

i. The parent-subsidiary controlled group restriction above prevents a parent corporation with assets greater than $50 million from avoiding a violation of the Aggregate Gross Asset Requirement by contributing assets to other corporations in exchange for stock in that corporation. The Aggregate Gross Asset Requirement and the parent-subsidiary limitation apply only to corporations, not to pass-through entities (e.g., upper and lower tier partnerships). Furthermore, there is no corresponding rule under section 1202 with regard to a "brother-sister controlled group," as defined in section 1563(a)(2).[235]

j. Section 1202(d)(1)(C) includes an additional qualification to be considered a QSB. In order to be considered a QSB, it must be a corporation that "agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section."[236] Under section 6652(k), if a corporation fails to make the report which contains the required information on the date prescribed (determined with regard to any extension of time for filing), then the corporation is subject to a penalty of $50 (per year covered). If the failure is due to negligence or intentional disregard, the penalty is $100. However, no penalty will be imposed for a failure which is shown to be due to reasonable cause and not willful neglect.[237]

2. "Domestic Corporation" and Non-U.S. Businesses

a. As noted above, the term "qualified small business" means, under section 1202(d)(1), a "domestic corporation" which is also a C corporation that meets, among other things, the Gross Asset Requirement. The term "domestic corporation" is not further defined in section 1202 (or in any Treasury Regulation thereunder). It does not seem that a "domestic corporation" requirement should be interpreted to mean that the business of the corporation must be primarily sourced or located in the U.S. (in contrast to the QOZ requirements). Rather, it seems that the "domestic corporation" requirement is met if the entity is formed under the laws of the United States or any State therein.

b. Under the S corporation rules, only a "domestic corporation" can make a valid S election.[238] The Treasury Regulations provide, "the term domestic corporation means a domestic corporation as defined in Section 301.7701-5 of this chapter, and the term corporation includes an entity that is classified as an association taxable as a corporation under Section 301.7701-2 of this chapter."[239] Under that Treasury Regulation, "A business entity (including an entity that is disregarded as separate from its owner under Section 301.7701-2(c)) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated association, general partnership, limited partnership, and limited liability company)

1563(e). In addition, affiliated companies are not treated as a separate group for purposes of the QSB test. § 1202(d)(3)(B).

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

[236] § 1202(d)(1)(C).

[237] § 6652(k).

[238] § 1361(b)(1)

[239] Treas. Reg. § 1.1361-1(c).

in the United States, or under the law of the United States or of any State."[240] In addition, a business entity organized both in the U.S. and in a foreign jurisdiction is still considered a domestic entity.[241]

c. Assuming, a "domestic corporation" under section 1202(d)(1) is defined in the same way, it means that a QSB can include a U.S. C corporation whose business is entirely outside of the U.S. In addition, a QSB would also include a holding company that owns more than 50% of a foreign corporation (the parent-subsidiary controlled group requirement discussed above).

H. Tax Free Exchanges

1. If a taxpayer exchanges QSBS for other stock in a transaction described in section 351 of the Code (contributions to a controlled corporation) or section 368 (corporate reorganization), the taxpayer will retain QSBS status over the newly acquired stock, even if the newly acquired stock is not otherwise QSBS.[242]

2. If the newly acquired stock is not QSBS, then the section 1202(a) exclusion shall apply only "to the extent of the gain which would have been recognized at the time of the transfer … if section 351 or 368 had not applied at such time."[243] In other words, the gain exclusion benefits are capped at the amount of gain rolled into the non-QSBS, determined at the time of the exchange (sometime referred to as the "exclusion ceiling"). For example, QSBS stock is exchanged for shares in a non-QSBS company, and the unrealized gain is $1 million at that time. If those newly acquired shares are subsequently sold and the taxpayer recognizes $1.5 million in gain, then $1 million will be Excluded Section 1202 Gain, and $500,000 will be Non-Section 1202 Gain (taxable at 23.8%). If the newly acquired stock is QSBS, then all such shares will be entirely QSBS.[244]

3. As discussed earlier, SPAC acquisitions are currently booming. SPAC transactions often take the form of a "B" or triangular "B" (involving a subsidiary of the parent company) reorganization,[245] which is a stock-for-stock exchange. Because SPAC shares are already publicly traded and because the SPAC will likely never qualify as a QSB,[246] if some or all of the shares of the private company target are QSBS, then the exclusion ceiling will be set at the value on the effective date of the merger/exchange. Often the effective date of the merger will be the date when the shares of the merged company starts to publicly trade and the value at the close

[240] Treas. Reg. § 301.7707-5(a).

[241] *Id.*

[242] § 1202(h)(4)(A).

[243] § 1202(h)(4)(B).

[244] *Id.*

[245] § 368(a)(1)(B).

[246] In order be considered QSBS, on the date of issuance, the C corporation must be a QSB. In turn, a QSB must meet the Aggregate Gross Asset Requirement (i.e., $50 million) "at all times" before and immediately after the issuance of the stock. *See* §§ 1202(c) and (d). Thus, to possible qualify as a QSB, the SPAC must have less than $50 million in investments and after the merger, the combined company must still meet the Active Business Requirement for "substantially all" of the taxpayer's holding period. *See* §§ 1202(c) and (e).

of that day's trading will set the exclusion ceiling.[247] This value is an important consideration when dealing with SPAC-QSBS shares due to the unique nature of SPAC mergers. SPAC shares have, by convention, a starting value of $10 per share. Often, after a SPAC and QSBS target company announce a merger, the announcement will cause the shares of the SPAC to trade above (or below) the $10 per share initial value. The initial value of the announced merger typically sets the multiple by which the stock-for-stock exchange will occur (e.g., if the QSBS target company has one million shares outstanding and the target is valued at $400 million, then each share of the target will be converted into 40 times that number (one million x $10 per share x 40 multiple = $400 million). This multiple will not change if the SPAC trades above or below $10 per share and the actual fair market value of the shares received by the target company shareholders will depend on the SPAC trading price on the effective date of the merger. So, for example, if SPAC shares are trading at $12 per share on the opening day of trading but closes at $14 per share, then the $14 per share sets the "exclusion ceiling" under section 1202(h)(4)(B) of the Code.[248]

4. There is no limit to the number of section 351 and section 368 transactions pursuant to which QSBS status will be preserved. However, after the first exchange of QSBS for non-QSBS, stock received in any subsequent transaction will be subject to the limitation above based on the first exchange for non-QSBS.[249]

5. In the case of a transaction described in section 351, the preservation of QSBS status will apply only if, immediately after the transaction, the corporation issuing the stock owns, directly or indirectly, stock representing "control" of the corporation whose stock was exchanged.[250] "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." [251] In other words, the

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[247] For income tax purposes, the rules for tax free reorganizations generally provide for an effective timing of end of the day. *See* § 381(a) ("In the case of the acquisition of assets of a corporation by another corporation—… (2) in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1), the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer."). *See also* § 381(b) ("Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)—(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer—(2) For purposes of this section, the date of distribution or transfer shall be the day on which the distribution or transfer is completed.")

[248] One issue that has not been resolved is whether the exclusion ceiling at $14 per share in this example sets the total maximum exclusion amount for section 1202 purposes or if each share of the now merged and publicly-traded company has an exclusion ceiling of $14 per share. In the latter case, if the shares are sold at $20 per share (assuming zero basis), then $14 of the gain would be subject to exclusion subject to the Per Issuer Limitation, and $6 of the gain would be Non-Section 1202 Gain. In the former case, each shareholder would have a total amount that would be subject to exclusion equal to $14 per share multiplied by the number of shares in the merged company. Any amount of gain above that product would be Non-Section 1202 Gain. In such case, a taxpayer could claim to sell and fully exclude a portion of their shares at whatever price until the total amount subject to exclusion is reached. Thereafter, all other shares sold would be not be subject to exclusion and would be considered, in full, Non-Section 1202 Gain.

[249] § 1202(h)(4)(C).

[250] § 1202(h)(4)(D).

[251] § 368(c).

issuing corporation must, after the transaction, hold at least 80% of the contributed QSB corporation.

6. If the newly acquired stock qualifies as QSBS, then the foregoing limitations on the exclusion benefit do not apply (other than the Per-Issuer Limitation).

a. As such, an exchange in a reorganization described in section 368(a)(1)(F) of the Code ("a mere change in identity, form, or place of organization of one corporation, however effected"[252]) would extend QSBS status without any limitations.[253] Section 1202(h)(3) provides, "Rules similar to the rules of section 1244(d)(2) shall apply for purposes of this section."[254] Section 1244(d)(2) provides, in part, that a successor corporation in a reorganization described in section 368(a)(1)(F) shall be treated as the same corporation as its predecessor.

b. Section 1202(f) of the Code provides that if any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is QSBS in the hands of the taxpayer (1) the stock so acquired shall be treated as QSBS in the hands of the taxpayer, and (2) the stock so acquired shall be treated as having been held during the period during which the converted stock was held. As such, an exchange of stock in a reorganization described in section 368(a)(1)(E) of the Code ("a recapitalization"[255]) would extend QSBS status without any limitation.

c. If the stock received in an exchange described in section 351 or any other section 368 reorganization is also QSBS, then QSBS status is extended without limitation (provided the additional "control" requirement is met).[256] The IRS has ruled favorably on a divisive D reorganization under sections 368(d)(1)(D) and 355. In that ruling, the QSB (Distributing) formed a new corporation (Controlled), contributed one of Distributing's lines of business into Controlled and then spun Controlled off to some of the shareholders of Distributing. The IRS ruled that stock of Controlled received by the Distributing shareholders would remain QSBS under section 1202(h)(4)(A) of the Code, and the shareholders would be able to tack the holding period in Distributing to their Controlled stock.[257]

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[252] § 368(a)(1)(F).

[253] PLRs 201603011, 201603010, and 201636003.

[254] § 1202(h)(3).

[255] § 368(a)(1)(E).

[256] § 1202(h)(4)(A).

[257] PLR 9810010.

I. Section 1045 Rollover

1. Generally

a. Section 1045 of the Code allows a taxpayer to sell QSBS and defer the recognition of gain by rolling the proceeds of the first sale into a new acquisition of QSBS within sixty 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 of the Code to the original sale.[258] If these conditions are met, then the taxpayer has a 60-day period beginning on the date of the original sale to purchase the replacement QSBS.[259]

b. Section 1045 of the Code was enacted in 1997,[260] and originally this rollover provision only applied 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,"[261] and such amendment became effective as though it had been included when the section was originally enacted.[262]

c. 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 with respect to the original QSBS. The portion of the gain that is not excluded (i.e., the eligible gain that exceeds the taxpayer's Per-Issuer Limitation for the taxable 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 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,[263] 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.[264]

d. Rollover treatment is available to the non-corporate partners of a partnership that holds QSBS. Section 1045(b)(5) provides that rules similar to section 1202(g) of the Code dealing with pass-thru entities shall apply for purposes of rollover. Final Treasury 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.[265] To date, Treasury Regulations have not been issued under section 1202(g) with respect to pass-thru entities. It is

[258] § 1045(a).

[259] *See* § 1045(a)(1).

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

[261] § 1045(a).

[262] *See* IRS Reform Act of 1998, P.L. 105-206, § 6005(f)(1).

[263] *See* § 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* § 1202(b), flush language.

[264] § 1045(b)(5) provides, "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.

[265] T.D. 9353, 72 Fed. Reg. 45346 (8/14/07).

unclear whether the regulatory guidance issued under section 1045 would also be applicable in the context of section 1202 issues. These regulations and planning issues with partnerships are discussed below.

2. Calculating Gain Rollover

a. 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"[266] (within the 60-day period), reduced by any portion of such cost previously taken into account under section 1045 of the Code.[267] To illustrate, consider the following examples:

(1) Example 1: A acquires QSBS for $1 million. In the same year, but more than 6 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 of the Code. A recognizes no gain.

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

(3) 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, then B will not recognize any gain on the sale of the first of stock (thereby deferring $700,000 of gain). On the second sale, the maximum amount that can be recognized is the excess of 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) of the Code, no more than $500,000 can be recognized, but the second sale only resulted in $200,000 of gain. As a result B recognizes $200,000. The end result is: (i) B invested $600,000 in the first QSBS company; (ii) sold that investment for $1.5 million; (iii) reinvested $1.0 million in a second QSBS company, retaining $500,000 in cash; and (iv) recognized only $200,000 in gain.

(4) Example 4: Same facts as Example 3 above, 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). With respect to the sale of the first block, under the formula under section 1045(a) of the Code, 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.

b. 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,[268] the taxpayer can avoid the result in Example 4 by ensuring that the first block is sold prior to the second

[266] § 1045(a) and (a)(1).

[267] § 1045(a)(2).

[268] *See* Treas. Reg. § 1.1012-1(c).

block. If the taxpayer fails to make "adequate identification" of the lots sold in each transaction, then a first-in, first-out accounting convention is used to determine gain or loss,[269] which would have negated the result in Example 4.

3. Rollover Basis Rules

a. When a taxpayer elects to rollover proceeds of a sale of QSBS, to the extent that gain goes unrecognized, it reduces the taxpayer's adjusted basis in the replacement QSBS.[270] If the taxpayer purchases replacement QSBS in more than one transaction, the basis reduction is applied "in the order acquired."[271]

b. To illustrate, in Example 3 above, 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 above, 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

a. As mentioned above, in order to qualify for rollover under section 1045 of the Code, the taxpayer must have held the QSBS for more than six months before the sale. The Code provides two modifications: (i) the taxpayer's holding period for such stock will be determined without regard to section 1223 of the Code; and (ii) only the first six months of the taxpayer's holding period in the stock shall be taken into account in applying section 1202(c)(2) of the Code.

b. To the extent gain from the sale of QSBS is rolled over under section 1045, with respect to 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."[272]

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[269] Treas. Reg. § 1.1012-1(c)(1)(i). The election to use the average basis method is likely not available to shareholders of a QSBS because the Treasury Regulations provide that it applies only to identical shares of stock (requiring a Committee on Uniform Security Identification Procedures (CUSIP) 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* Treas. Reg. § 1.1012-1(e).

[270] § 1045(b)(3).

[271] *Id.*

[272] § 1223(13).

5. Rollover Election (Other Than a Partnership)

a. 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 taxable year in which the QSBS is sold.[273]

b. 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).[274]

c. A taxpayer who has more than one sale of QSBS in a taxable year may make a rollover election for any or all of the sales.[275]

d. 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.[276]

6. Partnership Regulations

a. Generally

(1) As mentioned above, final Treasury Regulations were issued on the availability of the section 1045 rollover election to partnerships and their eligible partners.[277] These regulations utilize particular terms that should be noted:

(a) It refers to qualified small business stock as "QSB stock," and clarifies that QSB stock "does not include an interest in a partnership that purchases or holds QSB stock."[278]

(b) The term "replacement QSB stock" is any QSB stock purchased within 60 days beginning on the date of a sale of QSB stock.[279]

(c) 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."[280] For purposes of the foregoing, a taxpayer "who acquires from a partner (other than

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[273] Rev. Proc. 98-48, 1998-38 I.R.B. 7, § 3.01.

[274] *See* 2017 Instructions for Schedule D (Capital Gains and Losses) and 2017 Instructions for Form 8949.

[275] Rev. Proc. 98-48, 1998-38 I.R.B. 7, § 3.03.

[276] *See* Rev. Proc. 98-1, 1998-1 I.R.B. 7, and Rev. Proc. 2018-1, 2018-1 I.R.B. 1, the current version of the revenue procedure.

[277] T.D. 9353, 72 Fed. Reg. 45346 (8/14/07).

[278] Treas. Reg. § 1.1045-1(g)(1).

[279] Treas. Reg. § 1.1045-1(g)(2).

[280] Treas. Reg. § 1.1045-1(g)(3)(i). The Treasury Regulations also provide rules for tiered partnerships pursuant to which the upper-tier (parent) partnership is disregarded and the partners of the upper-tier

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."[281] The Treasury Regulations provide that these terms apply for purposes of section 1045, but the terms "by gift" or "at death" are likely references to transfers under section 1202(h)(2)(A) and (B) of the Code.

(d) A "purchasing partnership" is a partnership, different from the partnership selling the QSB stock, (i) that purchases replacement QSB stock, and (ii) 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."[282]

(e) A "selling partnership" is a partnership that sells QSB stock.

(2) Pursuant to the Treasury Regulations, if a partnership is involved in the purchase or sale of QSBS, there are three different options pursuant to which a taxpayer can get the benefits of rollover under section 1045 of the Code:

(a) "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."[283]

(b) "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."[284]

(c) "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."[285]

(3) The section 1045 election, whether made by partnership, eligible partner, or taxpayer (in one of three options), 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.[286]

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partnership are treated as owning an interest in the lower-tier partnership directly. *See* Treas. Reg. § 1.1045-1(g)(3)(iii) and (iv).

[281] Treas. Reg. § 1.1045-1(g)(3)(ii).

[282] Treas. Reg. § 1.1045-1(c)(1)(i).

[283] Treas. Reg. § 1.1045-1(a).

[284] *Id.*

[285] *Id.*

[286] *Id. See* Rev. Proc. 2007-1, 2007-1 C.B. 1 and Rev. Proc. 2018-1, 2018-1 I.R.B. 1, the current version of the revenue procedure.

b. Partnership Section 1045 Election

(1) If a partnership elects to apply section 1045 (in option 1 above), each eligible partner will not recognize its "distributive share" of any "partnership section 1045 gain."[287]

(2) "Partnership section 1045 gain" is equal to the partnership's gain from the sale of the QSB stock reduced by the greater of:

(a) Any amount of gain from the sale of the QSB stock that is treated as ordinary income;[288] or

(b) The "excess of the amount realized by the partnership on the sale over the total cost of all replacement QSB stock purchased by the partnership (excluding the cost of any replacement QSB stock purchased by the partnership that is otherwise taken into account under section 1045)."[289]

(3) "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."[290] For this purpose, these are determined without regard to basis adjustments under section 743(b) of the Code (relating to inside basis adjustments upon the sale of partnership interest or the death of a partner) and reductions in the basis of replacement QSB, discussed below.[291] An inside basis adjustment under section 743(b) of the Code, in the context of QSBS, is inappropriate because allowable transfers during lifetime must be "by gift" and although transfers "at death" are permissible, basis adjustments under section 1014 of the Code (or any adjustments after Original Issuance) are ignored for section 1202 purposes.[292]

(4) The Treasury 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 QSB stock that is not recognized by the partner as the result of a partnership election"[293] under section 1045. This is appropriate because if the entire amount realized on the sale of QSB stock is rolled over to replacement QSB stock, then 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 of the gain is eligible for a 100% exclusion under section 1202(a)(4) of the Code, then the excluded gain will result in an increase in

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[287] Treas. Reg. § 1.045-1(b)(1).

[288] Treas. Reg. § 1.045-1(b)(1)(i). This provision mirrors the flush language of section 1045(a) of the Code that provides the nonrecognition of gain will not apply to "any gain which is treated as ordinary income for purposes of this title." § 1045(a) [flush language].

[289] Treas. Reg. § 1.045-1(b)(1)(ii). This provision mirrors the calculation in sections 1045(a)(1) and (2) if the amount realized exceeds the cost of any QSBS purchased by the taxpayer, reduced by any portion of such cost previously taken into account under the section.

[290] Treas. Reg. § 1.045-1(b)(2).

[291] *Id.*

[292] *See* §§ 1202(h)(2)(A) and (B) and 1202(b)(1) [flush language] and Treas. Reg. § 1.1045-1(g)(3)(ii).

[293] Treas. Reg. § 1.1045-1(b)(3)(i).

outside basis under section 705(a)(1)(B) of the Code (increase in outside basis for partner's distributive share of partnership income exempt from tax).

(5) For purposes of determining the partnership's basis in replacement QSB, the Treasury Regulations provides 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."[294] This rule mirrors the same rule provided in section 1045(b)(3) of the Code, discussed above. However, the Treasury Regulations clarify that this basis reduction in the replacement QSBS is "with respect to that partner only"[295] under the modified principles set forth in section 1.743-1(g), (h), and (j) of the Treasury Regulations.

(6) As mentioned above, inside basis adjustments under section 743(b) of the Code 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.[296] 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,[297] and because the adjustments apply only to the transferee, they are not made to the common basis of the partnership.[298] 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) of the Code. 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.[299] Also, if a positive adjustment is made to depreciable (or amortizable) property, then 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.[300]

(7) With these principles in mind, the Treasury Regulations provide, "The basis adjustment that carries over to the replacement QSB stock shall be reduced (but not

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[294] Treas. Reg. § 1.1045-1(b)(3)(ii)(A).

[295] *Id.*

[296] "The basis of a partnership interest acquired from a decedent is the fair market value 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 § 1.706-1 and paragraph (b) of § 1.753-1) under section 691." Treas. Reg. § 1.742-1.

[297] Treas. Reg. § 1.704-1(b)(2)(iv)(m).

[298] Treas. Reg. § 1.743-1(j)(1). There is a limited exception in the case of certain distributions to a transferee partner. *See* Treas. Reg. § 1.734-2(b)(1).

[299] Treas. Reg. § 1.743-1(j)(3).

