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Qualified Small Business Stock Under IRC §1202: Tax-Free Money for the Masses?

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Introduction

Since January 1, 2013, taxpayers with gross incomes of $250,000 or more have seen a significant increase in the rate at which their long-term capital gains are taxed. The American Taxpayer Relief Act of 2012 (Pub L 112–240, 126 Stat 2313) increased the rate from 15 percent to 20 percent and imposed a net investment income tax of 3.8 percent, bringing the total current rate on long-term capital gains to 23.8 percent.

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In the face of such increases, it is surprising that Congress has, during the same general period, reduced to zero the tax on the sale of a specific class of stock. For sales of stock in a "qualified small business" acquired on or after September 28, 2010, IRC §1202 provides generally that no tax will be imposed on the greater of $10 million of gain or ten times a shareholder's basis in the stock, provided that the shareholder has held the stock for 5 years. In other words, even in an environment of increased taxes, Congress has given special dispensation to shareholders of qualified small business stock (QSBS). Since "qualified small businesses" under §1202 include tech start-ups and many other Silicon Valley companies, it is imperative for business and tax advisors to understand and be able to counsel their clients on the significant tax savings associated with this type of stock.

After a short analysis of policy considerations regarding QSBS, this article explains the general requirements to obtain the gain exclusion provided under §1202. The article also considers the related tax-deferral provisions for QSBS contained in IRC §1045. Finally, the article provides a comprehensive review of the (concededly small) universe of case law and administrative guidance from the Internal Revenue Service on QSBS. Although other articles have covered the general requirements of IRC §§1202 and 1045, no formal survey of the current case law and administrative guidance exists. Given the potential tax savings available for QSBS holders, such a review is invaluable to taxpayers and their legal advisors.

Note that this article does not address the prior California rules for QSBS under the Revenue and Taxation Code. Since January 1, 2013, the QSBS exclusion and deferral provisions have been disallowed for California income tax.

POLICY CONSIDERATIONS

As originally enacted in 1993, IRC §1202 provided a 50 percent exclusion from gain on the sale of QSBS, subject to certain alternative minimum tax adjustments. At that time, the long-term capital gains rate was 28 percent. According to its legislative history, §1202 was designed to provide "targeted relief for investors who risk their funds in new ventures [and] small businesses" and encourage investments in these enterprises. H Rep No. 111, 831, 103d Cong, 1st Sess (1993). The exclusion was intended to "encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing." H Rep No. 111, 831.

In 2009 and part of 2010, the exclusion for the sale of QSBS was increased to 75 percent and, ultimately, in September 2010, the exclusion was increased to 100 percent with the enactment of the Creating Small Business Jobs Act of 2010 (Pub L 111–240, 124 Stat 2504). According to the legislative history of these changes, the "increased exclusion and the elimination of the minimum tax preference for small business stock gain will encourage and reward investment in qualified small business stock." See, *e.g.,* S Rep No 208, 68, 112th Cong, 2d Sess (2012).

Viewed through the lens of its legislative history, IRC §1202 appears to be the product of Congresses that chose to provide special preference for investors willing to risk capital in new and small businesses. Evidently, Congress believed the value of overall increased investment in small businesses outweighed any loss to the fisc from the forgone tax revenue associated with the sale of stock from such businesses.

However, many commentators have questioned the supply-side economics justification for the QSBS exclusion. For example, Professor Victor Fleisher has written of QSBS that (*'Tax Extenders' That Slip Under the Radar,* New York Times, Dealbook, Jan. 15, 2013)

> [a] better name would be the 'angel investor loophole.' . . . Angel investors and venture capitalists, of course, argue that these are precisely the type of start-ups that tend to create new jobs, and thus they should be encouraged, not taxed. Perhaps the low tax rate encourages angels to put more money into start-ups instead of index funds. . . . On the other hand, it is not clear that the tax break is necessary to encourage investment that would not otherwise take place.

In short, the QSBS exclusion in IRC §1202 clearly has deep policy implications. Although those implications are beyond the scope of this article, practitioners and their clients should bear them in mind. Indeed, with the dearth of case law and administrative guidance on §1202, a taxpayer may need to argue his case before the IRS at least in part on the basis of the policy underlying the exclusion in the original legislative history.

