NEWS ANALYSIS

Qualified Small Business Stock and The 'Substantially All' Problem

by Marie Sapirie

When Treasury and the IRS established a concrete threshold for substantially all of a holding period under the Opportunity Zone regime, the definition might have also helped resolve a long-standing question on the holding period requirement for qualified small business stock (QSBS). There's no clear indication that either Congress or Treasury intended to provide an analogy for use in the QSBS area, but there aren't any obvious conflicts with its application there, either.

The treatment of QSBS in section 1202 allows noncorporate taxpayers who have held QSBS for more than five years to exclude the gain on the sale or exchange of the stock up to the greater of $10 million or 10 times the aggregate adjusted bases of QSBS issued by the corporation and disposed of by the taxpayer in that year. It's an attractive benefit for taxpayers who qualify, and it's getting attention from taxpayers partly because of the permanent expansion of the exclusion of gain from 50 percent to 100 percent in 2015. The benefit has piqued the interest of founders and investors in tech start-ups in particular, but many questions about how to apply the rules at the margins remain, and Treasury and the IRS might eventually have to answer them.

To be QSBS, the stock must be in a C corporation and be acquired by the taxpayer at its original issue in exchange for money or other property, or as compensation for services. The corporation must have less than $50 million of aggregate gross assets when the stock is issued. The active business requirement of section 1202(c)(2)(A) means that for stock in a corporation to be QSBS, the corporation must meet the active business requirement "during substantially all of the taxpayer's holding period for such stock." There's no definition of substantially all, but some practitioners have used 80 percent as a "general rule of thumb" based on other areas of the code. (Prior analysis: *Tax Notes*, Jan. 8, 2018, p. 205.)

QSBS treatment is available only if at least 80 percent of the value of the corporation's assets is used in the active conduct of qualified trades or businesses, defined as any trade or business that doesn't involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services, or any trade or business in which the principal asset is the reputation or skill of an employee. Also excluded are banking, insurance, financing, leasing, investing, or similar businesses, as well as farming and hotel operations.

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One of the chief problems for tech firms is that staying out of these section 1202(e)(3) categories can be a challenge because they could be construed broadly. The IRS might be willing to consider a narrower scope for those categories in the QSBS context, but the exact contours for now are unclear.

In May 2019 Treasury released proposed regulations (REG-120186-18) under section 1400Z-2 that defined substantially all in relation to the required holding period as 90 percent under section 1400Z-2(d)(2)(B)(i)(III). This means that for at least 90 percent of the period a qualified opportunity fund holds qualified Opportunity Zone (QOZ) stock, the corporation must be a QOZ business.

The objective of the numerical threshold is to reflect congressional intent that the regime be focused on investment in designated QOZs,

according to Treasury. Although they aren't directly applicable to section 1202, the proposed QOZ regulations provide a helpful guidepost for how Treasury might apply the substantially all requirement for a temporal holding period, said Christopher A. Karachale of Hanson Bridgett LLP.

> ***Taxpayers who don't meet 90 percent are still free to view the QOZ rules as unrelated and therefore distinguishable until Treasury says otherwise.***

Given the lack of guidance under section 1202, the proposed QOZ regs might serve as reassurance to taxpayers that they've met the holding period requirement, if they can meet the 90 percent threshold. The chief drawback in this new development is that 90 percent is higher than most taxpayers would prefer. Taxpayers who don't meet 90 percent are still free to view the QOZ rules as unrelated and therefore distinguishable until Treasury says otherwise.

History and (Limited) Guidance

Section 1202 has been around since 1993. Its original purpose was to help small businesses and start-ups attract long-term investments and create jobs, and that's essentially still true for shareholders that qualify for its benefits, except that they're more generous today.