[300] Treas. Reg. § 1.743-1(j)(4).

below zero) by the eligible partner's distributive share of the excess, if any, of the greater of" the reductions to QSB stock basis mentioned above, "over the partnership's gain from the sale of the QSB stock" (determined without regard to basis adjustments under section 743 reductions in the basis of replacement QSB stock).[301] This excess amount that reduces the basis adjustment shall be accounted for as gain in accordance with section 1.743-1(j)(3) of the Treasury Regulations.[302]

(8) The Treasury 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:[303]

> 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 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, 1/3 ($200) to A, 1/3 ($200) to X, and 1/3 ($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.

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[301] Treas. Reg. § 1.1045-1(b)(3)(ii)(A).

[302] "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." Treas. Reg. § 1.743-1(j)(3).

[303] Treas. Reg. § 1.1045-1(i), Ex. 5.

(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 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 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).

(9) As the foregoing example points out, eligible partners and non-eligible partners are treated very differently. To that end the Treasury 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."[304] If a partnership knows that a particular partner is classified, for Federal tax purposes, as a C corporation, then 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 such notification by the partner.[305] If a partnership makes an election under

[304] Treas. Reg. § 1.1045-1(b)(3)(ii)(A).

[305] *Id.*

section 1045, but an eligible partner opts out of the election and provides notification to the partnership, no basis adjustments are required with respect to that partner.[306]

(10) If a partnership makes any adjustments with respect to replacement QSB stock, it must attach a statement to the partnership tax return setting forth the computation of the adjustment, the replacement QSB stock to which the adjustment is made, the date on which the QSB stock was acquired by the partnership, and the amount of the adjustment that is allocated to each partner.[307]

(11) A partnership that makes a section 1045 election must notify all of its partners of the election and the purchase of replacement QSB stock, "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."[308] Each partner is required to determine whether the partner is an eligible partner and report the partner's distributive share of partnership section 1045 gain, including gain not recognized.[309] 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."[310]

(12) 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"[311] (discussed below). If an eligible partner opts out, then the partner is required to notify the partnership, in writing, that the partner is opting out of the partnership's section 1045 election.[312]

c. Partner Section 1045 Elections

(1) A partner can elect to apply section 1045 in a number of specified circumstances:[313]

(a) An eligible partner of a selling partnership may elect to apply section 1045 if the eligible partner directly purchases replacement QSB;

(b) An eligible partner of a selling partnership may elect to apply section 1045 if replacement QSB stock is purchased through a purchasing partnership; and

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[306] *Id.* The Treasury Regulations also provide rules for tiered partnerships that require the basis adjustments to be segregated and allocated to the eligible partner. *See* Treas. Reg. § 1.1045-1(b)(3)(ii)(B).

[307] Treas. Reg. § 1.1045-1(b)(3)(ii)(C).

[308] Treas. Reg. § 1.1045-1(b)(5)(i).

[309] *Id.*

[310] Treas. Reg. § 1.1045-1(b)(5)(ii).

[311] Treas. Reg. § 1.1045-1(b)(4).

[312] Treas. Reg. § 1.1045-1(b)(5)(ii).

[313] Treas. Reg. § 1.1045-1(c)(1).

(c) A taxpayer other than a C corporation that sells QSB stock held for more than 6 months at the time of the sale may elect to apply section 1045 if replacement QSB stock is purchased by a purchasing partnership (including a selling partnership).

(2) Subject to the "nonrecognition limitation" discussed below, if an eligible partner of a selling partnership elects to apply section 1045 with respect to a direct purchase of replacement QSB stock, the eligible partner must recognize its distributive share of gain from the sale of QSB stock by the selling partnership only to the extent of the greater of: (i) the amount of the eligible partner's distributive share of the selling partnership's gain from the sale of the QSB stock that is treated as ordinary income; or (ii) the "excess of the eligible partner's share of the selling partnership's amount realized … on the sale by the selling partnership 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)."[314]

(3) The eligible partner's share of the amount realized by the selling partnership on the sale of QSB stock (excluding the cost of any replacement QSB stock 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 QSB stock, and the denominator of which is the partnership's realized gain on the sale of the QSB stock.[315] The Treasury 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 QSB and if the eligible partner's interest in the purchasing partnership is reduced after the sale of QSB and the purchasing partnership realizes a gain from the sale of replacement QSB stock.[316]

(4) Subject to the "nonrecognition limitation" discussed below, if an eligible partner elects to apply section 1045 with respect to replacement QSB stock purchased by a purchasing partnership, the eligible partner must recognize its distributive share of gain from the selling partnership's sale of QSB stock (and gain from the subsequent sale of replacement QSB stock) [317] only to the extent of the greater of: (i) the amount of the eligible partner's distributive share of the selling partnership's gain from the sale of the QSB stock that is treated as ordinary income; or (ii) the "excess of the eligible partner's share of the selling partnership's amount realized … on the sale by the selling partnership 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)."[318]

(5) Subject to the "nonrecognition limitation" discussed below, if a taxpayer other than a C corporation elects to apply section 1045 with respect to replacement QSB purchased by a purchasing partnership, the taxpayer must recognize gain only to the extent of the greater of: (i) the amount of gain from the sale of the QSB stock that is treated as ordinary income; or (ii) the "excess of the amount realized by the taxpayer on the sale of the QSB stock over the

[314] Treas. Reg. § 1.1045-1(c)(1)(ii)(B).

[315] Treas. Reg. § 1.1045-1(c)(2)(i).

[316] *See* Treas. Reg. § 1.1045-1(c)(2)(ii) and (iii).

[317] *See* Treas. Reg. § 1.1045-1(c)(5).

[318] Treas. Reg. § 1.1045-1(c)(1)(iii)(A)(2).

partner's share of the purchasing partnership's cost of the replacement QSB stock … (excluding the cost of any QSB stock that is otherwise taken into account under section 1045)."[319]

(6) For purposes of the foregoing, a partner's share of the cost of replacement QSB stock 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."[320]

(7) The amount of gain that an eligible partner does not recognize cannot exceed the "nonrecognition limitation."[321] The "nonrecognition limitation" is equal to the product of: (i) the "partnership's realized gain from the sale of the QSB stock, determined without regard to any basis adjustment under section 734(b) or section 743(b)"[322] (other than the inside basis adjustments described above); and (ii) the eligible partner's "smallest percentage interest in partnership capital."[323] The "smallest percentage interest in partnership capital" is the partner's "percentage share of capital determined at the time of the acquisition of the QSB stock as adjusted prior to the time the QSB stock 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 by the eligible partner, but excluding income and loss allocations."[324]

(8) The Treasury 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.[325] If the selling partnership is also a purchasing partnership, the eligible partner's outside basis may be reduced.[326]

(9) A partner's basis in any replacement QSB stock that is purchased by the partner, as well as the adjusted basis of any replacement QSB stock 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 QSB stock that is not recognized by the partner, or by the gain on a sale of QSB stock by the partner that is not recognized under section 1045, as applicable.[327] If the purchasing partnership purchases replacement QSB stock, the purchasing partnership maintains its adjusted basis in the replacement QSB stock, but the eligible partner (in

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[319] Treas. Reg. § 1.1045-1(c)(1)(iii)(B)(2).

[320] Treas. Reg. § 1.1045-1(c)(3).

[321] Treas. Reg. § 1.1045-1(d)(1).

[322] Treas. Reg. § 1.1045-1(d)(1)(i).

[323] Treas. Reg. § 1.1045-1(d)(1)(ii).

[324] Treas. Reg. § 1.1045-1(d)(2). The Treasury Regulations also provide rules if an eligible partner owns an interest in a tired partnership that require that the eligible partner's percentage interest in the purchasing partnership be proportionately adjusted to reflect the eligible partner's percentage interest in the upper-tier partnership. *See* Treas. Reg. § 1.1045-1(d)(3).

[325] Treas. Reg. § 1.1045-1(c)(4)(i).

[326] See Treas. Reg. § 1.1045-1(c)(4)(iii).

[327] Treas. Reg. § 1.1045-1(c)(4)(ii).

computing its distributive share of income, gain, loss, and deduction with respect to the replacement QSB stock) must take into account the variation between the adjusted basis in the QSB stock (reduced as described above) and the adjusted basis determined without the reduction.[328]

(10) A partner that treats the partner's interest in QSB stock purchased by a purchasing partnership as the partner's replacement QSB stock 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 QSB stock that the partner defers, or by the gain on a sale of QSB stock by the partner that the partner defers under section 1045, as applicable.[329]

(11) The Treasury Regulations provide that if the partner or the purchasing partnership sells or exchanges replacement QSB stock, the amount recognized by the partner is determined by taking into account the basis adjustments described in paragraph above.[330]

(12) 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 taxable year during which the partner takes into account the partner's distributive share of the partnership's gain from the sale of the QSB stock under section 706 of the Code. In addition, a partner making an election under section 1045 must do so in accordance with the applicable forms and instructions.[331]

J. C Corporation Formation or Conversion

1. Generally

a. As noted above, by definition, QSB and QSBS require that the issuer of the stock must be a C corporation. Furthermore, 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 such 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.

b. QSBS companies are sometimes initially formed as C corporations, and the initial shareholders look to section 351 of the Code to avoid recognition of gain if appreciated property is contributed to the corporation in exchange for shares of stock in the corporation. More often than not, however, companies that eventually become QSBS companies often 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 pass-through entities will often, for a number of business and tax reasons, eventually convert to a C corporation. The owners of the pass-through entity also hope that the conversion itself will not be considered a recognition

[328] *Id.*

[329] Treas. Reg. § 1.1045-1(c)(4)(iii).

[330] Treas. Reg. § 1.1045-1(c)(5). In addition, a partner in an upper-tier partnership that owns an interest in a lower-tier partnership that holds replacement QSB stock 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.

[331] Treas. Reg. § 1.1045-1(h)(1).

event for income tax purposes, often relying on section 351 of the Code. 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

a. Under section 351(a) of the Code, 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)[332] 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."[333]

b. 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 fair market value of such other consideration ("boot") but does not recognize any loss realized.[334] 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.[335]

c. If a shareholder transfers property that has a relatively small value compared to 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 of the Code.[336] The IRS has ruled that it will not treat property as being relatively small in value compared to the value of the stock already owned if the fair market value of the property transferred is at least 10% of the fair market value of the stock already owned.[337]

d. 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.[338] If, however, the amount of liabilities

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[332] *See* § 351(g)(2). Nonqualified preferred stock is stock that is (i) limited and preferred as to dividends; (ii) does not participate in corporate growth to any significant way; and (iii) either can be put to the issuer or a related person, must be purchased by the issuer or a related person, 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 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. § 351(g)(2)(A) and (B).

[333] *See* §§ 351(a) and 368(c).

[334] § 351(b).

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

[336] Treas. Reg § 1.351-1(a)(1)(ii).

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

[338] § 357(a) and (d).

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.[339] For this purpose, the amount of liabilities assumed generally does not include a liability the payment of which 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.[340] If the principal purpose of the transferor with respect to the assumption of any liability either was to avoid federal income tax on the transfer or was not a bona fide business purpose, then the total amount of the transferor's liabilities assumed is treated as boot.[341]

e. 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 (i) the amount of money received as boot, (ii) the amount of liabilities assumed by the transferee corporation, excluding any liabilities not taken into account for purposes of applying section 357(c) of the Code, as discussed in the previous paragraph, and (iii) the fair market value of any other boot received, and increased by the amount of any gain recognized by the transferor.[342]

f. Section 358(h) provides that if, after applying the basis rules above, the basis of the stock received exceeds its fair market value 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 fair market value) to take into account contingent liabilities of the transferor assumed in the transaction.[343] 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.[344]

g. 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.[345] 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 fair market value.[346] Also, if the aggregate fair market value 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 fair market value 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 fair market value.[347] This last provision is intended to prevent the transferee corporation and the transferor

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339 § 357(c).

340 § 357(c)(3).

341 § 357(b) and Treas. Reg. § 1.357-1(c).

342 § 358(a)-(d).

343 § 358(h).

344 § 358(h)(2).

345 § 362(a).

346 § 362(d).

347 § 362(e)(2).

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) of the Code, 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, the property contributed will be deemed to have a basis equal to its fair market value at the time of the contribution.[348] 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 due to excess basis above fair market value of contributed assets.

h. 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 (e.g., real property and depreciable property used in a trade or business in the transferor's hands and held for more than one year).[349] 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.[350] 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.[351] As discussed later in these materials, section 1223(1) of the Code (tacking of holding periods) should not apply in determining the acquisition date for QSBS purposes and does not apply for purposes of the 5-year holding requirement.

i. The depreciation recapture rules of sections 1245 and 1250 of the Code do not require the recognition of gain in a section 351 transaction.[352] In contrast, the transfer of a debt instrument acquired at a market discount will cause taxation of the accrued but previously unrecognized market discount.[353]

j. 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."[354] In a section 351 transaction, the IRS ruled that a taxpayer may not select specific items to be exchanged for particular stock or securities in order to allocate the high bases of certain 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 fair market values.[355] 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 Treasury Regulations

[348] § 1202(d)(2)(B).

[349] § 1223(1).

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

[351] § 1223(2).

[352] §§ 1245(b)(3) and 1250(d)(3); Treas. Reg. §§ 1.1245-4(c) and 1.1250-3(c).

[353] § 1276(d)(1)(C).

[354] *See* Treas. Reg. § 1.1012-1(c).

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

provide 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 fair market value of the stock of each class.[356] 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 certain section 351 transactions but only when stock is contributed to the issuing corporation.[357] By definition, however, QSBS status is available to stock in an Original Issuance in exchange for money or property, other than stock,[358] so these tracing rules are not available.

3. Conversion of Pass-Through Entity

a. Conversion Generally

(1) A C corporation conversion of an entity taxable as a partnership,[359] regardless of entity form, can be accomplished with a "check-the-box" election to be an "association" taxed as a corporation.[360] The election is considered to be a transfer of all of 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).[361] This, as discussed below, is an "assets-over" transaction.

(2) When a state law corporation is preferred (e.g., Delaware), Revenue Ruling 84-111[362] provides that the taxpayer may choose among three different options to effectuate the conversion to a corporation:

(a) 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);

(b) 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

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[356] Treas. Reg. §1.358-2(b)(2) and Prop. Reg. § 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").

[357] Prop. Treas. Reg. § 1.358-2(g)(2), REG-143686-07, 74 Fed. Reg. 3509, 3512-13 (1/21/09). The preamble provides that the IRS and Treasury will continue to study the issue of tracing in section 351 exchanges. 74 Fed. Reg. at 3512.

[358] § 1202(c)(1)(B)(i).

[359] *See* Treas. Reg. § 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).

[360] *See* Treas. Reg. § 301.7701-3(b)(1).

[361] Treas. Reg. § 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 of the assets and liabilities of the entity to the association (corporation) in exchange for stock in the corporation. Treas. Reg. § 301.7701-3(g)(1)(iv).

[362] Rev. Rul. 84-111, 1984 C.B. 88.

(c) A transfer of all of the partnership interests to the corporation followed by a liquidating distribution of the partnership assets to the corporation (an "interests-up" transaction).[363]

(3) 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 the original partners receive shares in the new C corporation equal to the 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 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 discussed above.

(4) As discussed below 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 such assets. The resulting basis of the liquidated assets will have a direct or indirect impact 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.[364] This is in contrast to the "separate lot" rules applicable to shares of corporate stock. Under this unitary basis concept, basis is generally allocated in property to the relative fair market value of different interests when determining such 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 fair market value of the property in question.[365]

(5) Unitary basis is determined on a partnership-by-partnership basis even, so it seems, if a partner has an interest in 2 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 as it bears to reason that it might make sense for taxpayers to segregate low basis and high basis assets into different partnerships in a tax-free partnership division[366] prior to converting to a C corporation.

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[363] For partnership merger or division purposes, "interests-up" transactions are not valid, but can be used apparently for purposes of converting a partnership to a corporation. *See* T.C. 8925, 66 Fed. Reg. 715 (1/4/01).

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

[365] *See* Treas. Reg. § 1.1223-3.

[366] *See* § 708(b)(2)(B) and T.D. 8925, 66 Fed. Reg. 715 (1/4/01).

(6) 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) due to 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. Revenue Ruling 85-13[367] 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, subsequent 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 direct impact on the basis in C corporation stock received in a subsequent conversion of the partnership.

(7) Because each conversion transaction involves a contribution of property (assets or partnership interests) to a corporation in exchange for shares in the corporation, advisors should consider whether, and to what extent, the fair market value of the contributed assets should include valuation discounts due to lack of marketability or other factors (e.g., an "interests-up" conversion involves the contribution of partnership interests). In addition, consideration should be given to whether value can, or should be, attributed to the goodwill of the business. As mentioned, fair market value, however determined, has a direct impact on how the 10 Times Basis Limitation and the Aggregate Gross Asset Requirement are calculated.

b. Assets-Over Conversion

(1) 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 of the Code, except to the extent of boot, as discussed above.[368] If the entire partnership (assets and liabilities) are contributed to the corporation, the transfer of liabilities will be considered only if the aggregate liabilities are in excess of the aggregate bases of the assets.[369] As noted above, under section 362(e) of the Code, 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).[370]

(2) As discussed above, 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).

[367] Rev. Rul. 85-13, 1985-1 C.B. 184.

[368] Since section 751 (relating to "hot" or ordinary income assets of the partnership) applies only to transfers of partnership interests and distributions, the contribution by the partnership of the assets to the corporation does not implicate section 751 of the Code and the general rule of nonrecognition under section 351 applies.

[369] § 357(c).

[370] *See* Treas. Reg. § 1.362-4(b).

(3) Liquidating distributions (whether in one distribution or a series of distributions) terminate the liquidated partner's entire interest in a partnership.[371] Generally, upon a distribution of property neither the partner nor the partnership will recognize any gain or loss upon a distribution of property.[372] 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).[373] The transfer of the liabilities from the partnership to the corporation (prior to 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.[374] 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).[375] As such, the holding period of the partner's interest in the partnership is generally irrelevant when determining the holding period of distributed property.

(4) 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 fair market value) by the amount of the liability and the outside bases of the partners are reduced by the same amount.[376] If the reduction is more than a partner's outside basis, it will result in the partner recognizing gain.[377] 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

(1) 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 discussed immediately above, 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.

(2) The distribution of the partners' shares of assets and liabilities is entitled to nonrecognition for both the partnership and the partners. The distribution of the assets to the partners may, however, result in gain under the "mixing bowl" rules or "disguised sale," if the distributed property includes assets that were contributed within two to seven years of the distribution.[378] The transfer of liabilities will generally be a wash because although the deemed

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[371] § 761(d).

[372] § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b).

[373] § 732(b).

[374] § 752(b).

[375] § 735(b).

[376] *See* Treas. Reg. § 1.752-7, which incorporates by reference to section 358(h)(3) of the Code.

[377] *See* Treas. Reg. § 1.358-7(b) and (e), Ex. 2.

[378] *See* §§ 707(c)(1)(B) and 737, "mixing bowl" provisions, and 707(a)(2)(B), "disguised sale" provision. A discussion of these rules is beyond the scope of these materials.

distribution will result in a reduction in the partner's share of partnership liabilities, there is an increase for the deemed contribution due to 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.

(3) 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 above, 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.

(4) The partners' basis in the corporate shares received upon the contribution of assets to the corporation is determined under section 351 of the Code, as discussed above. 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) of the Code (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) of the Code, 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 fair market value of the stock), by the amount of the liability.

d. Interests-Up Conversion

(1) 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 of 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 discussed above. 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.

(2) 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).[379] The mixing bowl rules do not apply to an interests-up conversion.[380] 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.[381] This boot is allocated in proportion to the fair market value of the property transferred.[382]

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[379] *See* PLR 9537013.

[380] Treas. Reg. §§ 1.704-4(c)(5) and 1.737-2(c).

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

[382] *See* Rev. Rul. 68-55, 1968-1 C.B. 140 (realized gain or loss computed on asset-by-asset basis, boot allocated in proportion to fair market values), and Rev. Rul. 85-164, 1985-2 C.B. 117(holding period allocated ratably, so that all shares have split holding period). When there is boot, section 751(a) treats the

4. Acquisition Date for QSBS Purposes on Formation or Conversion

a. As mentioned above, after its initial enactment in 1993, section 1202 was amended in 2009 and 2010 to increase the exclusion from 50 percent to 75 or 100 percent exclusions, depending on the acquisition date of the QSBS. After the 75 percent and 100 percent exclusions were enacted, each of the respective subsections were amended in 2012[383] 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."[384] Section 1223 of the Code currently provides for 15 different subsections, most of which provide for the tacking of holding periods depending on the transaction in question.

b. For section 1045 rollover purposes, section 1223(13) of the Code provides, in pertinent part, "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."[385] 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."[386] Except for section 1223(10) relating to the holding period of property acquired upon the death of decedent, all of the subsections in section 1223 provide for the inclusion of time prior to an exchange (or other transaction) and a relation back to a prior ownership. As such, the flush language of sections 1202(a)(3) and (a)(4) is broad enough to say that for purposes of determining the QSBS acquisition date, section 1223 could predate the creation of the C corporation if properties are contributed under section 351 of the Code (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, such stock would only be entitled to a 50% exclusion, not 100%.

c. Contrary to the foregoing, section 1202(i)(1) provides, in pertinent part, "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."[387] The Code makes clear that this rule applies "For

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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.

383 American Taxpayer Relief Act of 2012, P.L. 112-240, § 324(b)(1).

384 §§ 1202(a)(3) [flush language] and 1202(a)(4) [flush language].

385 § 1223(13).

386 § 1223(1).