GENERAL EXCLUSION FROM GAIN FOR QSBS

Amount of Exclusion Generally

When originally enacted, IRC §1202(a)(1) provided a 50 percent exclusion from gain on the sale of QSBS for the greater of $10 million of gain or ten times a shareholder's basis. However, the exclusion from gain was not exactly 50 percent. IRC §57(a)(7) treated the *excluded* gain as an alternative minimum tax (AMT) preference item subject to tax at a 7 percent rate, while the 50 percent taxable gain was subject to tax at the 28 percent collectibles rate under

IRC §1(h)(4). As a result, the effective tax rate on QSBS held for 5 years and sold between August 11, 1993 (the date of IRC §1202's enactment) and February 17, 2009, was 14.98 percent. As a point of reference, this rate of tax was just slightly lower than the general long-term capital gains rate (15 percent) between 2003 and 2009.

For sales of stock in a "qualified small business" acquired on or after September 28, 2010, IRC §1202 provides generally that no tax will be imposed on the greater of $10 million of gain or ten times a shareholder's basis in the stock, provided that the shareholder has held the stock for 5 years.

For QSBS sold between February 18, 2009, and September 27, 2010, the general exclusion from gain was increased to 75 percent by the American Recovery and Reinvestment Tax Act of 2009 (Pub L 111-5, 123 Stat 115) with the addition of IRC §1202(a)(3). However, the excluded gain was still treated as an AMT preference item, subject to tax. As a result, the effective rate of tax on QSBS sold between February 18, 2009, and September 27, 2010, was 8.47 percent.

Finally, with the enactment of the Creating Small Business Jobs Act of 2010 (Pub L 111-240, 124 Stat 2504) and the addition of IRC §1202(a)(4), the exclusion became complete, and shareholders who acquired stock on or after September 28, 2010, could exclude all gain up to $10 million or 10 times their basis, provided that the 5-year holding period was met. This means that shareholders who sold QSBS beginning on September 28, 2015, may effectively avoid all income tax on up to $10 million of gain (or ten times their basis).

Before 2016, the 100 percent exclusion for QSBS was subject to sunset provisions. Each year created confusion for taxpayers about whether the exclusion would revert to 50 percent as originally provided in the statute. However, in December 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act (Pub L 114-113, 129 Stat 2242), which made the 100 percent exclusion permanent. Unless there is a substantial amendment to IRC §1202, shareholders of QSBS should enjoy the 100 percent exclusion on the disposition of their stock for the foreseeable future.

In order to actually obtain the exclusion, QSBS shareholders report the sale of QSBS on Schedule D and IRS Form 8949 just like any other capital gain. The exclusion (50 percent, 75 percent, or 100 percent) is shown as a negative number on Form 8949. However, apart from providing information on Schedule D and Form 8949, neither the shareholder nor the company needs to submit any information to the IRS.

Definition of QSBS

QSBS is stock in a C corporation that is a "qualified small business" when a shareholder receives such stock at "original issuance" in exchange for money or other property or as compensation for services rendered to the corporation. IRC §1202(c). This means that stock in S corporations and equity in other pass-through entities do not qualify for the QSBS exclusion. Although the default entity choice for new businesses is often a pass-through entity, practitioners should consider the underlying business activities when forming a new entity. If the business is a "qualified small business," the dreaded double taxation associated with a C corporation may well be worth considering because, on disposition of the entity's stock, no tax will be incurred.

When an individual purchases shares of a C corporation from a prior shareholder, those shares will lose their QSBS status. However, as described below under "Tax-Free Transfers of QSBS," most tax-free transactions, including transfers by gift, at death, or in an IRC §368 reorganization, preserve QSBS status.

Stock for QSBS purposes must be actual shares of C corporation stock. Stock acquired through the exercise of options or warrants, or through the conversion of convertible debt, can be QSBS, but only at the time of exercise or conversion. H Rep No. 111, 834, 103d Cong, 1st Sess (1993).

Limitations on Redemptions of QSBS

To enforce the requirement that stock be "newly issued," IRC §1202(c)(3) imposes restrictions on redemptions of C corporation stock. Stock acquired by a shareholder is not QSBS if, in one or more purchases during the 4-year period beginning on the date 2 years before the issuance of the stock, the issuing corporation purchases more than a de minimis amount of its stock from the taxpayer (or from a person related to the taxpayer). Treas Reg §1.1202-2(a)(1). Similarly, stock is not QSBS if, in one or more purchases during the 2-year period beginning on the date 1 year before the issuance of the stock, the issuing corporation purchases more than a de minimis amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of the issuing corporation's stock as of the beginning of such 2-year period. Treas Reg §1.1202-2(a)(2).

