Qualified Trades or Businesses for QSBS Defined

by Christopher A. Karachale

As many taxpayers in the startup and technology sectors know, qualified small business stock ("QSBS") can provide significant tax advantages to founders, employees, and investors. If a taxpayer has held her QSBS for more than five years, she can exclude 50% of the gain on disposition of those shares for federal income tax purposes. But in order for stock to qualify as QSBS, a number of requirements must be met. The shares must be originally issued by a C corporation with less than $50 million in gross assets and, during substantially all of the taxpayer's holding period of such stock, the C corporation must have used at least 80% of its assets in the active conduct of one or more qualified trades or businesses.

Private Letter Ruling (PLR) 201436001 (May 22, 2014), released at the beginning of September 2014, provides a helpful roadmap for taxpayers worried about whether their business is a "qualified trade or business" under Internal Revenue Code ("IRC") section 1202(e)(3). This letter ruling demonstrates that a business can provide significant services based in large part on skills or reputation and still constitute a qualified business.

The Definition Qualified Trade or Business

For purposes of QSBS qualification, IRC section 1202(e)(3) defines a "qualified trade or business" by exclusion. A "qualified trade or business" means any trade or business *other than* the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, athletics, financial services, brokerage services, consulting, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. See IRC section 1202(e)(3)(A). In addition, the term qualified trade or business *does not* include businesses in which the principal activity involves providing services in the fields of finance, insurance, banking, investing, leasing, farming, mining, or running a hotel, motel, restaurant or similar businesses. See IRC section 1202(e)(3)(B)&(E).

As a result of this statutory construction, taxpayers only knew what was *not* a qualified business for purposes of QSBS rules and, until recently, the IRS and Treasury Department had never promulgated regulations or other guidance providing affirmative

examples of what constitutes a qualified trade or business. PLR 201436001 provides such guidance.

New Guidance on Qualified Trade or Business

PLR 201436001 describes a company that provided products and services in the pharmaceutical industry. The company's business activities included (1) research on drug formulation effectiveness; (2) pre-commercial testing procedures such as clinical testing; (3) manufacturing of drugs; and (4) working with clients to solve problems in the pharmaceutical industry, such as developing successful drug manufacturing processes. To perform these tasks, the company used its physical assets, such as its manufacturing and clinical facilities, as well as its intellectual property assets, including its patent portfolio. According to the letter ruling, the company's successful performance of these activities in the past had earned the company several valuable relationships in the pharmaceutical industry.

The IRS's analysis of whether this company constituted a qualified trade or business appears to be two-fold. First, the IRS reviewed whether "they offer value to customers primarily in the form of services." Second, the IRS queried whether the company was involved in one of the proscribed trades or businesses listed at IRC section 1202(e)(3). Despite seemingly favorable arguments on both sides of each issue, the IRS determined that the pharmaceutical company was engaged in a qualified trade or business for purposes of the QSBS rules.

Services as Part of a Larger Enterprise

Analyzing the four business activities of the pharmaceutical company, the IRS conceded that the company's activities involved significant services. The company engaged in "research", "testing", "manufacturing", and "problem solving" for pharmaceutical companies. Clearly, a portion of its work in this regard involved providing services and a particular "skill" that the company had developed. In addition, the company's "reputation" in the pharmaceutical field earned it more customers. Such skill and reputation appear to run afoul of the requirement that the business's principal asset not involve "the reputation or skill of one or more of its employees." IRC section 1202(e)(3)(A).

However, the dispositive factual issue appears to have been the *nature* of the services provided by the company. According to the letter ruling, the company was essentially "a pharmaceutical industry analogue of a parts manufacturer in the automobile industry." This language shows that even if the skill and reputation of a company are important assets, the company can still be a qualified business provided that it produces some tangible (or potentially intangible) asset in conjunction with the services rendered. In other words, a "consulting" firm which provides services based on its reputation and particular skill in one area may still be a qualified business under IRC section 1202(e)(3) as long as its work is part of some larger enterprise to produce products.

Importance of Appellation

PLR 201436001 also makes clear that the name given to the taxpayer's particular service industry is significant. The letter ruling indicates that the company was involved in the "pharmaceutical" industry, rather than the "health" industry (which is one of the proscribed classes of industries). But this distinction appears somewhat strained. In fact, the PLR letter 201436001 concedes that the company worked primarily in the pharmaceutical industry, "which is certainly a component of the health industry." Nevertheless, the letter ruling concludes that the company was not "performing services in the health industry within the meaning of IRC section 1202(e)(3). Neither are the Company's business activities within any of the prohibited categories set forth in §1202(e)(3)."

Although it is unclear from the letter ruling, it appears that the IRS reached this conclusion because the entity specified that it was engaged in the pharmaceutical business, rather than the broader health business. Presumably had the entity applied for the letter ruling and indicated that it was involved in the business of providinge health services, the IRS might have reached a different conclusion. In this respect, taxpayers should closely examine the particular name of the industry in which their business is operating. If, for example, the taxpayer is engaged in some particular area of "finance," specifying this particular area (e.g. optimizing financial modeling) as a trade or business may help to demonstrate that the taxpayer is engaged in a qualified trade or business, notwithstanding the fact that the broader business (finance) is one of the enumerated exceptions listed in IRC section 1202(e)(3).

Conclusion

PLR 201436001 provide welcome guidance to all taxpayers who are operating small businesses. It clearly demonstrates that the IRS will not read the list of proscribed trades or business at IRC section 1202(e)(3) literally. Arguably many taxpayers who previously believed their businesses might not qualify as a QSBS eligible trade or business may now take the position that they do qualify given (1) the nature of the services provided and (2) the name given to the particular business.

Taxpayers in the startup or technology fields are welcome to contact the lawyers at Hanson Bridgett for questions about QSBS qualification or other tax questions affecting their industry.

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