387 § 1202(i)(1) and (1)(A).

purposes of this section,"[388] namely for purposes of section 1202. Section 1202(i) was enacted with the original statute in 1993, and as mentioned above, the 75% and 100% exclusions were added in 2009 and 2010 respectively, but the flush language was added in 2012.[389] 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.

d. The authors of an excellent article on QSBS[390] 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,[391] which focused on section 1045 rollovers, and to the Joint Committee on Taxation's report which includes 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."[392] 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."[393] Suffice it to say, clear guidance from the IRS on this issue would be greatly appreciated.

K. Reporting Requirements and Statute of Limitations

1. 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. In addition, 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 or not. QSBS is not elective. When a shareholder sells stock in a corporation, the stock either qualifies as eligible gain of a QSBS, in whole or in part, or it does not (which is more likely the case). As discussed above, given the federal rate applicable to Section 1202 Gain (31.8%) versus other long-term gain (23.8%), the difference can be significant for taxpayers.

2. As discussed above, in order 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

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388 § 1202(i).

389 American Taxpayer Relief Act of 2012, P.L. 112-240, § 324(b)(1).

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

391 S. Rep. No. 112-208, at 67-69 (2012) (the Senate's version of the eventual bill was the Family and Business Tax Cut Certainty Act of 2012).

392 JCT, *General Explanation of Tax Legislation Enacted in the 112th Congress*, JCS-2-13 (Feb. 2013), p. 185, fn. 490.

393 Janet Andolina and Kelsey Lemaster, *Candy Land or Sorry: Thoughts on Qualified Small Business Stock*, Tax Notes (Jan. 8, 2018), p. 223.

carry out the purposes"[394] of section 1202 of the Code. To date, no guidance has been issued, other than such reports that may be mandated on audit of a particular transaction in question.

3. 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),[395] and in completing Schedule D, a taxpayer is instructed to complete the 28% Rate Gain Worksheet with the appropriate amount that would be taxable at 28% depending on the percentage exclusion.[396]

4. 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."[397] Pursuant to these instructions, a fractional portion of the 28% taxable gain would need to be reported each year depending on the percentage exclusion. As discussed later in these materials, these instructions may not be appropriate in all circumstances.

5. Generally, under section 6501(a) of the Code, the IRS must assess tax within 3 years after a taxpayer files his or her tax return. Under section 6501(e)(1) of the Code, that period of time is extended to 6 years if the taxpayer omits from gross income an amount in excess of twenty-five percent of the gross amount of income claimed on the return. In Chief Counsel Advice Memorandum,[398] the IRS ruled that in determining the 25% threshold under section 6501(e)(1), the excluded amount under section 1202(a) is not included in that determination. The CCA 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% exclusion, it's likely that the IRS will be limited to the 3-year statute of limitations.

L. State Income Tax Treatment

1. For residents in states that do not impose an individual income tax (e.g., Florida, Texas, Nevada, and Washington) or do not impose a capital gains tax (e.g., 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 while the vast majority of these states do not make 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.

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[394] § 1202(d)(1)(C).

[395] 2019 Instructions for IRS Form 8949, How to Complete Form 8949, Columns (f) and (g).

[396] 2019 Instructions for IRS Schedule D, Exclusion of Gain on Qualified Small Business (QSB) Stock.

[397] *Id.*

[398] CCA Memo. 200609024 (Mar. 3, 2006).

2. 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.[399] Prior to the enactment of the 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 only applicable to those companies that met certain qualifications including whether assets and activities were in California. Ultimately, the California appeals court ruled 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, as they improperly favored investment in California companies (defined as corporations using 80% of their assets in the conduct of business in California and maintaining 80% of their payrolls in California) over investments in non-California companies.[400]

3. Like California, some states (e.g., Pennsylvania) completely disallow the QSBS exclusion benefit, while other states (e.g., Massachusetts, New Jersey, and Hawaii) make state modifications to the exclusion.[401] That being said, a large proportion of the states follow the federal treatment, so for many taxpayers the QSBS benefits will apply, in full, for state tax purposes.

III. QUERIES, QUALMS, AND QUALIFICATIONS FOR QUANTUM EXCLUSIONS

A. How Are Transfers "By Gift," "At Death," and Other Transfers Defined?

1. Transfers "By Gift" or "At Death"

a. As mentioned above, section 1202 provides that a transfer "by gift" or "at death" to a transferee will be treated as if the transferee had acquired the stock in the same manner as the transferor (continuing to satisfy the Original Issuance requirement) and having a tacked holding period with respect to the stock.[402] Definitions of transfers "by gift" and "at death" are not defined in section 1202, although the instructions to Schedule D refer to a transfer at death as an "inheritance."[403] "Gift" is defined in Chapter 12 of the Code,[404] and Chapter 11 of the Code broadly describes how certain transfers of property at the death of a decedent will be taxed for estate tax purposes.[405] Some commentators have asserted that transfers "by gift" and "at death" refer to whether the transfers would be considered taxable gifts for gift tax purposes or transfers subject to estate tax. We respectfully disagree. Section 1202 of the Code is an income tax section under Chapter 1 of the Code, and we believe the definition of "gift" should be determined under income tax principles, not transfer tax principles.

[399] Ca. Rev. & Tax Code § 18152 and California Franchise Tax Board Notice 2012-03.

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

[401] *See* Benetta P. Jenson and Stuart J. Kohn, *Maximize Qualified Small Business Stock Exclusion*, 40 Est. Plan No. 10, p. 3 (Oct. 2018) for a summary of each state's QSBS treatment as of April 15, 2018.

[402] §§ 1202(h)(1) and 1202(h)(2)(A), (B).

[403] *See* 2017 Instructions for Schedule D (Capital Gains and Losses).

[404] The Treasury Regulations provide, for example, that a gift, for gift tax purposes, includes "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed." Treas. Reg. § 25.2511-1(c). Furthermore, a gift, for gift tax purposes, is not limited to gift under the common law, which is a voluntary transfer without consideration. Treas. Reg. § 25.2511-8.

[405] *See* §§ 2031 to 2046.

b. There is no definition of "gift" or a transfer "at death" in Chapter 1 of the Code. Rather, for income tax purposes, whether a gift has occurred is a question of fact.[406] The Supreme Court wrote, "The meaning of the term "gift" as applied to particular transfers has always been a matter of contention. Specific and illuminating legislative history on the point does not appear to exist. Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious."[407] The courts have consistently held that a "gift" for income tax purposes should be defined and interpreted without reliance upon how it is defined for transfer tax purposes. In one opinion the Second Circuit wrote:

> But we find nothing in this decision to show that a transfer, taxable as a gift under the gift tax, is ipso facto to be treated as a gift in construing the income tax law… In our opinion the income tax provisions are not to be construed as though they were in pari materia with either the estate tax law or the gift tax statutes… Because of this we think that a transfer which should be classed as a gift under the gift tax law is not necessarily to be treated as a gift income-tax-wise.[408]

In another opinion, the Ninth Circuit wrote:

> We are not here concerned with the interpretation of statutes defining gift tax obligations. Our problem involves section 102(a) of the Internal Revenue Code of 1954, pertaining to taxable income. We are not necessarily bound by the considerations which might result in the finding of a taxable gift under section 2512 of the Code.[409]

c. In most instances, the determination of whether someone has received a gift or a bequest/inheritance for income tax purposes is to resolve the question of who should be taxed on the income of the property, based upon the facts and circumstances and income tax section at issue. Under section 102 of the Code, gross income of the transferee does not include the value of property acquired by gift, bequest, devise, or inheritance.[410] The issue is often whether a particular transfer is a gift or bequest, on one hand, or a sale of an asset or the payment of compensation, a dividend, interest, or other taxable income to the transferee, on the other hand. Importantly, when a transferor makes a gift or a bequest, the transferor is no longer the taxpayer for income tax purposes. After the gift or bequest, the transferee now has responsibility for the payment of tax on any taxable income related to the property.

d. On the question of adjusted basis of the transferred property, under section 1015(a) of the Code, if a transferor gifts property, the transferee's basis in the property will be the same as it would be in the hands of the donor (carryover basis).[411] If the fair market value

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[406] *See Commissioner v. Duberstein*, 363 U.S. 278 (1960).

[407] *Id.* at 284. *See also U.S. v. Davis*, 370 U.S. 65, 69 (1962) ("In interpreting the particular income tax provisions here involved, we find ourselves unfettered by the language and considerations ingrained in the gift and estate tax statutes.").

[408] *Farid-EsSultaneh v. Commissioner*, 160 F.2d 812, 35 AFTR 1049, 1051-1052 (2d Cir. 1947).

[409] *Hamberg v. Commissioner*, 400 F.2d 435, 438 (9th Cir. 1968).

[410] § 102(a).

[411] § 1015(a). The basis of the property is increased by any Federal gift tax paid attributable to any appreciation in the property transferred. § 1015(d).

of the gift is less than the donor's basis, the donee's basis on a subsequent sale of the property will depend on whether the sale creates a gain or a loss. If the donee recognizes a loss, the donee's basis for purposes of determining the recognizable amount of such loss is the fair market value of the property at the time of the gift. If the donee recognizes a gain, the donee's basis for purposes of determining the recognizable amount of such gain is the donor's basis at the time of the gift.[412] Under section 1014 of the Code, if a transferee acquires property "from a decedent or to whom the property passed from a decedent," the transferee's basis in the property will be the "fair market value of the property at the date of the decedent's death."[413]

e. With the foregoing in mind, we believe a transfer "by gift" under the meaning of section 1202(h)(2)(A) of the Code is properly interpreted to mean a transfer that has the following elements:

(1) The transfer is recognized for income tax purposes but is not a taxable sale or exchange;

(2) After the transfer, a different taxpayer becomes the owner of the stock for income tax purposes, and thereafter the taxpayer has responsibility for the payment of tax on any taxable income related to the stock; and

(3) The transferee's basis in the stock will be the same as it would be in the hands of the transferor under section 1015 of the Code.

f. Thus, any transfer to a grantor trust, whether considered a taxable gift for gift tax purposes or not, should simply be ignored and clearly no transfer "by gift" has occurred. Furthermore, an installment sale to an IDGT would also be ignored. The IRS position over the last few decades has consistently been that a grantor trust is not treated as a separate entity from the grantor for federal income tax purposes.[414] As such, these transfers are not recognized for income tax purposes, and none of them result in a different taxpayer/transferee.[415] The Treasury Regulations acknowledge the transfer of property to a grantor trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.[416] The IRS has also ruled that the termination of grantor trust status results in a transfer, for income tax

[412] *See* Treas. Reg. § 1.1015-1(a)(1) & (2). A sale at an amount somewhere in between the basis for determining loss and the basis for determining gain results in no gain or loss recognized.

[413] § 1014(a)(1).

[414] *See* § 671 ("[T]he grantor … shall be treated as the owner of any portion of a trust…"), Rev. Rul. 85-13, 1985-1 C.B. 184 (Taxpayer "is treated as the owner of the entire trust" and "is considered to be the owner of the trust assets for federal income tax purposes."), Rev. Rul. 2007-13, 2007-1 C.B. 684, and CCA 201343021 ("The Service position of treating the owner of an entire trust as the owner of the trust's assets is consistent with and supported by the rationale for attributing items of income, deduction, and credit to the owner. Accordingly, we conclude that a trust that is treated as a grantor trust is ignored as a separate entity apart from the owner for all federal income tax purposes."), and Treas. Reg. § 1.1001-2(c) (Grantor of a grantor trust "is treated as the owner of the entire trust."). *But see Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984) and Rev. Rul. 74-243, 1974-1 C.B. 106.

[415] *See also* PLRs 9508007 and 9535026 (There is no change in the adjusted basis and holding period of stock "sold" to a grantor trust).

[416] Treas. Reg. 1.671-2(e)(2)(i). Section 2511(c) of the Code also provides that "a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse" under the grantor trust rules of sections 671-679 of the Code.

purposes, of the underlying assets held by the grantor trust.[417] Consequently, the loss of grantor trust status, whether caused by the death of the grantor or some other reason (e.g., the release of a power,[418] a change in trustees,[419] or repayment of borrowed trust assets[420]) is considered a transfer that would qualify as a transfer "by gift" under section 1202(h)(2)(A).[421] If the stock in the grantor trust is subject to debt, taxable gain will be recognized to the extent that the debt encumbering the property is in excess of its tax basis. Under such circumstance, the IRS could take the position that in this instance the transfer would be considered a part gift, part sale. The result would be that the sale portion of the transfer would be a disqualifying transfer for QSBS purposes, but the gift portion would be a permissible transfer retaining QSBS status.

g. The IRS has yet to affirmatively rule on the resulting tax basis of property in a grantor trust (specifically, an IDGT, the assets of which generally will not be includible in the estate of the grantor[422]) when grantor trust status is terminated, particularly if the termination event is the death of the grantor.[423] Some notable commentators believe that the assets qualify for a "step-up" in basis under section 1014 of the Code.[424] Most practitioners and commentators take the position that whatever assets happen to be in the IDGT at the time of the grantor's death carry their historical tax basis (carryover basis), because the assets are treated as if they had been transferred by gift under section 1015(a) (or section 1015(b), as proposed in a recent article, but which gets to the same result).[425] The IRS has implied this result already. For example, the IRS

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[417] *See* Rev. Rul. 77-402, 1977-2, 1977-2 C.B. 122. *Madorin v. Commissioner*, 84 T.C. 667 (1985), Treas. Reg. § 1.1001-2(c), *Ex. 5*, TAM 200011005, and GCM 37228 (Aug. 23, 1977).

[418] *E.g.,* § 675(4)(C) power.

[419] *E.g.,* § 674(c) power.

[420] *E.g.,* § 675(c). .

[421] *See*, *e.g.*, *Crane v. Commissioner*, 331 U.S. 1 (1947); see also, Treas. Reg. §§ 1.1001-2(a)(4)(v), 1.1001-2(c), *Ex. 5*, and Rev. Rul. 77-402, 1977-2 C.B. 222, in the partnership context. The IRS could take the position that in this instance the transfer would be considered a part gift, part sale.

[422] In 2015, the IRS put the issue of "whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not included in the gross estate of that owner" on the no ruling list. Rev. Proc. 2015-37, 2015-27 I.R.B. 1196.

[423] *See* CCA 200937028, dealing with a taxpayer who transferred assets into a trust and reserved the power to substitute assets. In the ruling, the chief counsel quotes from Section 1.1014-1(a) Treasury Regulations: "The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death . . . Property acquired from the decedent includes, principally . . . property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]" From this the chief counsel concludes, "Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9)."

[424] Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death,* 97 J. Tax'n 149 (2002), and Elliott Manning and Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est., Gifts & Tr. J. 3 (1999).

[425] *See* Austin Bramwell and Stephanie Vara, *Basis of Grantor Trust Assets at Death: What Treasury Should Do*, Tax Notes (Aug. 6, 2018), p. 793. The authors argue that section 1015(b) of the Code specifically should apply to determine the basis of assets in IDGTs when termination of grantor trust status is cause by the death of the grantor. Section 1015(b) provides if property is acquired "by transfer in trust (other than by a gift,

ruled that when property transferred to a grantor trust is transferred to the grantor under the terms of the trust instrument at the termination of the trust, its basis is the same as the basis of the property in the hands of the grantor upon the original contribution.[426]

h. Based on the foregoing, we believe a transfer "by gift" under section 1202(h)(2)(A) of the Code would include:

(1) A gratuitous transfer of QSBS to another individual;

(2) A gratuitous transfer of QSBS to a non-grantor trust (including a non-grantor charitable lead trust), whether such transfer is considered a taxable gift or not for gift tax purposes;

(3) A gratuitous transfer of QSBS to a charitable remainder trust;

(4) A distribution of QSBS from a grantor or non-grantor trust to an individual beneficiary, other than the grantor;

(5) A distribution of QSBS from a grantor or non-grantor trust to another non-grantor trust that is a separate taxpayer from the distributing trust, pursuant to a decanting or otherwise;[427]

(6) A transfer of QSBS from trust pursuant to the exercise of a limited (and, as discussed below, a general) power of appointment,[428] in favor of an individual or another non-grantor trust that is treated as a separate taxpayer;

(7) A segregation of stock that is being held for the benefit of a group of beneficiaries into a separate share for the benefit of one or more of such beneficiaries, [429]

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bequest, or devise), the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer." Thus, if the death of the grantor is not a taxable event for income tax purposes, then the acquired basis is simply the donor's basis prior to death. *See* GCM 200923024 (After providing that a taxable event occurs when grantor trust status is terminated during the lifetime of the grantor, the memorandum goes on to say, "We would also note that the rule set forth in these authorities is narrow, in so far as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event."). For purposes of this outline, the result is the same, carryover basis to the transferee, provided no taxable sale or exchange has occurred.

[426] Rev. Rul. 72-406, 1972-2 C.B. 462. *See also Pierre S. Du Pont v. Commissioner*, 18 B.T.A. 1028 (1930).

[427] Also assuming the trust is not subject to the multiple trust rules under section 643(f), as discussed later in these materials.

[428] Restatement Third of Property: Wills and Other Donative Transfers, § 17.1 comment c, provides, "The beneficial owner of an interest in property ordinarily has the power to transfer ownership interests in or confer powers of appointment over that property to or on others by probate or non-probate transfer.... By contrast, a power of appointment traditionally confers the authority to designate recipients of beneficial ownership interests in or powers of appointment over property that the [powerholder] does not own." Upon the exercise of a power of appointment, the doctrine of relation back provides that the appointed property passes directly from the donor to the appointee. The powerholder's appointment is deemed to relate back to and become part of the donor's original instrument. The powerholder is viewed as akin to the donor's agent.

[429] *See* § 663(c) and Treas. Reg. § 1.663(c)-3(c).

provided the separate share is treated as a separate taxpayer for income tax purposes, having its own tax identification number and filing a separate tax return; and

(8) A deemed transfer upon a termination of grantor trust status for any reason, including the death of the grantor (provided there is no deemed taxable event due to debt in excess of basis).

i. Of course, the foregoing means that any transfer or transaction that is ignored for income tax purposes will ***not*** be considered a transfer "by gift" under section 1202(h)(2)(A) of the Code (or any other type of transfer for income tax purposes). As such, any transfer of QSBS from a grantor to a grantor trust will be disregarded, including a contribution to a revocable living trust, a taxable gift to an IDGT, an installment sale to an IDGT, and a contribution to a grantor charitable lead trust. Furthermore, in contrast to the IRS's position on the termination of grantor trust status (i.e., a recognized transfer for income tax purposes), the IRS has ruled the conversion from non-grantor trust to grantor trust status is not a transfer.[430] Thus, the conversion is ignored for income tax purposes. It should be noted that all of the foregoing disregarded or ignored transfers are predicated on the grantor being deemed the owner of the entire trust, rather than just a portion of the trust.[431]

j. This analysis regarding a transfer "by gift" is supported by the 2020 QOZ Final Regulations. Gain deferred pursuant to an investment in a qualified opportunity fund under section 1400Z-2(a) of the Code will be included in income if such investment is "sold or exchanged" prior to December 31, 2026.[432] Notwithstanding the "sold or exchanged" language of the Code, the 2020 QOZ Final Regulations restate "sold or exchanged" in terms of an "inclusion event."[433] An "inclusion event" is generally any transfer to a different taxpayer and includes a "taxpayer's transfer of a qualifying investment by gift, as defined for purposes of chapter 12 of subtitle B of the Code, whether outright or in trust, … regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift."[434] With regard to grantor trusts, the 2020 QOZ Final Regulations provide, "If the owner of a qualifying investment contributes it to a trust and, under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust), the contribution to the grantor trust is not an inclusion event. Similarly, a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event."[435] Notably, the 2020 QOZ Final Regulations expand the foregoing rule originally set out in the 2019 QOZ Proposed Regulations to provide, in addition, "Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust

[430] PLR 201730018 (The conversion of a non-grantor CLAT to grantor CLAT is "not a transfer of property held by Trust to Grantor as settlor of Trust for income tax purposes.") and CCA 200923024 (IRS held that the conversion of a non-grantor trust to a grantor trust would not result in taxable income to the grantor. It did not opine on whether a transfer is deemed to occur upon such a conversion but relied, in part, on Revenue Ruling 85-13 and essentially said no taxable event occurred upon the conversion).

[431] *See* Treas. Reg. § 1.671-3.

[432] § 1400Z-2(b)(1).

[433] Treas. Reg. § 1.1400Z2(b)-1(c).

[434] Treas. Reg. § 1.1400Z2(b)-1(c)(3).