As originally written, section 1202 allowed a taxpayer to exclude 50 percent of the gain from selling QSBS from gross income. In 2009 Congress raised the exclusion temporarily to 75 percent, and in 2010 again temporarily raised it to 100 percent. The increases were an attempt to deal with the recession. In 2015 Congress made the 100 percent exclusion permanent. Despite the other corporate tax changes, the Tax Cuts and Jobs Act made no changes to section 1202.

Treasury promulgated reg. section 1.1202-2 regarding redemptions and transfers by shareholders in 1997, but there has been little informal guidance under section 1202, except for two letter rulings that shed some light on what constitutes a qualified trade or business under section 1202. These rulings don't address the holding period question, but they hint that the IRS is amenable to reading the statute in a relatively taxpayer-favorable light.

In LTR 201436001 and LTR 201717010, the IRS permitted healthcare-related companies to qualify as qualified trades or businesses, because they weren't offering direct patient care or specific individual expertise, which sufficiently distinguished them from healthcare as a service and put them outside section 1202(e). Before those two letter rulings, taxpayers were essentially on their own to decide whether they had a qualified trade or business, as they still largely are for the other requirements of section 1202. Practitioners have therefore looked to other code sections for analogies, and the proposed rules under section 1400Z-2 offer a new one.

Echoes of 'Substantially All'

Although the TCJA left the treatment of QSBS unchanged, the provision wasn't overlooked. The law created cross-references from new provisions that aren't obviously related to section 1202: the section 199A passthrough deduction and the QOZ rules in section 1400Z-2. These express references make the repeated use of "substantially all" look less like a coincidence in section 1400Z-2.

In the passthrough deduction, Congress adopted the extant list of trades or businesses in section 1202(e)(3)(A) but excluded engineering and architectural businesses. The TCJA also imported the redemption rule from section 1202(c)(3) into section 1400Z-2(d)(2)(B)(ii) by explaining that a "rule similar to" the rule regarding redemptions of QSBS will apply for QOZ stock.

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The rule in section 1202(c)(3) prevents stock from being QSBS if the issuing corporation purchased any of its stock from the taxpayer or a related person, or the corporation had a recent

significant redemption of its stock. The October 2018 proposed regulations (REG-115420-18) under section 1400Z-2 offered no further guidance, explaining only that "rules similar to the rules of section 1202(c)(3) apply for purposes of determining whether stock in a corporation qualifies as qualified opportunity zone stock." Sanctioning a rule "similar" to the QSBS redemption rules sounds like Congress intended for Treasury to step in and add a more concrete explanation of the proper treatment, but so far Treasury hasn't addressed it.

To construe "substantially all" in section 1202, the important point is that whatever Congress intended to do by creating those links between sections, legislators probably hadn't forgotten that they'd used the same words that were repeated multiple times in section 1400Z-2 in section 1202. However, section 1202 has a markedly different purpose than section 1400Z-2, which could suggest that the phrase has different meanings in the different contexts. The analogy is there for the taking, but disregarding it when it's inconvenient is also an option, at least for now.

More to Come?

Taxpayers would of course like to see section 1202 made less difficult to qualify for and even more advantageous, and the TCJA initially seemed like a promising vehicle. In a July 2018 letter that was directed at the then-nascent tax reform law, the Biotechnology Innovation Organization asked congressional leaders to raise the maximum gross assets threshold for qualified small businesses from $50 million to $100 million on the grounds that research is expensive, as well as to allow investors to include up to four years of their holding periods in limited liability companies that are converted into C corporations in the five-year holding period requirement. Those requests didn't make the cut, but look for similar proposals to follow in the wake of any future economic downturns.

The prospects for guidance anytime soon on the unresolved questions in section 1202 seem slim because of the TCJA's demands on Treasury and the IRS, but the increasing awareness and use of the provision, particularly by tech companies and their investors, might demand more regulatory attention as audits from the years following the permanent 100 percent exclusion proceed. There are questions about how to apply the $10 million maximum exclusion to transfers by gift into trusts for the benefit of family members, and regulations addressing the scope of the qualified trade or business categories probably belong at the top of the list.

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