

New Favorable Qualified Small Business Stock Guidance for Fintechs and Insurtechs

On April 9, 2021, the IRS released [Private Letter Ruling \(PLR\) 202114002](#) (January 13, 2021), which provides additional context to taxpayers worried about whether their Fintech or Insurtech shares represent Qualified Small Business Stock (QSBS) under Internal Revenue Code (IRC) section 1202. PLR 202114002 suggests that a Fintech or Insurtech company that conducts "administrative services beyond those that would be performed by a mere intermediary facilitating a transaction between two parties" would not be considered engaged in "brokerage services" for purposes of IRC section 1202(e)(3)(A). More importantly, PLR 202114002 helps confirm that as long as the company does not fall under the definition of a bank or an insurance company, it does not appear to be engaged in any "banking," "insurance," or "similar business" for purposes of IRC section 1202(e)(3)(B).

Qualified Trade or Business Background

Under IRC section 1202, taxpayers who hold QSBS may be able to exclude \$10 million of gain (or ten times their basis in the shares) on sale if they have held the shares of QSBS for more than five years. However, the taxpayer and the corporation must meet a number of requirements for QSBS status. Among these, the taxpayer must receive shares of a domestic C corporation at original issuance in exchange for money or other property or as compensation for services. In addition, for substantially all of the taxpayer's holding period, at least 80 percent of the company's assets by value must be used in the active conduct of one or more qualified trades or businesses under IRC section 1202(e)(3).

IRC section 1202(e)(3) defines qualified trades or businesses by exclusion. In other words, the statute only tells taxpayers what does not constitute a qualified trade or business, including the performance of services in the health, legal, financial services, or brokerages services fields, as well as any banking, insurance, or similar business. Prior to 2014, only one Tax Court case, *Owen v. Commissioner*, TC Memo 2012-21, offered guidance on what constituted a qualified trade or business. However, in 2014 and in 2017, the IRS released two Private Letter Rulings that offer guidance on the scope of the IRC section 1202(e)(3) limitations.



by Christopher A. Karachale

[PLR 201436001](#) (May 22, 2014) describes a pharmaceutical company that helped clients commercialize experimental drugs. As we described in a [previous client alert](#), the PLR explains that even though the company was in the health field, it was still engaged in a qualified trade or business because the company's "activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers."

[PLR 201717010](#) (January 23, 2017) describes a genetic testing company. The IRS reasoned that although the company's "laboratory reports provide valuable information to healthcare providers, the company does not provide health care professionals with diagnosis or treatment recommendations for treating a health care professional's patients." Given this fact, the IRS ruled that the company was not in the "health" field for the purpose of IRC section 1202(e)(3). [View our detailed analysis of both PLRs.](#)

Insurance Agent PLR

The new PLR fills in certain gaps left by PLR 201436001 or PLR 201717010. PLR 202114002 describes a business that serves as an insurance agent or broker. It is unclear from the facts or analysis of the PLR whether the business is an online Insurtech company. Thus, we believe the analysis could extend to an Insurtech company as well as a more traditional insurance broker.

The company in the PLR generated revenue through commissions paid directly from the insurance company or through withholding on a portion of a customer's premium payments. Under the terms of its contracts with the insurance companies, the company had to perform certain administrative services, including reporting all known incidents, claims, suits, and notices of loss to the insurance company or its designated claims adjuster and cooperating fully to facilitate any investigation, adjustment, settlement and payment of any claim. It also had to keep accurate and complete records and accounts of all transactions and correspondence with the insureds at its principal office, and such records and accounts had to be open to examination, inspection, verification, and audit by the insurance company upon reasonable notice.

Based on these facts, the IRS ruled that the company was not engaged in "brokerage services" for purposes of IRC section 1202(e)(3). Acknowledging that IRC section 1202(e)(3) does not define "brokerage services," the PLR looked to the dictionary definition of a broker, concluding that a broker is "one who acts as an intermediary." Because the business described in the PLR performed a "number of administrative services beyond those that would be performed by a mere intermediary facilitating a transaction between two parties," the IRS determined that it was engaged was in a qualified trade or business for purposes of IRC section 1202(e)(3).

Larger Implications for Fintechs and Insurtechs

There a number of important teachings from the new PLR. Although the PLR may not be used as precedent, the guidance still appears highly favorable for Fintech and Insurtech companies. First, the PLR shows that Fintechs that broker transactions are not necessarily engaged in "brokerage services" for purposes of IRC section 1202(e)(3), so long as the Fintech company also performs additional administrative services.

For example, businesses like [Coinbase](#) and [Robinhood](#) are arguably not engaged in brokerage services for QSBS purposes because they are not "mere intermediaries" for trades. Rather, such companies may provide additional tools or "administrative services" to help clients make informed trading decisions. Therefore, they may be engaged in a qualified trade or business under IRC section 1202(e)(3).

Second, the PLR shows that the IRS respects the difference between Fintechs that hold themselves out as banks (or Insurtechs that hold themselves out as insurance companies) and actual banks and insurance companies. In the most recent PLR, the IRS could have collapsed the distinction between the insurance agent and the insurance business more generally (excluded as a qualified trade or business under IRC section 1202(e)(3)(B)).

Instead, the IRS makes clear that the insurance broker company described in the new PLR was engaged in a qualified trade or business, even though it is within the insurance field. The new PLR is a helpful guidance to Fintechs like [SoFi](#) and [Chime](#), which are not technically banks with charters. Rather, as long as these sorts of Fintechs continue to serve as a link between actual banks and customers (and other provide qualifying functions, such as adequate administrative services), the IRS appears willing to respect their qualified trade or business status for QSBS purposes.

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