[435] Treas. Reg. § 1.1400Z2(b)-1(c)(5)(i).

rules (that is, subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code)."[436] In other words, an inclusion event would not include, for example, a grantor's sale of a QOZ investment to his or her "intentionally defective" grantor trust.[437] With respect to changes in grantor trust status, the 2020 QOZ Final Regulations provide, "In general, a change in the income tax status of an existing trust owning a qualifying investment in a QOF, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event."[438] If grantor trust status is changed by reason of the death of the grantor, it is not considered an inclusion event but certain rules applicable to the death of a taxpayer otherwise apply.[439]

k. Defining a transfer "at death" under section 1202(h)(2)(B) of the Code is a bit more circumspect. No authority addresses the scope of transfers that qualify as transfers "at death" for section 1202 purposes. Given this silence, we looked for additional income tax rules that might support a reasonable construction of this criterion. Section 1014 of the Code describing the basis of property acquired from a decedent or to whom the property passed from a decedent provides the closest analog to define transfers at death in the income tax context. The class of property that could be treated as "acquired from" or "passing from" a decedent could be extremely broad based on the general meaning of those terms. However, section 1014(b) specifically defines the types of transfers considered to pass from or be acquired from a decedent and the basis adjustment is limited to these categories.[440] Thus, while helpful in providing a close conceptual comparison, interpretation of section 1202(h)(2)(B) by analogy to section 1014(b) may be conservative.

l. Practitioners often describe the basis adjustment under section 1014(b) by shorthand reference as the adjustment for transfers subject to inclusion in the gross estate for estate tax purposes. However, such inclusion is only one potential ground for the adjustment, and the full list applicable to decedents now dying includes the following:[441]

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[436] *Id.*

[437] The preamble to the 2020 QOZ Final Regulations state provide: (i) "The Treasury Department and the IRS note that a defective grantor trust is a grantor trust for Federal income tax purposes, so its funding does not change the conclusion that the transfer is not an inclusion event under section 1400Z-2." and (ii) "A commenter also requested clarification that non-gift transactions between a grantor trust and its deemed owner that are not recognition events for Federal income tax purposes are not inclusion events, and that such transactions do not start a new holding period for purposes of section 1400Z. In such transactions, the deemed owner of the trust continues, for Federal income tax purposes, to be the taxpayer liable for the Federal income tax on the qualifying investment. Thus, the Treasury Department and the IRS have determined that, like transfers by the deemed owner to the grantor trust, these transactions (including transfers from the grantor trust to its deemed owner) are not inclusion events."

[438] Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii).

[439] *See* Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii) and -1(c)(4).

[440] *Collins v. U.S.*, 318 F. Supp. 382 (C.D. Cal. 1970), *aff'd per curiam*, 448 F. 2d 787 (9th Cir. 1971) (rejecting spouse's argument that section 1014(b) applies to additional transfers caused by a decedent's death that are not identified in the statute because the statutory categories are not exclusive).

[441] *See* § 1014(b). In addition, section 1014(b)(5) also treats as acquired or passing from a decedent who died after August 26, 1937, and before January 1, 2005, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent's death was, under the law applicable to such year, a foreign personal holding company. Such property is excluded from the separate section 1014(b)(9) category for transfers of property included in the gross estate for federal estate tax purposes. § 1014(b)(9)(B).

(1) Property acquired from the decedent by bequest, devise, or inheritance, or by the decedent's estate;

(2) Property the decedent transferred during lifetime in trust to pay the income for life to or on the decedent’s order or direction, if the decedent reserved the right at all times before his death to revoke the trust;

(3) Property the decedent transferred during lifetime in trust to pay the income for life to or on the decedent’s order or direction, if the decedent reserved the right at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust; [442]

(4) Property passing without full and adequate consideration under a general power of appointment the decedent exercised by will;

(5) Property representing the surviving spouse's one-half share of community property held by the decedent and the surviving spouse, if at least one-half of the whole community property interest was includible in the decedent's gross estate for federal estate tax purposes; [443]

(6) Property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is included in decedent's gross estate for federal estate tax purposes, except certain annuities, and “property described in any other paragraph of this subsection [1014(b)].” [444]

(7) Property of a marital qualified terminable interest property (QTIP) trust includible in the decedent’s gross estate under section 2044 of the Code.

m. The examples in this statutory list reflect a broad class characterized by the common element that they are effective at a decedent’s death, even if the decedent did not directly own the property and if it was held in trust. Section 1014(b) makes clear that the transfer tax (i.e., gift, estate or GST tax) character or consequence of a transfer is not the sole or even primary determinant of the basis adjustment for income tax purposes. In fact, the estate tax inclusion category expressly specifies that if it overlaps with any other category (which it certainly does), then the other provision operates first to define the grounds for a basis adjustment. In the absence of more specific guidance regarding the meaning of “at death” under section 1202, application of the categories treated as transfers passing or acquired from a decedent for section 1014 purposes seems reasonable. These categories describe more of the transfers typical in modern planning than simple bequests. The expansiveness of the categories to include cases beyond the simple direct transfer at death from a decedent’s estate (for example, by powers of appointment) is helpful.

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[442] For decedents dying after December 31, 1951. § 1014(b)(3).

[443] For decedents dying after December 31, 1947. § 1014(b)(6).

[444] For decedents dying after December 31, 1953. § 1014(b)(9).

n. Given the foregoing, we believe that a permissible transfer "at death" would reasonably include, at the least, a transfer that (i) is recognized for income tax purposes (but not a taxable sale or exchange); (ii) results in a different taxpayer becoming the owner of the stock for income tax purposes; and (iii) provides the transferee with basis determined under section 1014 of the Code. As such, a permissible transfer "at death" includes:

(1) A distribution of QSBS from the estate of the decedent who acquired the QSBS during lifetime to an individual beneficiary or testamentary trust;

(2) A distribution of QSBS from a revocable living trust created and funded by a decedent who acquired the QSBS during lifetime to an individual beneficiary or trust created upon the death of the decedent;

(3) A transfer of ownership in QSBS upon the death of a joint tenant who acquired the QSBS during lifetime, whether in accordance with a joint tenancy with right of survivorship or a joint tenancy by the entirety; and

(4) Any other transfer of ownership created upon the death of an individual who acquired the QSBS during lifetime under a beneficiary designation, transfer on death provision, or other similar method of transferring ownership.

2. Transfers Related to Partnerships

a. As mentioned above, distributions of QSBS from a partnership to a partner are permissible transfers that allow for tacking of the holding period and retention of the QSBS status of the stock owned by the partnership, provided certain requirements and limitations are met.[445] There is no provision that allows for a transfer from a partner to a partnership. Thus, a contribution of QSBS stock by an eligible QSBS shareholder to a partnership in exchange for an interest in that partnership, followed by a sale of such stock by the partnership, would certainly not allow the partnership (or its partners) to get the exclusion benefit. The legislative history makes that clear. [446]

b. Less clear is if a partner contributes QSBS to a partnership in a nontaxable exchange,[447] but prior to any sale of the QSBS, the stock is distributed back to the contributing partner. Presumably the contribution and distribution would not be a taxable event.[448] If the QSBS is then sold by the original taxpayer who acquired it by original issuance, shouldn't such taxpayer still be allowed to claim the QSBS exclusion benefit under section 1202(a)? It seems

[445] § 1202(h)(2)(C). The requirements generally provide that the exclusion benefits of section 1202 will be limited by the interest "held by the taxpayer on the date on which such pass-thru entity acquired such stock," and may not exceed the amount that would have been excludable "by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired." § 1202(g).

[446] "Transferees in other cases are not eligible for the exclusion. Thus, for example, if qualified small business stock is transferred to a partnership and the partnership disposes of the stock, any gain from the disposition will not be eligible for the exclusion." Conference Report (H. Rept. 103-213) on Omnibus Budget Reconciliation Act of 1993, p. 526.

[447] *See* § 721(a).

[448] Even if the distribution occurred within 7 years of its original contribution because the "mixing bowl" provisions do not apply if the contributed property is distributed back to the contributing partner. *See* §§ 707(c)(1)(B) and 737.

that no tax policy is violated in this instance, and this might be a way to "save" inadvertent contributions of QSBS to FLPs. In other words, whether certain transfers are disqualifying or not might best be determined at the time of sale. Again, guidance would be appreciated on this issue.

c. In contrast, if an individual QSBS shareholder contributed the QSBS stock to a wholly-owned limited liability company (LLC) that is treated as a disregarded entity, the contribution of the QSBS in exchange for interests in the disregarded entity would not be a transfer for income tax purposes.[449] QSBS status would be retained, unless and until the LLC became another taxable entity like a partnership, at which time it is possible the conversion would disqualify the stock. The IRS has provided guidance on the tax issues involved in a conversion of a disregarded entity to a partnership. [450] In both of the illustrated situations, the IRS ruled that the conversion is treated as if the underlying assets in the disregarded entity are contributed to a newly formed partnership in exchange for an interest in the partnership. Thus, a conversion may be treated as a contribution to a partnership by a partner, which is not a permissible transfer. However, as just discussed, if the QSBS is distributed back to the "contributing" partner because of a conversion before the sale of QSBS and that QSBS is sold by that partner, shouldn't the partner be entitled to the QSBS exclusion benefit?

d. It is unclear whether a permissible transfer "by gift" includes a gratuitous transfer of an interest in a partnership that holds properly acquired QSBS at Original Issuance. In order for a partner to be afforded exclusion benefits on partnership QSBS, section 1202(g)(2)(B) not only requires that the partnership interest must be "held by the taxpayer" on the date the QSBS was acquired, but it also mandates that the partnership interest must be held "at all times thereafter before the disposition of such stock by such pass-thru entity."[451] If a donor gifts an interest in the partnership to a grantor trust, the transfer will be ignored and QSBS status is retained because the donor remains the taxpayer for section 1202 purposes. If, on the other hand, a donor gifts an interest in the partnership to another taxpayer, on its face, the donor did not "at all times thereafter" hold the partnership interest. Thus, the gift of the partnership interest could have disqualified the stock, at least with respect to the gifted portion of the partnership interest. This seems a particularly harsh result since the QSBS could have been distributed to the original taxpayer, and then gifted to the donee, and QSBS status would be retained for the benefit of the donee. The partnership rules provide a number of mechanisms to ensure that any built-in gain or loss or other economic interest associated with the transferred interest passes to a transferee. For example, the Treasury Regulations provide, "If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner."[452]

e. In addition, the Treasury Regulations provide, for purposes of defining an "eligible partner" for section 1045 rollover purposes, "a taxpayer who acquires from a partner…

[449] The entity is "disregarded as an entity separate from its owner if it has a single owner," and this applies for "federal tax purposes." Treas. Reg. § 301.7701-3(b)(1)(ii).

[450] Rev. Rul. 99-5, 1999-1 C.B. 434.

[451] § 1202(g)(2)(B).

[452] Treas. Reg. § 1.704-3(a)(7). In addition, the Treasury Regulations provide that "upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner." Treas. Reg. §§ 1.704-1(b)(2)(iv)(*l*) and 1.704-1(b)(5), ex. 13.

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… held the interest in the partnership."[453] This Treasury Regulations may not, however, apply for all section 1202 purposes. Thus, until the IRS provides guidance on this issue, practitioners should avoid making gifts of interests of partnerships that hold QSBS. That being said, a transfer of a disregarded entity holding QSBS to a grantor trust, like a GRAT, would not be considered a transfer for income tax purposes, unless and until the disregarded entity became another taxable entity like a partnership. If, for example, the GRAT term expires, and the disregarded entity shares are distributed to another grantor trust for the benefit of the grantor's children, then QSBS status would be retained. On the other hand, if (i) the GRAT term expires and a portion of the disregarded entity shares are distributed to children or a non-grantor trust, or (ii) the grantor dies, thereby terminating grantor trust status, then the disregarded entity will convert to a different taxable entity (i.e., partnership) and QSBS status is lost. Given the risk of losing QSBS status, practitioners should consider liquidating the disregarded entity prior to the event that will cause it to convert to a different taxable entity.

3. Powers of Appointment

a. It is unclear how a transfer pursuant to the exercise or lapse of a testamentary general power of appointment should be treated for these purposes. As noted above, a transfer pursuant to a limited power of appointment would qualify as a transfer "by gift," in part, because the powers of appointment, under common law, are treated as if the power holder is acting as the agent of the donor. Upon the exercise of a power of appointment, the doctrine of relation back provides that the appointed property passes directly from the donor to the appointee, without any ownership by the powerholder. This applies whether the power of appointment is limited or general. For transfer tax purposes, a general power of appointment, whether exercised or not, causes estate and gift tax inclusion of the assets subject to the power, resulting in a "step-up" in basis under section 1014,[454] and the power holder being deemed the transferor.[455] For income tax purposes, however, the Treasury Regulations provide that with respect to a grantor trust, if a powerholder exercises a general power of appointment (not a lapse) in favor of a transferee trust, the powerholder is treated as the grantor of the transferee trust.[456]

b. Ultimately, we believe that the "step-up" in basis due to the exercise of a testamentary general power of appointment does not alter the treatment of the transfer as one "by gift." This is because the "step-up" in basis is caused by inclusion at the powerholder's death, not the original donor's death (which is needed, in our opinion, for the transfer to be considered a permissible transfer "at death" under section 1202(h)(2)(B)). Indeed, the transfer of QSBS pursuant to the exercise of an *inter-vivos* general power of appointment would provide a carryover basis to the transferee. Thus, we conclude that the transfer of QSBS pursuant to the exercise of a limited or a general power of appointment, whether exercised during the lifetime or at the death of the powerholder, is a permissible transfer "by gift" under section 1202(h)(2)(A). The lapse of a general or limited power is ignored for QSBS purposes, and it does not make a difference whether the transferee acquires a carryover basis or a "step-up" in basis on the QSBS.

[453] Treas. Reg. § 1.1045-1(g)(3)(ii).

[454] §§ 2041, 1014(b)(9), and 1014(b)(4).

[455] *See* § 2652(a) and Treas. Reg. § 26.2652-1(a).

[456] Treas. Reg. § 1.671-2(e)(5).

4. Summary of Movement of QSBS Shares

a. Attached to these materials is APPENDIX: MOVEMENT OF QSBS SHARES CHART.

b. The chart summarizes how different transfers or deemed transfers are treated for section 1202 purposes, denoting when the transfer is (i) a permissible transfer, (ii) a disqualifying transfer that results in the loss of QSBS status, (iii) an ignored transfer that retains QSBS status, and (iv) one that results in an additional $10 Million Per Taxpayer Limitation for the transferee.

B. Can You "Stack" and "Pack" the Per-Issuer Limitation?

1. Generally

a. As mentioned above, the Per-Issuer Limitation is based on a per-issuer (per corporation), per taxpayer basis. Furthermore, the Per-Issuer limitation has two mutually exclusive limitations: (i) the $10 Million Per Taxpayer Limitation, and (ii) the 10 Times Basis Limitation. At an initial glance it may seem that taxpayers are limited to one or the other, but a careful reading of the section makes it clear that taxpayers are entitled to both of the limitations, not just the greater of the two of them. Section 1202(b)(1) provides that the QSBS exclusion benefit "for the taxable year" may not exceed the greater of the two limitations. Thus, each taxable year in which the taxpayer has eligible gain on QSBS, either the $10 Million Per Taxpayer Limitation or the 10 Times Basis Limitation will be applied (the greater of the two of them).

b. The $10 Million Per Taxpayer Limitation is reduced by eligible gains taken in previous taxable years, and once the taxpayer has recognized an aggregate of $10 million of eligible gain under this limitation, the taxpayer no longer has this limitation available. On the other hand, the 10 Times Basis Limitation is taken into account only for the taxable year in question, and it is not reduced by eligible gains taken in previous years. This means that the order in which QSBS is sold is extremely important.

c. Assume taxpayer A acquires two lots of QSBS: lot 1 (100 shares) for $800,000 in 2011, and lot 2 (also 100 shares) for $1.2 million in 2012 (each qualifying for the 100% exclusion with an aggregate tax basis of $2 million). Assume that A holds both lots of QSBS for more than 5 years, and A's total holdings in QSBS is worth $30 million (each lot is worth $15 million).

(1) Scenario 1: If A sells all of the QSBS for $30 million in 2018, the total realized gain is $28 million. The greater of the two limitations is the 10 Times Basis Limitation, allowing A to exclude $20 million (Excluded Section 1202 Gain) and recognizing $8 million of long-term capital gain (Non-Section 1202 Gain).

(2) Scenario 2: If A sells lot 1 for $15 million in 2018 (realizing $14.2 million of gain) and lot 2 for $15 million the following year (realizing $13.8 million of gain), the Per Issuer Limitation would be applied in the following manner. Lot 1 has a tax basis of $800,000, and the 10 Times Basis Limitation would only be $8 million. Therefore, in 2018, the $10 Million Per Taxpayer Limitation must be applied, and A recognizes $4.2 million of gain. Lot 2 has a tax basis of $1.2 million, and the 10 Times Basis Limitation would be $12 million. Therefore, in 2019, A recognizes $1.8 million. Over the 2 years, A recognizes an aggregate of $6 million of gain.

(3) Scenario 3: If A sells lot 2 for 15 million in 2018 (realizing $13.8 million of gain), and lot 1 for $15 million in 2019 (realizing $14.2 million of gain), the Per Issuer Limitation would be applied in the following manner. Lot 2 has a tax basis of $1.2 million, as such the greater of the two limitations is the 10 Times Basis Limitation ($12 million). Therefore, on the sale of lot 2 in 2018, A recognizes $1.8 million of gain. Lot 1 has a tax basis of $800,000, and the 10 Times Basis Limitation would only be $8 million. Thus, one would hope to use the $10 Million Per Taxpayer Limitation. However, the Code says the $10 million cap is "reduced by the aggregate amount of eligible gain taken into account by the taxpayer under subsection (a) for prior taxable years."[457] In this example, A excluded $12 million of gain in 2018, and as a result, A no longer has any of the $10 Million Per Taxpayer Limitation remaining. Thus, with respect to sale of lot 1 in 2019, only $8 million can be excluded, and A recognizes $6.2 million of gain. Over the 2 years, A recognizes an aggregate of $8 million (the same result as scenario 1).

d. As one can see, if a taxpayer holds 100% exclusion shares of QSBS, the taxpayer should seek to use the $10 Million Per Taxpayer Limitation first, choosing to sell the lowest tax basis lots first until that limitation is exhausted. Afterwards, only the 10 Times Basis Limitation will be available, and selling higher basis lots in those subsequent sales obviously increases the amount of eligible gain that can be excluded. If, however, a taxpayer holds 50%, 75%, and 100% exclusion shares of QSBS in the same issuer, the calculation of which lot to sell becomes more complicated because the 50% and 75% exclusion shares will create Section 1202 Gain, which is taxable at a maximum rate of 28% [31.8%] and which also reduce a taxpayer's $10 Million Per Taxpayer Limitation if sold first. The determination of which lots to sell becomes even more complicated if appreciated assets are exchanged for QSBS in a section 351 exchange because the unrecognized built-in gain inherent in the shares will not be excluded at all because they are Non-Section 1202 Gain, which is taxable at the long-term capital gain tax rate.

2. "Stacking" or Multiplying the $10 Million Per Taxpayer Limitation

a. One method of maximizing the potential section 1202 exclusion benefit is by multiplying the number of taxpayers entitled to the $10 Million Per Taxpayer Limitation. As discussed above, each transfer "by gift" or "at death" to another taxpayer would create another $10 Million Per Taxpayer Limitation. Furthermore, as noted, as long as the transferee of such transfer is an eligible QSBS shareholder like an individual or a non-grantor trust (but not a partnership, S corporation, or other pass-thru entity), then QSBS status is retained in the hands of the transferee. Subject to the multiple trust rules discussed below, each transfer to a non-grantor trust would allow each trust to claim a separate $10 Million Per Taxpayer Limitation (in addition to the 10 Times Basis Limitation).

b. If QSBS is contributed to a non-grantor trust and the transfer is taxable for gift tax purposes, the donor will be able to take advantage of the temporary doubling of the "Applicable Exclusion Amount" under TCJA.[458] If a portion of the taxable gift qualifies for the annual gift tax exclusion because one or more of the trust beneficiaries has a *Crummey*[459] power to withdraw a portion of the QSBS contribution and such power lapses, then the IRS has ruled that

[457] § 1202(b)(1)(A).

[458] § 2010(c)(3).

[459] *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

the beneficiary will be treated as a part owner of the trust under section 678(a) of the Code.[460] Under such circumstances, the donor's contribution of the QSBS to the trust will be treated as a permissible transfer "by gift," and such transfer will result in at least two different taxpayers, one being the non-grantor trust, the other being the deemed partial owner-beneficiaries under section 678(a) of the Code. These taxpayers would all presumably be able to claim a separate $10 Million Per Taxpayer Limitation.

c. For taxpayers who do not wish to make a taxable gift but who desire to make a transfer "by gift" for section 1202 purposes, one possibility seems to be a transfer of QSBS to an "incomplete gift, non-grantor trust." Most often practitioners have utilized these trusts for state income tax purposes, often taking advantage of the laws of Delaware (Delaware incomplete non-grantor trust or "DING") and Nevada (Nevada incomplete non-grantor trust or "NING").[461] These DINGs and NINGs ostensibly allow a donor to make a non-taxable gift of assets to a non-grantor trust that is treated as a separate taxpayer from the donor for income tax purposes, notwithstanding the fact that the donor is a permissible beneficiary of such trust. Prior to 1997, a self-settled trust (a trust that provides for the benefit of the grantor) would not have qualified as a non-grantor trust. The Treasury Regulations provide, "Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor." Thus, if under state law creditors of the grantor can reach the assets of the trust, then the trust will be considered a grantor trust for income tax purposes. Prior to 1997, all of the states provided that creditors of a grantor could reach the assets of any self-settled trust. Since 1997, a number of states like Delaware and Nevada have enacted "domestic asset protection trust" statutes that allow grantors to create self-settled trusts but prohibit creditors of the grantor from reaching the assets in the trust. The contribution to the trust is deemed non-taxable due to certain powers of appointment, retained consent powers, and the imposition of distribution committees.[462] A full discussion of DINGs and NINGs is beyond the scope of this topic, but for QSBS purposes the planning implication are straightforward. A transfer to a DING or NING would be a permissible transfer "by gift," thereby allowing the DING or NING to claim its own $10 Million Per Taxpayer Limitation, even though the donor is a permissible beneficiary of such trust. Notwithstanding the foregoing, it is important to note that in 2021 and subsequently for 2022, the IRS placed incomplete gift, non-grantor trusts on its list of areas under study in which rulings will not be issued until the service resolves the issue through the publication of a revenue ruling, revenue procedure, regulation, or otherwise.[463]

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[460] *See* PLRs 200747002, 200104005, 200022035, 200011058, 200011054, 200011056, 199942037, 199935046, 199935047, and 9812006.

