

# Why Qualified Small Business Stock Matters Even More Under Trump Tax Reform

The [Tax Cuts and Jobs Act](#) (the "TCJ Act") signed into law by President Trump on December 22, 2017, creates sweeping changes in the way individuals and businesses are taxed. One of the most important changes involves the taxation of pass-through entities and directly implicates the standards for qualified small businesses stock ("QSBS") under IRC section 1202.

## New Rules and Opportunities for Pass-Throughs

New IRC section 199A generally allows individual taxpayers to deduct 20% of the business income generated by their sole proprietorships, partnerships, or S corporations up to a threshold of \$315,000 for joint filers (\$157,500 for single filers). Above the \$315,000 threshold, the deduction begins to phase out. For many taxpayers, the phase-out is based on the amount of W-2 wages paid to employees (as well as the unadjusted basis of property). The greater the wages paid (or basis of property), the more prolonged the phase-out of the 20% deduction.

However, for any "specified service trade or business," new IRC section 199A requires a complete phase-out of the 20% deduction at \$415,000 of business income for joint filers (\$207,500 for single filers). New IRC section 199A(d)(2)(A) states that a specified service trade or business means any trade or business:

which is described in section 1202(e)(3)(A) (applied without regard to the words 'engineering, architecture,') or which would be so described if the term 'employees or owners' were substituted for 'employees' there in...

So, under new IRC section 199A, taxpayers who generate pass-through business income in the fields of health, law, accounting, performing arts, consulting, athletics, financial services, or any business where the principal asset of the pass-through business is the reputation or skill of 1 or more of its employees or owners are subject to a complete phase-out on the 20% business income deduction. In other words, the same types of businesses that cannot be qualified small businesses (and issue QSBS) under IRC section 1202 are now also subject to more restrictive phase-outs for the new business income deduction under IRC section 199A.



by Christopher A. Karachale

## Considerations for Specified Service Trades or Businesses under New IRC Section 199A

In many ways, it is odd that the TCJ Act adopted the IRC section 1202(e)(3)(A) qualified small business definition as the limiting standard for the new IRC section 199A phase-out. The most obvious issue is that QSBS has nothing to do with the pass-through businesses described in the new IRC section 199A. Among other requirements, a company can only be a qualified small business and its shares can only be QSBS if the company is a C corporation. The pass-through entities that benefit from the 20% business income deduction could *never* be qualified small businesses or issue QSBS because they are not C corporations. In fact, it appears that the drafters of the TCJ Act simply grafted the IRC section 1202(e)(3) trades or businesses limitations onto the new section 199A statute as a convenient proxy to restrict certain service industries from the benefit of a more extensive business deduction.

Second, the choice to limit the new IRC section 199A deduction for IRC section 1202(e)(3) trades or businesses seems to lack a policy justification. Congress arguably provided a [rational justification](#) for the exclusion from gain on the sale of QSBS in order to "encourage the flow of capital to small businesses." H Rep No. 111, 831, 103d Cong, 1st Sess (1993). Generally service businesses such as health, law, accounting, or the other fields excluded from QSBS status under IRC section 1202(e)(3) do not create a benefit for investors. But the capital intensive industries that benefit from the QSBS exclusion do provide significant potential opportunities (and risks) for founders and early investors.

In contrast, the legislative history for new IRC section 199A offers no policy justification for the distinction between the specified service trade or businesses as defined at IRC section 1202(e)(3) and other businesses. Why, for example, should an investor in real estate benefit from a more advantageous business deduction phase-out than a doctor? The new IRC section 199A deduction appears to make an arbitrary distinction that lacks the policy justification underlying the IRC section 1202 exclusion from gain.

Third, the decision to tie the 20% business income deduction to the IRC section 1202(e)(3) definition creates interesting statutory interpretation issues for the IRS as well as tax practitioners. In Private Letter Rulings [201436001](#) (Sept. 5, 2014) and [201717010](#) (April 28, 2017), the IRS offered exceedingly taxpayer friendly readings of the IRC section 1202(e)(3) businesses excluded from QSBS qualification. In respective letter rulings, the IRS concluded that a [pharmaceutical company](#) and a [genetic testing company](#) were still qualified small businesses, notwithstanding the fact that both those companies were in the health field – one of the proscribed trades or businesses under IRC section 1202(e)(3).

As pass-through entities seek to deduct business income above the \$415,000 cutoff under new IRC section 199A, will the IRS apply the limited (but favorable) administrative guidance already issued for QSBS under IRC section 1202(e)(3)? If so, there may be many planning opportunities for pass-throughs even if they may be considered "specified service trade or businesses" under new IRC section 199A(d)(2)(A).

### Implications of the TCJ Act for QSBS Generally

Finally, it is important to note that the TCJ Act leaves untouched the favorable treatment of QSBS under IRC sections 1202 and 1045. Taxpayers who have held QSBS for more than five years can continue to exclude 100% of the gain on up to \$10 million provided the shares were issued after September 27, 2010. Similarly, taxpayers who have not met the five year holding period can roll QSBS gain into new a qualified small business as long as they reinvest within 60 days.

Businesses and individuals with questions about new IRC section 199A or qualified small businesses under IRC section 1202 can contact [Christopher Karachale](#) or the Hanson Bridgett [Tax Practice Group](#).