[461] S*ee* Michael Gordon, *Using Self-Settled Asset Protection Trusts for Tax Planning Purposes,* 53rd Annual Southern Federal Tax Institute (Oct. 2018), Outline Y, Peter Melcher and Steven J. Oshins, *New Private Letter Ruling Breathes Life into Nevada Incomplete Gift Non-Grantor Trusts*, Wealthmanagement.com, the digital resource of REP. and Trusts & Estates (Apr. 16, 2013), and Steven J. Oshins, *NING Trusts Provide Tax and Asset Protection Benefits*, CCH Estate Planning Review - The Journal, Page 150 (Aug. 20, 2013).

[462] *See e.g.*, 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005, and 200731019 (Delaware). Other rulings and jurisdictions, *see* PLRs 200647001, 200715005, 200731019, 201310002-20131000, 201410001-201410010, 201426014, 201430003-201430007, 201436012-201436032, 201636027-201636032, 201650005, 201729009, 201742006, 201836006, 201848002, 201848009, 201908003-201908005, and 201925005-201925010.

[463] Rev. Proc. 2022-3, 2022-1 I.R.B. 140, Section 5.01(10) and (18).

d. As mentioned above, the $10 Million Per Taxpayer Limitation is cut to $5 million per spouse if spouses file separately. So, a transfer of QSBS to a spouse who files separately will not "stack" the $10 Million Per Taxpayer Limitation. This reduction does not apply to spouses filing jointly. Thus, a transfer of QSBS to a spouse with spouses filing jointly seemingly works to double the $10 Million Per Taxpayer Limitation. Because taxable gifts to spouses automatically qualify for the gift tax marital deduction,[464] this could be an easy way to double the exclusion limitation without incurring gift tax. For practitioners wary about the uncertainty regarding the QSBS treatment of spouses filing jointly, a gift to a non-grantor trust with a spouse as a beneficiary is theoretically possible, notwithstanding section 677(a) of the Code, which provides that a grantor is treated as the owner of any portion of a trust if the income may be paid to the grantor or the grantor's spouse with the consent of an adverse party.[465] Thus, the trust could require the consent of an adverse party, or the trust could initially be a non-grantor trust without the spouse as a beneficiary but later, in subsequent taxable years, the spouse might be added as a beneficiary or the trust assets could be decanted to a trust with a spouse as a beneficiary, all exercisable by the action of an adverse party.[466]

3. Multiple Trust Rules

a. Section 643(f) of the Code authorizes the Treasury Department to issue Treasury Regulations pursuant to which 2 or more trusts would be treated as 1 trust if: (i) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries; and (ii) a principal purpose of such trust is the avoidance of a tax.[467] For this purpose, spouses (the Code section actually reads, husband and wife) are treated as one person.[468] Until recently, Treasury Regulations had not been issued. When the Treasury Department released the 199A Final Regulations, it finalized Treasury Regulations under section 643(f) of the Code (the "643(f) Final Regulations").[469]

b. The new 643(f) Final Regulations provide: [470]

> For purposes of subchapter J of chapter 1 of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.

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[464] *See* § 2523(a) and § 1041 ("No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse…[T]he property shall be treated as acquired by the transferee by gift.")

[465] *See* § 677(a) ("grantor shall be treated as the owner of any portion of a trust…whose income… is, or may be" distributed or accumulated for future distribution to the grantor or the grantor's spouse).

[466] *See* § 674.

[467] § 643(f).

[468] *Id.* (flush language).

[469] T.D. 9847, 84 Fed. Reg. 2952 (2-8-19).

[470] Treas. Reg. § 1.643(f)-1(a).

c. The proposed Treasury Regulations issued in 2018[471] (the "643(f) Proposed Regulations") provided a "principal purpose" provision which read, "A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts."[472] This provision and the examples noted below were stricken from the 643(f) Final Regulations. The preamble to the 643(f) Final Regulations, in response to comments to the proposed regulations, explained:

> [T]he Treasury Department and the IRS have removed the definition of "principal purpose" and the examples illustrating this rule that had been included in the proposed regulations, and are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as "principal purpose" and "substantially identical grantors and beneficiaries" should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms. Nevertheless, the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations.

d. The proposed regulations provided two examples. The first was a straightforward example where multiple and nearly identical trusts were created to solely maximize the section 199A deduction, and the trusts were aggregated into a single trust.[473] The second read, as follows:[474]

> *Example 2*. (i) X establishes two irrevocable trusts: one for the benefit of X's son, G, and the other for X's daughter, H. G is the income beneficiary of the first trust and the trustee is required to apply all income currently to G for G's life. H is the remainder beneficiary of the first trust. H is an income beneficiary of the second trust and the trust instrument permits the trustee to accumulate or to pay income, in its discretion, to H for H's education, support, and maintenance. The trustee also may pay income or corpus for G's medical expenses. H is the remainder beneficiary of the second trust and will receive the trust corpus upon G's death.
>
> (ii) Under these facts, there are significant non-tax differences between the substantive terms of the two trusts, so tax avoidance will not be presumed to be a principal purpose for the establishment or funding of the separate trusts. Accordingly, in the absence of other facts or circumstances that would indicate that a principal purpose for creating the two separate trusts was income tax avoidance, the two trusts will not be aggregated and treated as a single trust for Federal income tax purposes under this section.

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[471] REG-107892-18, 83 Fed. Reg. 40884 (8-16-18) (the "643(f) Proposed Regulations").

[472] Prop. Treas. Reg. § 1.643(f)-1(b).

[473] Prop. Treas. Reg. § 1.643(f)-(1)(c), *Ex. 1*.

[474] Prop. Treas. Reg. § 1.643(f)-(1)(c), *Ex. 2*.

e. Even though the foregoing example was removed, it seems to imply that the aggregation of multiple trusts into one trust would not be applicable if, for example, a grantor created separate trusts for each of his or her children (and their descendants as remainder beneficiaries) even if each of the trust provisions were otherwise identical. Moreover, if significant differences existed between different trusts for the same group of beneficiaries, it would seem that aggregation would not be applicable either. The issue is how significant must such non-tax differences be to avoid the application of aggregation of the trusts.

f. The effective date for the 643(f) Final Regulations apply to taxable years ending after August 16, 2018.[475] Although the preamble to 643(f) Proposed Regulations explains that it could apply to arrangements and trusts created prior to that point, "In the case of any arrangement involving multiple trusts entered into or modified before August 16, 2018, the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f)."[476]

g. The preamble to the 643(f) Proposed Regulations points out, "The application of proposed §1.643(f)-1, however, is not limited to avoidance of the limitations under section 199A and proposed §§1.199A-1 through 1.199A-6."[477]

4. "Packing" or Maximizing the 10 Times Basis Limitation

a. Because each QSBS taxpayer may ultimately exhaust its $10 Million Per Taxpayer Limitation and there are practical limitations on the amount of "stacking" or multiplying of different taxpayers that can be achieved, the 10 Times Basis Limitation is often more valuable to taxpayers. As mentioned above, for purposes of the 10 Times Basis Limitation, if a taxpayer contributes property (other than money or stock) to a QSB, the basis "shall in no event be less than the fair market value of the property exchanged."[478] This provides taxpayers with an opportunity to greatly increase the Per-Issuer Limitation by contributing appreciated property in a section 351 non-recognition transaction (including a conversion of a partnership to a corporation).

b. It is common for founders to contribute intellectual property to their start-up companies, and as such, the founders should be able to claim fair market value of the property as their basis for purposes of the 10 Times Basis Limitation. From a planning standpoint, it is important that the values used for these purposes be consistent with the values that are used for other purposes, including the values used for section 409A purposes[479] and for different rounds of investor funding. In addition, contributions of appreciated property need to be coordinated with the Aggregate Gross Asset Requirement (i.e., $50 million). Although the Aggregate Gross Asset Requirement is based on the cash and adjusted bases of property held by the corporation, for this

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[475] Prop. Treas. Reg. § 1.643(f)-(1)(b).

[476] 643(f) Proposed Regulations (Explanation of Provisions, VII. Proposed §1.643(f)-1: Anti-avoidance Rules for Multiple Trusts).

[477] *Id.*

[478] § 1202(i)(1)(B).

[479] *See* § 409A (determining gross income on nonqualified deferred compensation). If a privately held company issues options to a service provider at a valuation below the fair market value, section 409A of the Code applies. *See* T.D. 9321 (Application of Section 409A to a Nonqualified Deferred Compensation Plans) and Treas. Reg. §§ 1.409A-1 to 1.409A-9.

purpose the basis of contributed property is equal to its fair market value at the time of the contribution.[480]

c. Often founders of companies will start their business as an entity taxed as a partnership (or a disregarded entity) so that the losses that are incurred at the beginning of the enterprise can be used by the founders on their individual income tax returns. When private equity or venture capital funding becomes available, they will often set a pre-funding, pre-money valuation for the enterprise. If, for example, the enterprise is valued at a pre-funding value of $40 million, then the conversion of the partnership to a C corporation prior to the funding would set the Per-Issuer Limitation for the founders at $400 million ($40 million fair market value of enterprise value which is contributed in exchange for shares in the QSB multiplied by the 10 Times Basis Limitation). It is critical in the planning process that taxpayers properly document this conversion, including obtaining contemporaneous valuation appraisals. As mentioned above, one of the qualifications to be a QSB, the corporation must agree to "submit such reports to the Secretary and to shareholders as the Secretary may require."[481]

5. "Packing" the 10 Times Basis Limitation with Non-Eligible Gain

a. An interesting way to "pack" or maximize the 10 Times Basis Limitation is to coincide the taxable sale of QSBS that creates eligible gain (i.e., 5-year holding period QSBS) with the taxable sale of QSBS that is not eligible gain (i.e., QSBS held for less than 5 years) in the same taxable year. The Code defines the "10 Times Basis Limitation" as "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."[482] The Code does ***not*** require that in calculating the aggregate adjusted bases of QSBS disposed of by the taxpayer during the taxable year, it only include the bases of QSBS that would create eligible gain. Eligible gain, as mentioned above, only includes gain from QSBS that has been held for more than 5 years.[483] Therefore, a taxpayer can increase the 10 Times Basis Limitation by selling high tax basis QSBS that does not satisfy the 5-year holding requirement (recognizing little or no gain) with very low tax basis QSBS that does satisfy the 5-year holding requirement.

b. This situation is not as unusual as it may seem at first. For example, imagine a founder of a corporation who has a great idea that has significant value but no tax basis (e.g., patent, copyright, process, or other type of intellectual property). The value of the founder's shares is worth $30 million today, and over the years, the founder's stake has been diluted by many rounds of financing over time. In order to keep the founder motivated, the company has granted the founder stock options. The stock options, if exercised, provide the founder with the right to purchase $4 million of stock at a strike price of $1 million ($3 million of ordinary income on exercise). The corporation is about to be sold to a buyer through a tender offer. If the founder sells his or her shares in the corporation, along with the stock options, the founder would be limited to the $10 Million Per Taxpayer Limitation on the sale of the stock, and the options would not qualify for QSBS treatment at all.[484] Instead, the founder exercises the options prior to the sale and then

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[480] § 1202(d)(2)(A) and (B).

[481] § 1202(d)(1)(C).

[482] § 1202(b)(1)(B).

[483] *See* § 1202(b)(2).

[484] *See Natkunanathan v. Commissioner*, 99 T.C.M. (CCH) 1071, T.C. Memo. 2010-15, *aff'd* 479 Fed. Appx. 775 (9th Cir. 2012).

immediately sells the newly acquired stock, along with the original stock held by the founder, to the buyer. The stock option shares are QSBS but do not meet the 5-year holding requirement. However, since the founder is selling the option QSBS in the same taxable year as the founder is selling QSBS that satisfies the 5-year holding period (i.e., the zero basis founder's stock), for purposes of the 10 Times Basis Limitation, the founder can use $4 million of "aggregate adjusted bases" to exclude as much as $40 million of eligible gain. As a result, $30 million of gain is excluded, at the cost of $3 million of ordinary income.

C. Can a Preexisting Trade or Business Become a QSB?

1. Some practitioners are surprised to discover that a pre-existing business, even one that has been in existence before the enactment of section 1202, can nonetheless become a QSB and provide its shareholders with the benefits of QSBS. In order to be QSBS, Section 1202(c)(1) of the Code provides that QSBS is "any stock in a C corporation which is originally issued after the date of enactment of the Revenue Reconciliation Act of 1993." Of course, QSBS also requires that such corporation meet the other requirements of section 1202 of the Code. None of the other qualifications (i.e., the Active Business Requirement, Aggregate Gross Asset Requirement, and Original Issuance requirement) mandate that a QSB be a newly created, start-up business. Furthermore, as discussed above, in determining the acquisition dates for QSBS purposes, the legislative history makes it clear that historical holding periods of assets contributed to a QSB (under section 1223 of the Code) do not apply for purposes of the formation of a C corporation or the conversion of a preexisting pass-through entity to a corporation.

2. Individuals, disregarded entities, and other noncorporate taxpayers doing business as sole proprietorships can contribute cash or property to a newly formed C corporation in a section 351 transaction and the shares acquired will qualify for potential QSBS treatment. This can be accomplished in a series of exchanges, and as long as the corporation continues to meet the Aggregate Gross Asset Requirement at each issuance and the Active Business Requirement, the shares acquired will continue to qualify as QSBS.

3. Partnerships are eligible holders of QSBS and have the option of contributing cash and other property to a newly created (or controlled) C corporation in a section 351 transaction in exchange for QSBS shares.[485] Those shares can be retained by the partnerships or distributed to the partners without jeopardizing the QSBS status of such shares.[486] Preexisting business entities taxed as partnerships (S corporations are discussed below) can also meet the Original Issuance requirement by converting to a C corporation. As noted above, that can be accomplished by making the appropriate "check-the-box" election or converting to a corporation pursuant to an "assets-over," "assets-up," or "interests-up" conversion. Typically, the owners of the partnership prefer to convert to a C corporation in a non-taxable manner relying on section 351. It should be noted, however, that built-in gain on appreciated property that is contributed to a QSB is Non-Section 1202 Gain and, as such, not excludable under section 1202. Owners should consider offsetting gains with losses if at all possible, prior to the contribution, thereby increasing the adjusted tax basis of contributed assets and reducing the Non-Section 1202 Gain in the QSBS shares.

4. As discussed in more detail above, each of the foregoing conversion transactions essentially involve a contribution of property to a newly formed corporation and liquidation of the partnership, but with each involves a different contribution of property and in a

[485] § 1202(g)(4)(A).

[486] §§ 1202(g) and 1202(h)(2)(C).

different order. Each transaction can result in the corporation and the shareholders receiving different adjusted tax basis in their exchanged assets. Each transaction can also result in gain or loss being recognized either upon liquidation of the partnership or as a result of the mixing bowl or disguised sale rules. Understanding these nuances is important because tax basis is critically important in calculating the Aggregate Gross Asset Requirement and the 10 Times Basis Limitation.

5. Because the Aggregate Gross Asset Requirement is calculated on the fair market value of contributed assets, partnerships that have more than $50 million in assets will need to reduce the value of the assets contributed in the conversion. This can be accomplished in a number of ways, including simply contributing less than $50 million in property to the corporation under section 351 in a "check-the-box," "assets-over," and "assets-up" conversion or distributing partnership property to the partners prior to the conversion to C corporation. Distributions of property are generally non-taxable events,[487] but they result in a reduction of the outside basis of the distributee partner.[488] The parent-subsidiary limitation of section 1202(d)(3) of the Code applies only to corporations, so any transaction that has the effect of reducing the value of the assets below $50 million is allowable, provided the reduction occurs prior to the conversion to a C corporation (the deemed Original Issuance).

6. A restructuring of a preexisting partnership that is in excess of the $50 million Aggregate Gross Asset Requirement can also be accomplished through a partnership division under section 708(b)(2)(B) of the Code.[489] A partnership division is any transaction that converts a single partnership into two or more resulting partnerships. Like conversions to a corporation, a division of a partnership can be accomplished in a number of different ways, referred to as, "assets-over, assets-up, and interests-over."[490] The Treasury Regulations issued in 2001,[491] provide that the IRS will not respect the "interests-over" form of partnership division. In addition, while both an "assets-over" and "assets-up" division are respected, there is a preference to treat the transaction as an assets-over transaction.[492] In the "assets-over" form, the divided partnership transfers assets to the recipient partnership in exchange for interest in the recipient partnership, followed by a distribution of the recipient partnership interests to the partners.[493]

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[487] *See* § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b).

[488] § 733.

[489] *See also* Treas. Reg. § 1.708-1(d).

[490] Cassady V. Brewer, *Coming Together and Breaking Apart: Planning and Pitfalls in Partnership Mergers and Divisions*, 43rd Annual Southern Federal Tax Institute (2008), Outline F, F-13. Described as follows: (i) Assets-Over: Divided partnership contributes some of its assets (and perhaps liabilities) to a recipient partnership in exchange for an interest in the recipient partnership, followed by a distribution of the interests in the recipient partnership to the partners; (ii) Assets-Up: Divided partnership contributes some of its assets (and perhaps liabilities) to some or all of its partners, and the partners then contribute those assets (and liabilities, if any) to the recipient partnership for interests in the recipient partnership; and (iii) Interests-Over: Some or all of the partners in the divided partnership contribute a portion of their interest in the divided partnership to the recipient partnership in exchange for interests in the recipient partnership, followed by a liquidating distribution of assets (and perhaps liabilities) into the recipient partnership.

[491] T.D. 8925, 66 Fed. Reg. 715 (1/4/01).

[492] *See* Treas. Reg. § 1.708-1(d)(3).

[493] Treas. Reg. § 1.708-1(d)(3)(i)(A). The transitory ownership by the divided partnership of all the interests in the recipient partnership is ignored. Treas. Reg. § 1.708-1(d)(5) Ex. 3-6.

7. In a "vertical slice" division, both of the resulting partnerships retain the same ownership as the original partnership. The distribution of the recipient partnership interest to the partners will be current distributions rather than liquidating distribution because no partner is terminating his or her interest in the divided partnership. Because of this parity of ownership, it is unlikely that the "mixing bowl" transaction will trigger any gain or loss.[494] Furthermore the preamble to the Treasury Regulations point out that when a division results in a pro rata division, there are no section 704(c) implications.[495] Similarly, given the parity of ownership before and after the division, there should be no gain resulting from a deemed distribution of cash under section 752 of the Code because the division will not result in a change in the share of the liabilities of the partners. The resulting basis that the partners have in their respective interests in the divided partnership and the recipient partnership depend on what assets and liabilities are contributed and distributed as a result of the division.

8. In a division, the Treasury Regulations provide that a "resulting partnership"[496] (a partnership that has at least 2 partners from the prior partnership) will be considered a continuation of the prior partnership if the partners in the resulting partnership had an interest of more than 50 percent in the capital and profits of the prior partnership.[497] All resulting partnerships that are considered a continuation of the prior partnership are subject to all preexisting tax elections (for example, a section 754 election) that were made by the prior partnership.[498] Thus, in pro rata divisions where all of the partners retain the same ownership in the resulting partnerships, all of the resulting partnerships will be considered continuing partnerships, retaining all prior tax elections of the divided partnership.[499]

9. Thus, a vertical slice division can be used to divide a preexisting business into two smaller partnerships with identical ownership at the partner level, one or both of which can be converted to a C corporation and possibly qualify as a QSB. As mentioned above, the parent-subsidiary aggregation rule of section 1202(d)(3) likely does not apply to partnerships, and significantly, section 1202 does not have any rule regarding brother-sister entities. As such, a division like this is a nontaxable reorganization that can qualify a preexisting business into one more QSBs. For example, consider a partnership that has a trade or business related to health care. It derives revenue by directly providing medical services to patients but uses proprietary software to maximize the revenue from those services. As discussed above, a trade or business involving the performance of services in the field of health is not considered a qualified trade or business for QSBS purposes.[500] However, a software company would be considered a qualified trade or business. In such instance, a vertical slice division would allow the partnership to divide into a health care services partnership, and a software company that can be converted to a C corporation that would qualify as a QSB.

10. If a partnership has over $50 million in assets, a division could possibly be used to qualify the trade or business as a QSB prior to its conversion to a C corporation. For example,

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[494] §§ 704(c)(1)(B), 737 and Treas. Reg. §§ 1.704-4(c)(4), 1.737-2(b)(2).

[495] T.D. 8925, 66 Fed. Reg. 715 (1/4/01). Non-pro rata divisions are still being reviewed.

[496] Treas. Reg. § 1.708-1(d)(4)(iv)

[497] Treas. Reg. § 1.708-1(d)(1).

[498] Treas. Reg. § 1.708-1(d)(2)(ii).

[499] *See* PLR 9015016 (seven continuing partnerships with same owners in the same proportions).

[500] § 1202(e)(3)(A).

consider a partnership that has a trade or business that, in aggregate, is worth $80 million. The trade or business consists of a manufacturing division that is worth $45 million, and a distribution division that is worth $35 million. A vertical slice division of the partnership into a manufacturing partnership and a distribution partnership would reduce the value of each partnership to allow each of the separate businesses to qualify as a QSB upon conversion to a C corporation.

D. Can S Corporation Shareholders Benefit from QSBS?

1. Section 1202(c)(1) requires that shareholders acquire their QSBS through Original Issuance by a C corporation, the foregoing requirement embedded in the definition of a QSB.[501] Thus, shareholders of existing S corporations who were issued shares when the corporation was an S corporation can never qualify for QSBS treatment by simply revoking the corporation's S election. That doesn't necessarily mean that the shareholders of this corporation can never get the benefit of the QSBS exclusion, as long as they subsequently acquire, and are originally issued, shares in the C corporation in the future. Of course, the C corporation must meet all of the additional QSBS requirements, specifically including the two-fold requirement that for "substantially all" of the taxpayer's holding period the corporation must be a C corporation and meet the Active Business Requirement.

2. Section 1202(c)(2)(A) provides, "Stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of subsection (e) and such corporation is a C corporation."[502] Although not entirely clear, the better interpretation of the foregoing is that "substantially all" holding period requirement applies to both the Active Business Requirement and to the C corporation requirement (rather than only to the Active Business Requirement).[503] The foregoing distinction is significant in that it allows a company that initially starts as an S corporation, but later converts to a C corporation (perhaps due to subsequent rounds of funding) to provide QSBS treatment to the shareholders who acquired stock after the conversion (including, for example, founding shareholders who receive shares as part of ongoing compensation arrangements). Notwithstanding the foregoing, the shares that were issued when the company was an S corporation will never qualify for the QSBS exclusion.

3. Some advisors and promoters have mistakenly taken the position that an S corporation can merge with a C corporation (often a SPAC) pursuant to which the S corporation shareholders do a tax-free exchange of shares, receiving shares in the surviving C corporation that would be eligible for QSBS treatment. Section 1202(h)(4)(A), dealing with a reorganization under section 368, only applies when QSBS is exchanged for other stock that would not qualify for QSBS. In this instance, this is an exchange of non-QSBS stock for purported QSBS stock, and as such, section 1202(h)(4)(A) is inapplicable.

4. In addition to the foregoing, S corporations, like partnerships, are eligible holders of QSBS for the benefit of the S corporation shareholders who would otherwise be

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[501] *See* § 1202(d)(1).

[502] § 1202(c)(2)(A).

[503] Also, the Active Business Requirement requires the corporation to be an "eligible corporation," which is defined, with certain exceptions, as "any domestic corporation," without any requirement that such corporation be a C corporation. *See* § 1202(e)(4).

Qualified QSBS Shareholders (i.e., individuals, trusts, and estates).[504] As a result, an S corporation can give its shareholders QSBS benefits by contributing assets to a C corporation under section 351, in exchange for shares of a QSB. The S corporation would then need to retain the QSBS shares because a distribution of the shares to the shareholders (unlike a distribution from a partnership to a partner) is a disqualifying transfer that is not described in section 1202(h)(2). Furthermore, the distribution of the QSBS is also a recognition event for income tax purposes.[505]

5. Under these circumstances, the S corporation essentially serves as a holding company of the QSB on behalf of its shareholders. If the S corporation holds the QSBS for at least 5 years and sells, the shareholders will get the benefit of the QSBS exclusion. The S corporation will pass through all items of income and deduction, including non-taxable items like Excluded Section 1202 Gain (tax-exempt income).[506] The Excluded Section 1202 Gain will increase the basis of each shareholder's stock in the S corporation,[507] thereby allowing the S corporation to distribute the cash proceeds from the sale of QSBS tax free to its shareholders.[508] As discussed above in the context of partnerships, it is unclear whether a transfer by gift of the shares of the S corporation will "stack" or multiply the $10 Million Per Taxpayer Limitation and to make things worse, there is no option to distribute the QSBS to the shareholders so they can gift the QSBS shares.

6. One option is for the S corporation to contribute assets to a wholly-owned subsidiary corporation and fail to elect to treat the subsidiary as a qualified subchapter S subsidiary (QSub), which if elected would have been treated as a disregarded entity.[509] An S corporation with a preexisting QSub can also terminate its QSub election.[510] The effect of the termination is that the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation.[511] This exchange would qualify as an Original Issuance under section 1202.

7. Unlike partnerships, the parent-subsidiary aggregation rule under section 1202(d)(3) likely applies to S corporations (although the controlled group of corporation rules are only used in the context of C corporations). As such, if an S corporation's assets are already in excess of the $50 million, then even if the S corporation contributes less than $50 million in assets to a wholly owned C corporation or revokes the QSub election on an entity that has less than $50 million in assets, the newly created corporation would not be considered a QSB because the Aggregate Gross Asset Requirement is not met. In such instance, the S corporation could distribute cash or property to its shareholders in order to get below the $50 million threshold, but the distribution of cash is only tax free to the extent of each shareholder's basis in his or her S corporation shares, and property distributions are taxable events. Another alternative is to divide the S corporation in a tax-free division under section 355 of the Code. Generally, section 355(a)

504 § 1202(g)(4)(B).

505 *See* § 311(b).

506 *See* § 1366(a)(1)(A).

507 § 1367(a)(1).

508 *See* § 1368(b)(1).

509 *See* § 1361(b)(3) and Treas. Reg. § 1.1361-3(a)(2).

510 *See* Treas. Reg. § 1.1361-5(a)(1).

511 Treas. Reg. § 1.1361-5(b)(1)(i).

of the Code mandates that a corporation must distribute stock or securities of a corporation that constitutes control, both corporations must conduct an active trade or business, and the distribution must not constitute a device to distribute earnings and profits. In addition, there are other requirements, most notably the distribution of the stock must have a corporate business purpose.[512] The Treasury Regulations provide that a shareholder purpose does not constitute a corporate business purpose.[513]

8. It should be noted that if a C corporation converts to an S corporation, QSBS is not automatically lost, provided the corporation converts back to a C corporation. The business must only be a C corporation during "substantially all"[514] of the taxpayer's holding period. However, as discussed above, no guidance has been issued on what constitutes "substantially all" for purposes of section 1202.

E. Can You Get the Benefit of QSBS Through Carried Interest?

1. As mentioned above, partnerships are eligible QSBS shareholders for the benefit of their noncorporate partners,[515] allowing the noncorporate partners the benefit of the section 1202 exclusion, if the following requirements are met:

a. The gain results from the sale by the partnership of QSBS that has been held by the partnership for more than 5 years;[516]

b. The gain is includible in the gross income of the taxpayer (partner) by "reason of holding an interest in such entity;"[517]

c. The interest in the entity was "held by the taxpayer on the date on which such pass-thru entity acquired such stock;"[518] and

d. The interest was also held by the taxpayer "at all times thereafter before the disposition of such stock" by the partnership.[519]

2. In addition, the amount of gain eligible for exclusion may not exceed the amount that would have been excludable "by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired."[520] Thus, a partner would be unable to claim a larger share of the QSBS gain when recognized if the partner's share of the partnership is larger than it was when the stock was acquired. To date, the IRS has not issued any guidance under section 1202 with regard to how the "by reference to the interest the taxpayer held"

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[512] Treas. Reg. § 1.355-2(b)(1).

[513] Treas. Reg. § 1.355-2(b)(2).

[514] § 1202(c)(2)(A).

[515] § 1202(g)(4)(A).

[516] § 1202(g)(2)(A).

[517] § 1202(g)(2)(B).

[518] *Id.*

[519] *Id.*

[520] § 1202(g)(3).

is to be determined. The partner's "proportionate share of the adjusted basis of the pass-thru entity in such stock"[521] is used for determining such partner's 10 Times Basis Limitation.

3. As mentioned above, distributions of QSBS from a partnership to a partner are permissible transfers that allow for tacking of the holding period and retention of the QSBS status of the shares provided "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)."[522] Thus, whether a partnership sells the QSBS or it distributes the QSBS to a partner, the exclusion benefits of section 1202 will be limited by the interest "held by the taxpayer on the date on which such pass-thru entity acquired such stock," and may not exceed the amount that would have been excludable "by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired."

4. The Treasury Regulations provide special rules for changes in a partner's interest in a partnership due to the admission or withdrawal of partners or other transactions that change the relative partner share of continuing partners in a partnership. These rules, often referred to as "reverse 704(c)" adjustments, permit revaluations of the partner's capital accounts to reflect the fair market value of partnership assets, and any book-tax disparities at that time, and generally require equivalent adjustments that allocate unrealized gain or loss to continuing partners,[523] (i) for property distributed in kind,[524] and (ii) on adjustments of partnership interests as a result of (a) contributions of money, property, or services, or (b) distributions of money or property.[525] These reverse 704(c) adjustments do not specifically provide for adjustments due to QSBS considerations, but they could provide a mechanism and insight on how the "by reference to the interest the taxpayer held" is to be determined.

5. As discussed earlier in these materials, many investments in QSB companies are through private equity or venture capital funds. Commonly, these funds are compensated, in part, through carried interest which vests when the underlying portfolio investments meet certain profit or valuation targets. Carried interest is generally defined as a share of the profits of an investment that is paid to the investment manager in excess of the amount of capital that the manager contributes to the partnership. Typically, carried interest is paid in the form of an interest in the partnership (the fund).

6. In Revenue Procedure 93-27,[526] the IRS provided guidance on the receipt of a partnership interest for services provided to a partnership. In the ruling the IRS defined a capital interest as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership"[527] as determined at the time of the receipt of the partnership interest. A profits

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[521] § 1202(g)(1)(B).

[522] § 1202(h)(2)(C).

[523] Treas. Reg. §§ 1.704-1(b)(2)(iv)*(d)(3)*, 1.704-1(b)(2)(iv)*(e)*, 1.704-1(b)(2)(iv)*(f)*, 1.704-1(b)(4)(i), 1.704-1(b)(5), Ex. 14(i), 1.704-1(b)(5), Ex. 14(ii), 1.704-1(b)(5), Ex. 14(iv), 1.704-1(b)(5), Ex. 18(ii), 1.704-1(b)(5), Ex. 18(vii), 1.704-1(b)(5), Ex. 18(ix), 1.704-1(b)(5), Ex. 18(x), and 1.704-1(b)(1)(iv).

[524] Treas. Reg. § 1.704-1(b)(2)(iv)*(e)*.

[525] Treas. Reg. § 1.704-1(b)(2)(iv)*(f)*.

[526] Rev. Proc. 93-27, 1993-2 C.B. 343.

[527] *Id.* at section 2.01.

interest is defined as a "partnership interest other than a capital interest."[528] The ruling provides that if a person receives a profits interest for providing services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the receipt of the interest is not a taxable event for the partner or the partnership. This safe harbor does not apply, however, if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets (e.g., high-quality debt securities or high-quality net leases), (2) within two years after receipt, the partner disposes of the profits interest, or (3) the profits interest is an interest in a publicly-traded partnership. In Revenue Procedure 2001-43,[529] the IRS clarified the 1993 revenue procedure, providing whether an interest granted to a service provider is a profits interest is tested at the time the interest is granted, even if, at that time, the interest is "substantially nonvested."[530] The 2001 ruling provides, "where a partnership grants an interest in the partnership that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date of its grant," provided the following conditions are met:[531]

a. "The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;"

b. "Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest;" and

c. All the conditions of the 1993 revenue procedure are also satisfied.

7. The foregoing revenue procedures provide a safe harbor method for private equity and venture capital funds to grant carried interest to the manager of the fund (and its employees) in a manner that is not considered compensation upon grant, when the profits interest vests, or importantly, when the carried interest is earned (upon meeting certain profit or valuation targets). Rather, it allows the manager and its employees to be treated as a partner upon grant and taxed as a partner on its distributive share of partnership profits and losses. For this reason, carried interest is often structured to meet the requirements of the revenue procedures.

8. It is unclear, how the section 1202 exclusion will be applied to carried interest. As noted above, Revenue Procedure 2001-43 requires that the service provider be treated as "the owner of the partnership interest from the date of its grant," and the service provider is required to take into account "the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest." This applies whether the carried interest is vested or unvested, subject to a substantial risk of forfeiture or not, and regardless of an election under section 83(b) of the Code.[532] Thus, the IRS recognizes situations where a taxpayer will be

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[528] *Id.* at section 2.02.

[529] Rev. Proc. 2001-43, 2001-34 I.R.B. 191.

[530] *See* Treas. Reg. § 1.83-3(b).

[531] Rev. Proc. 2001-43, 2001-34 I.R.B. 191, section 4.

[532] "Taxpayers to which this revenue procedure applies need not file an election under section 83(b) of the Code." Rev. Proc. 2001-43, 2001-34 I.R.B. 191, section 3.

treated as a partner even if profits have not yet been realized and even before the taxpayer has vested in such profits interest. This would seem to sufficiently satisfy the requirement under section 1202(g)(2)(B) that interest must be "held by the taxpayer on the date on which such pass-thru entity acquired such stock" It may also satisfy the limitation under section 1202(g)(3) that limits the exclusion "by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired" because once carried interest is earned, it retroactively applies to give the partner an interest in a portfolio company (i.e., the QSBS company) that has already been acquired by the partnership fund. The Treasury Regulation provide, "The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners."[533] The Treasury Regulations specify certain factors to consider in determining a partner's "interest in the partnership" including the partner's relative contribution to the partnership, interest of the partner in economic profit and loss, interest of the partner in cash flow and other non-liquidating distributions, and rights of the partner to distributions of capital upon liquidation.[534]

9. In contrast to the foregoing, the Treasury Regulations under section 1045 dealing with partnerships and the rollover election may provide a very different answer, if these regulations apply for section 1202 purposes. As mentioned above, rollover elections under section 1045 by partnerships and their eligible partners are subject to a "nonrecognition limitation." The amount of gain that an eligible partner does not recognize (pursuant to a sale of QSBS by a selling partnership) and that can be rolled over into replacement QSBS under section 1045 cannot exceed the "nonrecognition limitation."[535] The "nonrecognition limitation" is generally determined by multiplying the partnership's realized gain on the QSBS sale against the eligible partner's "smallest percentage interest in partnership capital."[536] The "smallest percentage interest in partnership capital" is the partner's "percentage share of capital determined at the time of the acquisition of the QSB stock."[537] as adjusted prior to the time the QSB stock 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 by the eligible partner, but excluding income and loss allocations."[538] Although the Treasury Regulations specifically provide the foregoing provision applies "For purposes of this section"[539] (not referencing section 1202), given the extensive linkages and cross references between sections 1202 and 1045, the "smallest percentage interest in partnership capital" limitation could apply for purposes of sections 1202(g)(2)(B) and 1202(g)(3). If the smallest percentage interest in partnership capital limitation did apply for purposes of section 1202, then the partners of the fund manager (general partner) of a private equity and venture capital funds would not be afforded the benefits of QSBS treatment to the extent the stock is attributable to the fund manager's carried interest (non-capital interest). This limitation, if applicable, would presumably also apply to any interest in the fund manager to the extent the fund manager received additional partnership fund interests due to a "fee waiver" (i.e., foregoing the annual management fee for additional carried interest in the fund) or other cashless contribution.

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[533] Treas. Reg. § 1.704-1(b)(3)(i).

[534] Treas. Reg. § 1.704-1(b)(3)(ii).

[535] Treas. Reg. § 1.1045-1(d)(1).

[536] Treas. Reg. § 1.1045-1(d)(1)(ii).

[537] Treas. Reg. § 1.1045-1(d)(2).

[538] *Id.*

[539] Treas. Reg. § 1.1045-1(d)(1).

10. To date, there is no published guidance on point. It should be noted, however, that section 1045 was enacted in 1997, and the partnership Treasury Regulations under section 1045 were finalized in 2007, whereas section 1202 was enacted in 1993. Section 1202 refers generally to the interest "held by the taxpayer on the date on which such pass-thru entity acquired such stock," and the exclusion benefits being limited "by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired." It does not specifically require a determination that it should be based upon the "smallest percentage interest in partnership capital." The 1993 and 2001 revenue procedures dealing with profits interests, discussed above, were published before the section 1045 partnership regulations, and nothing in those regulations refer to or are in contradiction to these rulings. Therefore, without further guidance that specifically provides that the section 1045 partnership limitations also apply for purposes of determining eligibility under section 1202, taxpayers may be able to take a position that stock acquired or sold as a result of earned carried interest is still eligible for QSBS status and the gain exclusion benefits thereunder.

11. The IRS has been asserting penalties more often as a strategic device, especially in areas in which the law is undeveloped or otherwise uncertain. All tax advisers need to be cognizant of their potential penalty exposure for paid advice regarding filing positions taken in client tax returns based on that advice. It is especially important for the adviser to understand when a client can take a position without penalty risk but the adviser cannot — without disclosure in the client's tax return. For example, an adviser may tell a client there "is a position" for claiming a section 1202 exclusion, and in fact that position may have a reasonable basis. The client potentially can take that position without penalty in that case. However, that does not protect the paid adviser whose advice is incorporated into that filing position. Only with a properly filed Form 8275, "Disclosure Statement" — something that is unnecessary for client protection and might actually increase the client audit risk — can the adviser be penalty-protected.

F. How Should Installment Sales Be Treated for QSBS and Rollover Purposes?

1. An installment sale is generally defined as a disposition of property in which one or more payments are to be received after the close of the taxable year in which the disposition occurs.[540] In order to qualify as an installment sale, at least one payment must be received in a taxable year after the year of sale, but there is no requirement that there be more than one payment. Under section 453 of the Code, the installment method permits gain from installment sales to be reported as the taxpayer receives the payments.[541] Each payment received is treated in part as a tax-free return of a portion of the seller's adjusted basis in the property, a taxable realization of the seller's gain, and interest. Assuming the QSBS is not publicly-traded at the time of its sale,[542] if the seller receives payments in different taxable years, the installment method is required unless the seller elects not to have the installment method apply to the sale.[543]

2. According to the instructions for Schedule D, "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

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[540] § 453(b)(1).

[541] § 453(c).

[542] § 453(k)(2).

[543] § 453(d)(1).

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."[544] As such, the instructions essentially prorate the Excluded Section 1202 Gain.

3. Consider a taxpayer who sells his or her QSBS shares in a corporation that qualifies for the 100% Exclusion Percentage in 2018 for a total consideration of $14 million, but $4 million of the proceeds will be held in escrow to be paid in 2019. Assume the taxpayer's Per-Issuer Limitation is $10 million (and zero basis in the QSBS), and the taxpayer will have, in aggregate, $10 million of Excluded Section 1202 Gain and $4 million of Non-Section 1202 Gain. How should the taxpayer report the sale for 2018 and 2019?

a. Option 1: Follow the Schedule D instruction which calls for prorating of the Excluded Section 1202 Gain.

(1) Pursuant to this approach, the taxpayer should multiply the total $10 million of Excluded Section 1202 Gain by a fraction equal to current year recognized eligible gain divided by the total eligible gain. Total eligible gain would be $14 million and current year amount would be $10 million, so the exclusion would be approximately 71% or $7.1 million, leaving $2.9 million for 2019 – if received.

(2) However, the instructions appear to have no basis in the tax law. Section 1202(a) of the Code explicitly excludes from gross income <u>any</u> gain from the sale of QSBS stock held for 5 years. There is no exception for installment sales.

b. Option 2: Claim the entire Excluded Section 1202 Gain in 2018 based on a reasonable reading of sections 453 and 1202 of the Code.

(1) The Treasury Regulations provide, "Under the installment method, the amount of any payment which is income to the taxpayer is that portion of the installment payment received in that year which the gross profit realized or to be realized bears to the total contract price (the "gross profit ratio")."[545]

(2) In this example, $10 million is realized in 2018 of a total contract price of $14 million. Since there is no tax basis, the installment gain for 2018 would be $10 million. Apply section 1202(a) and (b) of the Code to the 2018 tax return to determine the amount of exclusion. $10 million is the recognized gain, so the $10 million Per-Issuer Limitation would eliminate the full gain for 2018.

(3) For the 2019 taxable year, the installment sale computation, assuming full collection of the remaining $4 million, would generate installment Non-Section 1202 Gain of $4 million. There is no remaining exclusion available for 2019.

(4) This result is practical, since it does not require taxpayers to recalculate gains or exclusion under section 1202 and amend tax returns in the event the anticipated payments to be paid after 2018 are not collected.

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[544] 2017 Instructions for IRS Schedule D, Exclusion on Qualified Small Business (QSB) Stock.

[545] Treas. Reg. § 15a.453-1(b)(2)(i).

4. Installment sale treatment on the sale of QSBS likely may not be relied upon to satisfy, in part, the 5-year holding period requirement. For example, consider a taxpayer who has held QSBS for 4 years. The taxpayer sells the QSBS, agreeing to receive equal payments over the next 3 taxable years. The taxpayer may not rely upon installment sale treatment and claim that the last 2 installment payments (received more than 5 years after Original Issuance) qualify as eligible gain, thereby entitling the gain attributable to those payments to exclusion under section 1202(a). Although there is no direct guidance on this issue, allowing a taxpayer to satisfy the 5-year holding requirement through deferred installment payments would be in conflict with the provisions relating to disqualifying hedging transactions under section 1202(j) of the Code, as discussed above.

5. On the other hand, installment treatment might be useful with respect to a section 1045 rollover. As discussed above, section 1045(a) of the Code provides a relatively short 60-day period to defer and reinvest recognized QSBS gain into a new acquisition of QSBS stock. The issue is if a taxpayer sells QSBS stock in an installment sale, can the taxpayer qualify for section 1045 rollover by reinvesting, within 60 days, each payment of principal on the installment sale in replacement QSBS as the taxpayer receives it, or is the taxpayer required to reinvest the total sales price within 60 days of the closing, regardless of the amount of cash or other consideration the taxpayer may have received? There is no guidance under section 1045 on this issue. However, the 2020 QOZ Final Regulations may shed some light on how the IRS could rule on this issue. Under section 1400Z-2 of the Code, eligible taxpayers have a 180-day period to reinvest capital gain in a QOF in order to defer (and possibly exclude a portion) of such original gain. The Treasury Regulations allow an eligible taxpayer to elect to choose the 180-day period to begin on either (i) the date a payment under the installment sale is received for that year, or (ii) the last day of the taxable year the eligible gain under the installment method would be recognized but for deferral under section 1400Z-2.[546] Thus, "if an eligible taxpayer receives one or more payments on an installment sale and treats the date the payment on the installment sale is received as the beginning of the 180-day period, each payment will begin a new 180-day period."[547]

6. It should be noted that installment payments may not be utilized in this manner for purposes of the like-kind exchange period of 180 days under section 1031 of the Code. Perhaps the distinction lies in the language of the statutes. Unlike sections 1045 and 1400Z-2 of the Code, the time period of reinvestment under section 1031 of the Code starts "the date on which the taxpayer transfers the property relinquished in the exchange,"[548] whereas the time period of reinvestment starts "beginning on the date of such sale" for both section 1045 and section 1400Z-2.[549] More importantly, in the absence of significant rulings, regulations, or other IRS authority under sections 1045 and 1202 of the Code, it seems more appropriate to look to the QOZ rules for guidance, given that QSBS and QOZ share many of the same goals. Namely, both are meant to incentivize certain types of investments (i.e., small business growth investments and economic growth in distressed communities) and both provide mechanisms of gain deferral, exclusion, and rollover, in order to achieve those results.

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[546] *See* Treas. Reg. § 1.400Z2(a)-1(b)(11)(viii)(A) and (B).

[547] Treas. Reg. § 1.400Z2(a)-1(b)(11)(viii)(B).

[548] § 1031(a)(3)(B)(i).

[549] *See* §§ 1045(a)(1) and 1400Z-2(a)(1)(A).

G. When Does It Make Sense to Die with QSBS or Contribute to Charity?

1. The "Step-Up" in Basis

a. Appreciated QSBS is unlike other appreciated property in which a "step-up" in basis under section 1014(a) of the Code can be highly beneficial. However, QSBS carries Exclusion Percentage benefits that can be transferred (and possibly "stacked" or multiplied) "by gift" during the lifetime of the taxpayer, as discussed above. Generally, taxpayers will benefit more from lifetime transfers of QSBS than from the "step-up" in basis because the "step-up" is often at the cost of estate tax inclusion. However, the "step-up" in basis can be beneficial in certain circumstances, particularly if the taxpayer does not have any resulting estate tax liability.

b. For purposes of the 10 Times Basis Limitation, the "adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued."[550] Furthermore, if a taxpayer contributes property (other than money or stock) to a QSB in exchange for stock in the corporation, for section 1202 purposes, the "basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged."[551] Depending on the acquisition date of the QSBS, the Exclusion Percentage attributable to QSBS can be 50%, 75%, or 100%, and taxpayers will have varying Per-Issuer Limitations on eligible gain depending on a number of factors including whether the taxpayer has exhausted his or her $10 Million Per Taxpayer Limitation and the tax basis of the QSBS for purposes of the 10 Times Basis Limitation. Finally, at death, a taxpayer may have significant QSBS that is not considered eligible gain because the taxpayer has not held the stock for more than 5 years. All of the foregoing factors and circumstances will determine the amount of Excluded Section 1202 Gain, Section 1202 Gain, and Non-Section 1202 Gain that is unrealized at death and ultimately eliminated by the "step-up" in basis.

c. If the "step-up" in basis can be achieved without paying any or very little Federal estate and state death tax, then the tax savings are achieved with essentially no cost (sometimes referred to as a "free base" situation). This can occur if the decedent had sufficient Applicable Exclusion Amount (including the temporary doubling of this amount under TCJA) to cover the estate tax cost of inclusion or if the QSBS is transferred to for the benefit of a surviving spouse under the marital deduction under section 2056 of the Code.

d. As a result, a "step-up" in basis would be most beneficial to taxpayers if, at the time of death, some or all of the following factors are present with respect to the QSBS includible in the estate:

(1) Very low adjusted tax basis in the QSBS;

(2) QSBS entitled to an Exclusion Percentage of 50% (resulting in 50% of the unrealized gain treated as Section 1202 Gain, to the extent of the taxpayer's Per-Issuer Limitation at the time of death);

(3) Significant unrealized Non-Section 1202 Gain (due to (i) contributions of very low basis property at the time of conversion but not at a sufficiently high value at the time of contribution to dramatically increase the 10 Times Basis Limitation, and (ii)

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[550] § 1202(b)(1), flush language.

[551] § 1202(i)(1)(B).

significant appreciation above the taxpayer's remaining Per-Issuer Limitation at the time of death); and

(4) Significant unrealized appreciation on QSBS that has been held for less than 5 years at the time of death.

e. It bears repeating that the "step-up" in basis can result in a "step-down" in basis, if the fair market value of the QSBS is less than its adjusted tax basis on the date of death. For example, if a taxpayer purchases 100% exclusion QSBS for $3 million in cash and dies when the QSBS has a fair market value of $2 million, the basis in the QSBS will "step-down" to $2 million. If the QSBS is subsequently sold for $32 million (realizing $30 million of gain), the 10 Times Basis Limitation would exclude $20 million of the realized gain (not $30 million, based on the original cost). If the taxpayer had made a transfer "by gift" of the $2 million of QSBS immediately prior to death, the transferee would have been entitled to exclude up to $30 million of gain.[552]

f. Even if the QSBS is appreciated at the time of death, the IRS may argue there is a "step-down" in basis for purposes the 10 Times Basis Limitation. For example, a taxpayer holds 100% Exclusion QSBS that has zero adjusted tax basis, but for purposes of the 10 Times Basis Limitation, the basis under section 1202(i)(1)(B) is $5 million because the taxpayer contributed zero basis property valued at $5 million in a section 351 transaction when he or she acquired the QSBS. On the date of the taxpayer's death, the QSBS has a fair market value of $4 million. The estate will get a "step-up" in adjusted tax basis from zero to $4 million under section 1014. If the QSBS is subsequently sold for $54 million (realizing $50 million of gain), for purposes of the 10 Times Basis Limitation, is the exclusion limitation $50 million or $40 million? We believe the exclusion limitation remains at $50 million. Although there has been an "addition to basis after the date on which such stock was originally issued," it's important to remember that this language applies only for purposes of the 10 Times Basis Limitation. The basis used in the tenfold calculation is still $5 million and to that figure there has not been "any addition to basis." Section 1202(i) trumps any argument to reduce the basis as it clearly provides, "For purposes of this section—In the case where the taxpayer transfers property (other than money or stock) to a corporation in such corporation— the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged."[553]

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[552]A transferee of a gift generally acquires carryover basis, increased by any Federal gift tax paid attributable to any appreciation in the property transferred. If the fair market value of the gift is less than the donor's basis, the donee's basis on a subsequent sale of the property will depend on whether the sale creates a gain or a loss. If the donee recognizes a loss, the donee's basis for purposes of determining the recognizable amount of such loss is the fair market value of the property at the time of the gift. If the donee recognizes a gain, the donee's basis for purposes of determining the recognizable amount of such gain is the donor's basis at the time of the gift. A sale at an amount somewhere in between the basis for determining loss and the basis for determining gain results in no gain or loss recognized. § 1015 and Treas. Reg. § 1.1015-1(a)(1) & (2).

[553] § 1202(i)(1)(B).

2. Contributions to Charitable Entities

a. As noted above in the discussion on the "step-up" in basis, the unrealized gain in QSBS can be Excluded Section 1202 Gain, Section 1202 Gain, Non-Section 1202 Gain, and non-eligible gain. As such, QSBS is not necessarily the best candidate to give to a charitable entity (private foundation, donor advised fund, public charity, charitable lead trust, or charitable remainder trust) if one of the reasons for the gift is to save income taxes through a charitable income tax deduction under section 170 of the Code or by avoiding recognition of such gain. That being said, donors do make contributions of QSBS to charitable entities.

b. If donor contributes QSBS that is not publicly-traded to a private foundation, the resulting income tax deduction will be limited to the adjusted basis of the QSBS. Private foundations are also subject to an excise tax on investment income under section 4940 of the Code. It is unclear whether Excluded Section 1202 Gain can be used to reduce the excise tax, assuming that QSBS status can be retained. To that end, QSBS status can only be retained if the private foundation is a trust. If the trust is a corporation, the QSBS status is lost.

c. The QSBS factors listed above that would favor inclusion in the estate to benefit from a "step-up" in basis are the same factors that would favor contribution of the QSBS to a charitable entity (like a donor advised fund or other public charity) that is able to shelter the taxable gain resulting from the sale of the QSBS.

d. In addition, appreciated QSBS can be contributed (transfer by gift) to split-interest charitable trusts like charitable remainder trusts and charitable lead trusts.

(1) A charitable remainder trust is tax exempt, so the sale of QSBS by the trust will not be taxable. On the other hand, the distributions to the non-charitable beneficiary are taxable pursuant to the "category and class" tier rules of accounting.[554] If a charitable remainder trust sells QSBS, the Section 1202 Gain (taxed at maximum rate of 28% [31.8%]), Excluded Section 1202 Gain (not taxable), and the Non-Section 1202 Gain (taxable as long-term capital gain) will each be accounted for differently in the "category and class" tier rules of accounting. Pursuant to these rules, all of the charitable remainder trust's income is first divided into three categories of income: ordinary, capital gains, and other (excluded income). Then, within each category, the income is further subdivided into different classes based on the federal income tax rate applicable to the income, beginning with the class of income with the highest federal income tax rate.[555] In the context of QSBS, this means Section 1202 Gain will be deemed to be distributed first (i.e., taxed at 28% plus 3.8%), followed by Non-Section 1202 Gain and non-eligible gain (i.e., taxed at 20% plus 3.8%).[556] It is, however, unclear how or if Excluded Section 1202 Gain should be accounted for in the tier rules. One interpretation is the Excluded Section 1202 Gain is the gain subject to the lowest rate of tax (0%) and as such, Excluded Section 1202 Gain would be distributed at the end of the capital gain category. Under the foregoing interpretation, it's unclear how this would be calculated as the amount of Excluded Section 1202

[554] § 664(b) and Treas. Reg. § 1.664-1(d)(1).

[555] *See* Treas. Reg. § 1.664-1(d)(1)(i)(a).

[556] "The rules in this paragraph (d)(1) that require long-term capital gains to be distributed in the following order: first, 28-percent gain (gains and losses from collectibles and section 1202 gains); second, unrecaptured section 1250 gain (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation); and then, all other long-term capital gains are applicable for taxable years ending on or after December 31, 1998." Treas. Reg. § 1.664-1(d)(1)(ix).

Gain would be subject to the taxpayer's Per Issuer Limitation, but the taxpayer for these purposes could be the charitable remainder trust (as a separate taxpayer who received the QSBS in a transfer by gift) or alternatively, the taxpayer for these purposes is the grantor who contributed the QSBS since the tier rules function as a way to tax the retained interest of the grantor. Another interpretation is that the Excluded Section 1202 is not capital gain at all. One can find support for the latter interpretation in the Treasury Regulations which address the former repealed section 1202 stock, which generally provided for a 60% deduction on net capital gain for non-corporate taxpayers and under the idea that a deduction has the same effect as an exclusion over a portion of the gain. The Treasury Regulations provide, in pertinent part, "The deductions allowable to a trust under section … 1202 are not allowed in determining the amount or character of any class of items within a category of income described in paragraph (d)(1)(i)(a) of this section or to corpus."[557]

(2) Unlike charitable remainder trusts, charitable lead trusts are not tax exempt. They can either be structured as non-grantor charitable lead trusts or grantor charitable lead trusts. As discussed above, a contribution to a non-grantor charitable lead trust would be considered a permissible transfer "by gift," allowing the trust to become the taxpayer of the QSBS including an additional Per-Issuer Limitation, and a contribution to a grantor charitable lead trust is ignored as a transfer, so the stock retains its QSBS status but there is no additional Per-Issuer Limitation.

(3) Non-grantor charitable lead trusts do not provide the donor with an income tax deduction upon contribution, but the trust is entitled to a charitable income tax deduction under section 642(c) of the Code for the annual payments made to charity. The charitable deduction under section 642(c) is only limited by the taxable income of the trust and the annual payment to charity.[558] It is not limited, as section 170 of the Code limits individual donors, by concepts of contribution base and adjusted gross income. As such, the 642(c) deduction is a good mechanism to shelter gain resulting from the sale of QSBS that has significant Section 1202 Gain and Non-Section 1202 Gain, particularly if the QSBS is given in satisfaction of the required annual payment to charity (a recognition event).[559]

(4) Grantor charitable lead trusts entitle the donor to an income tax deduction, but the grantor continues to be the owner of the grantor trust's assets for income tax purposes.[560] The grantor remains responsible for the income tax liability associated with trust's assets. The IRS has ruled that the annual payment by a charitable lead trust to charity will result in recognition of gain if the payment is satisfied with appreciated securities.[561] As such, for grantors who wish to minimize this tax liability, it is better to contribute 100% Exclusion Percentage QSBS that has higher tax basis if at all possible.

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[557] Treas. Reg. § 1.664-1(d)(2). Former section 1202 was repealed by section 301(a) of the Tax Reform Act of 1986 (P.L. 99-514).

[558] In the case of an estate or trust…, there shall be allowed as a deduction in computing its taxable income (in lieu of the deduction allowed by section 170(a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c) (determined without regard to section 170(c)(2)(A)). § 642(c).

[559] *See* Rev. Proc. 2007-45 § 5.02(2), 2007-29 I.R.B. 89, and Rev. Rul. 83-75, 1983-1 C.B. 114.

[560] *See* Rev. Proc. 2007-45, 2007-29 I.R.B. 89 and Rev. Proc. 2007-46, 2007-29 I.R.B. 102.

[561] PLR 200920031.

(5) Both non-grantor and grantor charitable lead annuity trusts can have additional significant transfer tax benefits to the remainder beneficiaries, and those can be amplified by back-loading the payments. QSBS that is expected to appreciate would be good candidates to contribute toward that goal.[562]

H. Can QSBS and QOZ Investments Be Combined?

1. As discussed above, QSBS and QOZ investments encourage certain types of investments (i.e., small business investments and economic growth in distressed communities) and both provide mechanisms of gain deferral, exclusion, and rollover. Interestingly, there seems no prohibition against a taxpayer getting the benefits of both QSBS and QOZ, as long as all of the requirements under sections 1202 and 1400Z-2 are simultaneously satisfied. If, indeed, this is a possibility, taxpayers may be able to use the QOZ 180-day reinvestment period[563] in lieu of section 1045's relatively short 60-day reinvestment period, and exclude under section 1202(a) all or a portion (as limited by the $10 Million Per Taxpayer Limitation) of the deferred gain that otherwise would be recognized when the investment (or a portion thereof) is sold or exchanged prior to December 31, 2026 under section 1400Z-2(b)(1). Of course, a taxpayer can defer any recognized capital gain (even gain from the sale of a marketable security) by making a QOZ investment, and if that investment also qualifies for QSBS benefits, as discussed herein, that original gain or a portion thereof can be entirely excluded.

2. For example, in 2020, a taxpayer recognizes $10 million of capital gain[564] and the taxpayer elects under section 1400Z-2(a) to defer the $10 million of capital gain by making an investment, within the 180-day period, in a "qualified opportunity fund" ("QOF"), which can be organized as a corporation or a partnership.[565] Assume, for this example, the QOF is a partnership ("QOF partnership"),[566] and the QOF invests the entire $10 million investment in "qualified opportunity zone stock" ("QOZ Stock").[567] Assuming the QOZ Stock is issued by a C corporation that meets all of the QSB and QSBS requirements, then the taxpayer should be able to combine the QOZ and QSBS benefits. For purposes of this illustration, all other partners in the QOF partnership are ignored. Assume in this example, more than 5 years after the initial investment but before December 31, 2026, the $10 million investment in the QOZ stock appreciates to $30 million in value, and the QOF partnership sells a portion (approximately 37%) of the QOF Stock for $11 million and distributes the proceeds to the taxpayer. What is the resulting tax liability for the

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[562] For a more complete discussion of charitable lead trusts and this back-loading concept, *see* Paul S. Lee, Turney P. Berry, and Martin Hall, *Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse*, 37 ACTEC Law J. 93 (Summer 2011).

[563] § 1400Z-2(a)(1)(A).

[564] This could be a taxpayer who sells QSBS which results in $10 million of capital gain that is not subject to exclusion under section 1202(a) (that is, the taxpayer has not held the QSBS for five years, or the gain exceeds the taxpayer's Per-Issuer Limitation). Rather than attempting to roll over the gain under section 1045 (which would include a rollover of the tax basis in the QSBS, if any) within 60 days, the taxpayer elects to defer the $10 million of capital gain by making a QOZ investment.

[565] "The term 'qualified opportunity fund' means any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property." § 1400Z-2(d)(1).

[566] *See* Treas. Reg. § 1.1400Z2 (a)-1(b)(25).

[567] § 1400Z-2(d)(2)(A)(i).

taxpayer, and will the taxpayer be able to exclude taxable gain under section 1202(a) and still qualify for additional benefits under section 1400Z-2?

3. Section 1400Z-2(b)(1)(A) provides that deferred gain will be included in income on "the date on which such investment is sold or exchanged." In addition, section 1202(a) provides an exclusion for "any gain from the sale or exchange" of QSBS held for more than 5 years. In this example, there is no question that a sale or exchange of QSBS/QOF Stock has occurred at the partnership level. However, with QOFs, the mere sale or exchange doesn't necessarily result in taxable gain. By way of example, the Treasury Regulations provide that a QOF has 12 months from the time of the sale or disposition of QOZ property or the return of capital from investments in QOZ Stock to reinvest the proceeds in other QOZ property before the proceeds would not be considered QOZ property with regards to the 90-percent investment requirement.[568] In other words, without a corresponding "inclusion event" with respect to the taxpayer, no recognition of gain has occurred for the taxpayer. Section 1202(a) requires a "sale or exchange" by the taxpayer, and as such, the inclusion event may also need to be considered a "sale or exchange." Furthermore, QSBS gain recognized at the partnership level requires an amount to be "included in gross income by reason of holding an interest in a pass-thru entity."[569] As such, certain inclusion events like a transfer by gift of a qualifying interest in a QOF partnership[570] would not be considered a taxable "sale or exchange" and could potentially disqualify the QSBS status of the stock.[571] Therefore, in order to be sure that the taxpayer will get the benefit of the QSBS exclusion, it seems that a sale at the partnership level needs to have a corresponding inclusion event at the taxpayer level that is also considered a taxable "sale or exchange."

4. The Treasury Regulations provide that an inclusion event is any event that "reduces an eligible taxpayer's direct equity interest for Federal income tax purposes in the qualifying investment"[572] or pursuant to which the "taxpayer receives property … with respect to its qualifying investment and the event is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the eligible taxpayer's ownership of the QOF."[573] Specific to partnerships, the Treasury Regulations provide "an actual or deemed distribution of property, including cash, by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of the partner's basis in its qualifying investment."[574] In effect, the foregoing provision mimics section 731(a)(1) which provides distributions of money in excess of the partner's adjusted basis

568 *See* Treas. Reg. § 1.1400Z2(f)-1(b).

569 § 1202(g)(1).

570 *See* Treas. Reg. § 1.1400Z2(b)-1(c)(3).

571 As discussed earlier in these materials, section 1202(g)(1) provides that "any amount included in gross income by reason of holding an interest in a pass-thru entity" will be subject to exclusion at the partner-taxpayer level if certain requirements are met including (i) the partnership interest must have "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," § 1202(g)(2)(B); and (ii) such gain subject to partial or complete exclusion "shall not apply to any amount to the extent such amount exceeds the amount … which … would have applied if such amount were determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired." § 1202(g)(3).

572 Treas. Reg. § 1.1400Z2(b)-1(c)(1)(i).

573 Treas. Reg. § 1.1400Z2(b)-1(c)(1)(ii).

574 Treas. Reg. § 1.1400Z2(b)-1(c)(6)(iii). *See also* Treas. Reg. § 1.1400Z2(b)-1(c)(7)(ii) for the corresponding rule for S corporation distributions.

of such partner's interest in the partnership will result in gain (although distributions of property other than money are generally non-taxable). Importantly, section 731(a) provides "any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner."[575] The preamble to the 2020 QOZ Final Regulations explicitly confirms sale or exchange treatment on this inclusion event: "The Treasury Department and the IRS have determined that an election under section 1400Z-2(c)[576] should be available for gain resulting from … section 731(a) … on a qualifying investment because such gain is treated as gain from the sale or exchange of property for Federal income tax purposes."[577] It should be noted that simply holding the QOF partnership interest on December 31, 2026, would also be an inclusion event, but such event would likely not be considered a sale or exchange.[578]

5. Assuming the sale of the QSBS/QOF Stock and the corresponding distribution of $11 million of money to the taxpayer in this example will satisfy the "sale or exchange" requirement under section 1202(a), the taxpayer will recognize $10 million of net capital gain. The Treasury Regulations provide, in pertinent part, "In the case of an inclusion event described in paragraph (c)(6)(iii)… of this section…, the amount of gain included in gross income is equal to the lesser of—(i) The remaining deferred gain; or (ii) The amount that gave rise to the inclusion event."[579] The taxpayer's initial basis in the QOF partnership is zero, but because the taxpayer has held the qualified investment for more than 5 years, the basis at the time of the distribution is $1 million (10% of the deferred gain).[580] Assuming the QOF Stock also qualifies as QSBS, then the taxpayer can exclude the $10 million of recognized gain under section 1202(a). The relevant Per-Issuer Limitation for the taxpayer is the $10 Million Per Taxpayer, not the 10 Times Basis Limitation, because, for this purpose, any additions to the $0 basis QOF investment are ignored, and this results in no exclusion under the 10 times basis calculation.[581]

6. Section 1400Z-2(c) provides that if a taxpayer holds a qualifying investment for at least 10 years and the taxpayer so elects, "the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged." In this example, assume, after more than 10 years from the date of investment, the QOF partnership sells the remaining QOF Stock for $19 million (no change in value from date of the distribution to the taxpayer), and the taxpayer makes the appropriate election to get the benefits of the section 1400Z-2(c) basis adjustment. Does the taxpayer, who had a prior inclusion event recognizing the entire deferred gain, get the benefit of the basis adjustment to fair market value on all, or a portion, of the QOF Stock sold?

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[575] § 731(a), flush language.

[576] Referring to the taxpayer election to adjust the basis of a QOZ investment held for at least 10 years to fair market value on the date such investment is sold or exchanged.

[577] Preamble to the 2020 QOZ Final Regulations.

[578] *See* § 1400Z-2(b)(1). Deferred gain is recognized upon the earlier of a sale or exchange of the investment *or* December 31, 2026.

[579] Treas. Reg. §§ 1.1400Z2(b)-1(e)(2).

[580] § 1400Z-2(b)(2)(B)(i), (ii), (iii) and Treas. Reg. §§ 1.1400Z2(b)-1(c)(6)(iii), 1.1400Z2(b)-1(c)(6)(v), 1.1400Z2(b)-1(e)(5), and 1.1400Z2(b)-1(g)(4). *See also* Treas. Reg. §§ 1.1400Z2(b)-1(f)(10) and -1(f)(11) (dealing with debt financed distributions from a partnership)

[581] § 1202(b)(1), flush language.

7. The Treasury Regulations provide a specific set of rules for inclusion events that result from partnership distributions (and distributions by QOF S corporations). The preamble explains, "in the case of inclusion events under § 1.1400Z2(b)-1(c)(6)(iii) (partnership distributions) and § 1.1400Z2(b)-1(c)(7)(ii) (distributions by QOF S corporation), the section 1400Z-2(c) election continues to be available to a partner or S corporation shareholder, respectively, as long as the QOF owner continues to hold a qualifying investment in the QOF partnership or QOF S corporation, despite the distribution that caused an inclusion event."[582] Specifically, the Treasury Regulations provide, "The occurrence of an inclusion event described in § 1.1400Z2(b)-1(c)(6)(iii), which addresses a distribution of property by a QOF partnership to a QOF partner where the distributed property has a fair market value in excess of the QOF partner's basis in its qualifying investment, does not prevent the QOF partner from making a subsequent election described in section 1400Z-2(c) with respect to the QOF partner's qualifying QOF partnership interest."[583] Significantly, partnership distribution inclusions are not subject to the portion reduction rules[584] as are other inclusion events (i.e., a sale or gift of a portion of the taxpayer's QOF interest). These rules generally calculate the amount of gain based upon the fair market value of the disposed QOF interest and the fair market value of the total qualifying investment.[585] These portion rules, under certain circumstances, could limit a taxpayer's benefit under section 1400Z-2(c). For example, a gift of 90% of a taxpayer's QOF interest would be an inclusion event of 90% of the deferred gain but would also prevent the taxpayer from getting the section 1400Z-2(c) basis election on 90% of the QOF investment.[586] In contrast, the QOF partnership distribution in this example provides for an inclusion event of 100% of the deferred gain (also excludable under section 1202(a)) but still allows the taxpayer to get the benefits of the basis adjustment under section 1400Z-2(c).

8. In this example, the QOF partnership sells the remaining QOZ Stock after the 10-year holding period has been satisfied.[587] Pursuant to section 1.1400Z2(c)-1(b)(2)(ii)(A) of the Treasury Regulations, the taxpayer can make an election to exclude all gain allocable to the sale of the qualifying investment.[588] The taxpayer is treated as receiving a distribution of cash and immediately recontributing the cash to the QOF partnership in exchange for a non-qualifying investment in the QOF partnership.[589] The foregoing contribution and recontribution is only for purposes of determining the taxpayer's qualifying or non-qualifying investment in the QOF

[582] Preamble to 2020 QOZ Final Regulations.

[583] Treas. Reg. § 1.1400Z2(c)-1(b)(1)(v).

[584] Portion rule applies "Except as provided in paragraphs (e)(2) and (4) of this section, …" § 1.1400Z2(b)-1(e)(1).

[585] *See* Treas. Reg. § 1.1400Z2(b)-1(e)(1)(i) and (ii).

[586] Treas. Reg. § 1.1400Z2(c)-1(b)(1)(i) provides, "to the extent a taxpayer described in the preceding sentence has an inclusion event described in § 1.1400Z2(b)-1(c) with respect to any portion of a qualifying investment, that portion is no longer a qualifying investment and the taxpayer is not eligible to make an election pursuant to section 1400Z-2(c) and this section with respect to that portion." Section 1.1400Z2(b)-1(c) of the Treasury Regulations refers generally to the "inclusion events."

[587] After the initial sale of QSBS/QOF Stock and corresponding distribution of the proceeds, it is not necessary that the QOF partnership to continue to hold the QOF Stock. The QOF Stock can be sold and reinvested, within 12 months, into a qualified opportunity zone investment that would not be considered QSBS and still maintain the ongoing QOZ benefits.

[588] Treas. Reg. § 1.1400Z2(c)-1(b)(1)(v).

[589] Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii)(B)(1).

partnership and has no other Federal income tax consequences.[590] The deemed contribution and recontribution is not necessary if the QOF partnership distributes, within 90 days, the cash proceeds from the sale.[591] If the QOF partnership sells the remaining QOZ Stock for $19 million and within 90 days distributes the proceeds, the taxpayer can elect to exclude such gain and when the proceeds from the sale are distributed to the taxpayer, the basis of the taxpayer's QOF partnership interest will be increased by $19 million to reflect the exempt income,[592] allowing the taxpayer to receive the proceeds free of tax. [593]

9. There seems no policy reason or any provision in the Code or the Treasury Regulations that would prevent a taxpayer from combining the benefits of QSBS and QOZ investments. However, getting both benefits will only happen under a narrow set of circumstances. The QOF Stock must satisfy all of the QSBS qualifications, including the Aggregate Gross Asset Requirement and the Active Business Requirement, which has a "qualified trade or business" definition that is narrower than the businesses that would be considered qualified opportunity zone businesses. Like QSBS, QOZ Stock must be acquired by original issuance from a domestic corporation which during "substantially all" of the QOF's holding period for such stock, the corporation is a "qualified opportunity zone business."[594] A "qualified opportunity zone business" is defined as a trade or business (within the meaning of section 162 of the Code)[595] in which: (i) substantially all of the tangible person property owned or leased by the taxpayer is qualified opportunity zone business property;[596] (ii) satisfies the requirements of section 1397C(b)(2), (4), and (8) of the Code;[597] and (iii) is not described in section 144(c)(6)(B) of the Code.[598]

10. The section 1397C(b) requirements are similar to, but not the same as, the Active Business Requirements under section 1202, discussed earlier in these materials. Section 1397C(b)(2) requires that for each taxable year at least 50 percent of the gross income of a qualified

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[590] *Id.*

[591] Treas. Reg. §§ 1.1400Z2(c)-1(b)(2)(ii)(B)(2)(ii) and 1.1400Z2(c)-1(d)(4), Ex. 4.

[592] "With respect to the taxpayer making an election under paragraph (b)(2)(ii) of this section, the excess of any gains over losses excluded from income under paragraph (b)(2)(ii) of this section is treated as income of the partnership … that is exempt from tax under the Internal Revenue Code for purposes of section 705(a)(1)(B)…" Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii)(C)(*1*).

[593] If, in this example, the remaining QOF Stock is distributed to the taxpayer, and the taxpayer then sells the QOF Stock, the taxpayer can elect under section 1400Z-2(c) to adjust the basis to fair market value at the time of the sale. "An eligible taxpayer who makes a deferral election with respect to, or acquires by reason of a transaction that is not an inclusion event, a qualifying investment in a QOF, recognizes gain (if any) on December 31, 2026, of an amount determined under § 1.1400Z2(b)-1(e)(3) (and so much of § 1.1400Z2(b)-1(e)(4) as relates to § 1.1400Z2(b)-1(e)(3)) with respect to that qualifying investment, and whose holding period in that qualifying investment is at least ten years, is eligible to make an election described in section 1400Z-2(c) on the sale or exchange of that qualifying investment." Treas. Reg. § 1.1400Z2(c)-1(b)(1)(i).

[594] § 1400Z-2(d)(2)(B)(i).

[595] *See* Treas. Reg. §§ 1.1400Z-1(d)(1).

[596] § 1400Z-2(d)(3)(A)(i). *See* Treas. Reg. §§ 1.1400Z-1(d)(1)(i) and 1.1400Z-1(d)(2), establishing a 70-percent tangible property standard.

[597] § 1400Z-2(d)(3)(A)(ii). *See* Treas. Reg. § 1.1400Z-1(d)(3).

[598] § 1400Z-2(d)(3)(A)(iii). *See* Treas. Reg. § 1.1400Z-1(d)(1)(iii).

opportunity zone business is derived from the active conduct of a trade or business[599] in the qualified opportunity zone.[600] Section 1397C(b)(4) requires, with respect to any taxable year, a substantial portion of the intangible property of an opportunity zone business to be used in the active conduct of a trade or business in the qualified opportunity zone.[601] Section 1397C(b)(8) limits in, each taxable year, the average of the aggregate unadjusted bases of the property of a qualified opportunity zone business that may be attributable to nonqualified financial property. Section 1397C(e)(1) defines the term nonqualified financial property for purposes of section 1397C(b)(8), and excludes from that term reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (working capital assets).[602]

11. The reference to section 144(c)(6)(B) provides that the following trades or businesses cannot qualify as a qualified opportunity zone business: (i) any private or commercial golf course, (ii) country club, (iii) massage parlor, (iv) hot tub facility, (v) suntan facility, (vi) racetrack or other facility used for gambling, or (vii) any store the principal business of which is the sale of alcoholic beverages for consumption off premises.[603] These are often referred to as the "sin businesses." However, outside of the enumerated sin businesses, all other trades or businesses would qualify. As such, there should be a significant amount of active trades or businesses that would fall within the "qualified trade or business" definition of section 1202(e)(3) and the "qualified opportunity zone business" definition of section 1400Z-2(d)(3). Notably, however, the ownership, operation, and leasing of real property is considered a qualified opportunity zone business but would likely not satisfy the Active Business Requirement for QSBS purposes.

I. What Are the QSBS Planning Opportunities with a SPAC IPO Merger?

1. As discussed earlier, when a QSB merges with a SPAC, the shares of the QSB will continue to qualify as QSBS with a tacked holding period,[604] but the exclusion benefits will be capped by the exclusion ceiling rule under section 1202(h)(4)(b) of the Code. In contrast, if a QSB participates in a traditional IPO (i.e., working with an underwriter, filing S-1 registration statement with the Securities and Exchange Commission, releasing shares on a listed exchange, etc.), the QSBS shares are not subject to the ceiling rule. The SPAC merger process typically includes the following steps: (i) the target company and the SPAC will sign a letter of intent, (ii) the SPAC will conduct due diligence on the target, (iii) the target and SPAC sign acquisition and financing commitments, (iv) a public announcement of the pending merger will be made, (v) each company will obtain shareholder approvals, (vi) the transaction closes and the merged company begins trading publicly.

2. Planning to maximize the QSBS exclusion benefits should occur as early in the SPAC process as possible, when the QSBS shares have a lower value. Transfers "by gift" to "stack" the $10 Million Per Taxpayer Limitation will carry a lower "cost" for gift tax purposes

[599] Solely for purposes of section 1400Z-2(d)(3)(A), the ownership and operation (including leasing) of real property is considered the active conduct of a trade or business, although merely entering into a triple-net-lease will not qualify. Treas. Reg. § 1.1400Z-1(d)(3)(iii)

[600] *See* Treas. Reg. § 1.1400Z-1(d)(3)(i).

[601] *See* Treas. Reg. § 1.1400Z-1(d)(3)(ii), defining "substantial portion" to mean at least 40 percent.

[602] *See* Treas. Reg. § 1.1400Z-1(d)(3)(iv).

[603] *See* Treas. Reg. § 1.1400Z-1(d)(4).

[604] § 1202(h)(4).

(i.e., decreased use of gift tax exclusion or lower resulting gift tax) if the transfer is a taxable gift, and if the transfer is to pursuant to an installment sale to an IDGT, the installment note held by the taxpayer will have a lower principal amount.[605] Because shares issued prior to the SPAC merger could be considered QSBS, employees of the QSB should seek to exercise their non-qualified stock options as soon as possible to minimize the resulting compensation income (i.e., the "bargain" portion, the difference between the exercise price and the value of the QSBS received). If employees are issued restricted stock in the QSB, as part of their compensation package, they should consider making a section 83(b) election within 30 days of receipt of such shares at a lower value (which could be as low as the value as determined by section 409A of the Code). The resulting compensation to the employee (plus the exercise price in the case of the non-qualified option) will set the employee's basis in the QSBS,[606] and the employees holding period will start "just after the date such property is transferred."[607] All future appreciation on the QSBS will be considered capital gain.

3. While the holding period will start at the time the employee receives the compensatory shares, these shares can be used to "pack" the 10 Times Basis Limitation, even if they are sold prior to reaching the 5-year holding period required to be considered eligible gain. As mentioned earlier, the basis of non-eligible gain shares can be used in the calculation of the 10 Times Basis Limitation if eligible gain QSBS shares are sold in the same taxable year. For example, a founder holds 100,000 founders shares in a QSB which he has held for more than 5 years with zero tax basis. As part of the founder's compensation package, the board of directors grant the founder 80,000 restricted stock shares that are subject to forfeiture and are only vested if certain performance metrics are met. All of these restrictions and performance metrics are eliminated if the company goes public or merges with a SPAC. Within 30 days of the grant of the restricted stock, the founder makes a section 83(b) election to take the value of the shares into income, which according to the company's section 409A valuation is $50 per share (total compensation of $4 million). Soon thereafter the QSB is approached by a SPAC and after the merger, founder's 180,000 QSBS (ignoring the actual number of shares that these would be multiplied into upon the SPAC merger) shares are worth $180 million ($1,000 per share) on the effective date of the merger. After the lock-up period, in the first taxable year, the founder sells $10 million of founders shares (10,000 shares), fully utilizing the founder's 10 Million Per Taxpayer Limitation, leaving the founder with 170,000 QSBS shares (90,000 founders shares and 80,000 shares with a holding period of less than 5 years and an aggregate basis of $4 million). In the second taxable year, the founder can sell and exclude up to $40 million of founders shares, utilizing the 10 Times Basis Limitation, if the founder sells the 80,000 shares of compensatory shares in that year.

IV. CONCLUSION

QSBS has finally matured. More than twenty-five years after the enactment of section 1202, the tax landscape has finally evolved so that the benefits of QSBS should be considered for all clients who own an interest in a closely-held trade or business (or who are planning to start one). It's not just for technology startups anymore. The time is finally here for sole proprietorships, disregarded entities, partnerships, limited liability companies, and S corporations (with certain

[605] In order to "stack" the $10 Million Per Taxpayer Limitation, the IDGT would need to be convert to a non-grantor trust prior to the sale of the QSBS.

[606] *See* Treas. Reg. §§ 1.61-2(d)(2)(ii) and 1.83-2(a).

[607] Treas. Reg. § 1.83-4(a).

limitations), to consider a reorganization that might involve a conversion to a C corporation or the creation of a new C corporation.

The benefits of QSBS can be extraordinary: (i) 100% exclusion of gain on the sale of QSBS; (ii) ability to rollover gains and defer taxable gains; and (iii) the opportunity "stack" and "pack" the exclusion so that the potential exclusion can be in the hundreds of millions. Unfortunately, section 1202 can present unusual challenges to taxpayers. It is easy to inadvertently lose the benefits of QSBS, and the lack of official guidance and the quirks of section 1202 makes planning difficult at times. These materials are an attempt to provide a complete and balanced discussion of the qualifications, potential pitfalls, the unresolved issues, answers to those issues, and the significant opportunities with QSBS for the careful planner and their clients.

APPENDIX:
MOVEMENT OF QSBS SHARES CHART

Description of Transfer	QSBS Treatment of Transfer	QSBS Status Retained?	Additional Per-Issuer Limitation?
Contribution of QSBS to revocable living trust	Ignored	Yes	No
Gift of QSBS to IDGT	Ignored	Yes	No
Contribution of QSBS to GRAT	Ignored	Yes	No
Payment of QSBS to grantor from GRAT in satisfaction of annuity payment	Ignored	Yes	No
QSBS transferred upon expiration of the GRAT term to grantor trust	Ignored	Yes	No
QSBS transferred upon expiration of GRAT term to individual (other than grantor) or to non-grantor trust	By Gift	Yes	Yes
Sale of QSBS to IDGT in exchange for installment note	Ignored	Yes	No
Transfer of QSBS from IDGT to grantor in satisfaction of installment note debt held by grantor	Ignored	Yes	No
Taxable sale of QSBS to individual or non-grantor trust	Disqualifying Transfer	No	No
Gift of QSBS to individual	By Gift	Yes	Yes
Transferring QSBS to spouse who is filing separately	By Gift	Yes	No
Transferring QSBS to spouse who is filing jointly	By Gift	Yes	Unknown

Transferring QSBS to non-U.S. citizen spouse	By Gift	Yes	Yes
Transferring QSBS incident to divorce	By Gift	Yes	Yes
Contribution of QSBS to non-grantor Trust	By Gift	Yes	Yes
Contribution of QSBS to DING, NING, or other incomplete gift non-grantor trust	By Gift	Yes	Yes
Distribution of QSBS from grantor or non-grantor trust to a beneficiary (other than the grantor)	By Gift	Yes	Yes
Distribution (or decanting) of QSBS from grantor or non-grantor trust to another non-grantor trust that is considered a separate taxpayer	By Gift	Yes	Yes
Splitting pot trust holding QSBS into separate trusts for certain beneficiaries	By Gift	Yes	Yes
Termination of grantor trust status when trust holds QSBS	By Gift	Yes	Yes
Termination of grantor trust status when trust holds QSBS and it collateralizes debt that is in excess of basis	By Gift & Disqualifying Transfer	Yes & No	Yes & No
Conversion of non-grantor trust to grantor trust status when trust holds QSBS	Ignored	Yes	No
Conversion of non-grantor trust to grantor trust status when trust holds QSBS and it collateralizes debt that is in excess of basis	Ignored	Yes	No
Transfer of QSBS pursuant to the exercise of a limited or general power of appointment	By Gift	Yes	Yes
Contribution of QSBS to FLP and sale by FLP	Disqualifying Transfer	No	No
Contribution of QSBS to FLP, distribution back to contributing partner, and sale by partner	Unknown	Unknown	Unknown

Distribution of QSBS from FLP to a partner	Partnership to Partner	Yes	No
Contribution of QSBS to disregarded entity LLC	Ignored	Yes	No
Conversion of disregarded entity LLC holding QSBS to partnership (may depend on whether the QSBS is sold by the partnership or by the "contributing" partner	Unknown	Unknown	Unknown
Gift of interest in FLP holding QSBS to individual or non-grantor trust	Unknown	Unknown	Unknown
Gift of interest in FLP holding QSBS to GRAT or IDGT, whether a "zeroed-out" gift or a taxable gift	Ignored	Yes	No
Sale of interest in FLP holding QSBS to an IDGT in exchange for installment note	Ignored	Yes	No
Contribution of QSBS to S corporation	Disqualifying Transfer	No	No
Distribution of QSBS from S corporation to shareholder	Disqualifying Transfer	No	No
Gift of interest in S corporation holding QSBS to individual or non-grantor trust	Unknown	Unknown	Unknown
Contribution of QSBS to charitable remainder trust	By Gift	Yes	Unknown
Contribution of QSBS to grantor charitable lead trust	Ignored	Yes	No
Contribution of QSBS to non-grantor charitable lead trust	By Gift	Yes	Yes
Bequest of QSBS	By Death	Yes	Yes
Transfer of QSBS in joint account by right of survivorship	By Death	Yes	Yes

Distribution of QSBS from a revocable living trust upon the death of the grantor	By Death	Yes	Yes