Congress established these redemption limitations as an "anti-churning" mechanism. See Preamble to Treas Reg §1.1202-2, TD 8749. Otherwise, shareholders could simply redeem their shares back to a corporation (and enjoy the gain exclusion), after which the shares could be issued to new shareholders as an original issuance and those new shareholders could later sell and benefit from the gain exclusion. Notwithstanding the general redemption limitations, redemptions of a shareholder's stock are permitted (and won't cause a company's other shares to lose their potential QSBS status) in the case of termination of services, death, disability or mental incompetency, or divorce of a shareholder. Treas Reg §1.1202-2(d).

Requirements for Qualified Small Businesses

Only shares of stock in a C corporation may qualify as QSBS. However, in order for the shares to be QSBS, that C corporation itself must also be a "qualified small business" that meets the active business test during "substantially all of the taxpayer's holding period for such stock." IRC §1202(a). As described above, there are no filing requirements with the IRS (either by a shareholder or the company) to ensure that a C corporation is a qualified small business. Instead, practitioners will offer opinion letters or other written guidance to corporations and their shareholders outlining the periods for which the qualified small business designation is met. Similarly, in venture capital financings, stock purchase agreements will often include a representation and warranty that the company is a qualified small business. But the paucity of IRS administrative guidance (as well as the lack of bright-line rules in the statute itself) leave many unanswered questions about whether a corporation is truly a "qualified small business" that meets the active business test.

Qualified Small Business

A C corporation is a qualified small business if, at the time the shares are issued, its gross assets are not greater than $50,000,000. IRC §1202(d). If the gross assets of the corporation exceed $50,000,000 after the shares are issued, those shares won't lose their QSBS designation. But once that corporation hits the valuation cap of $50,000,000, newly issued shares will not be QSBS.

Internal Revenue Code §1202(d) provides that in calculating the $50,000,000, the amount of cash and the aggregate adjusted bases of other property held by the corporation, over the aggregate amount of short-term indebtedness of the corporation, cannot exceed $50,000,000. For this purpose, cash or property received by the corporation as part of the stock issuance is taken into account. IRC §1202(d)(2). In addition, when a corporation owns more than 50 percent of the vote or value of a subsidiary, that subsidiary's assets are attributed to the parent corporation in calculating whether the parent corporation has exceeded the $50,000,000 gross assets test.

Active Business Test

Apart from the gross assets test, shares of a corporation qualify as QSBS only if, during substantially all of the taxpayer's holding period for such stock, at least 80 percent of the assets of the corporation are used in the active conduct of one or more "qualified trades or businesses." IRC §1202(e)(1). In general, a qualified trade or business is any trade or business other than one "involving the performance of services" in specified fields or one "the principal asset of [which] is the reputation or skill of 1 or more of its employees." IRC §1202(e)(3). In other words, IRC §1202 only tells taxpayers what does not count as a qualified trade or business. Under IRC §1202(e)(3), the proscribed fields or industries include

- Health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services;
- Banking, insurance, leasing, financing, investing, or similar business;
- Farming business (including the business of raising or harvesting trees); and
- Any business of operating a hotel, motel, restaurant, or similar business.

In addition, IRC §1202(e)(5) makes clear that when more than 10 percent of a corporation's assets consists of portfolio stock or securities in third party corporations, the corporation will not meet the active business test. Similarly, IRC §1202(e)(7) provides that when more than 10 percent of a corporation's assets consists of real estate, the real estate must be used as part of a qualified active trade or business. The mere ownership of, dealing in, or renting of real property will not meet the active business test.

Before 2014, the IRS had never provided affirmative guidance regarding which activities are qualified trades or businesses. However, as described in greater detail below under "IRC §§1202 and 1045 Administrative Guidance," in May 2014, the IRS released Letter Ruling 201436001 (May 22, 2014), which provides a liberal interpretation of the "qualified trade or business" test. The letter ruling, although not precedential, gives the taxpayer a good argument that as long as the corporation is engaged in the manufacture of some tangible or intangible property, that business is likely a "qualified trade or business." This is true even if significant skill and reputation are required to produce the property.

For corporations early in their life cycle, IRC §1202(e) does provide special rules for meeting the "active conduct" element of the qualified trade or business requirement. If, in connection with any future qualified trade or business, a corporation uses assets in certain start-up activities, research and experimental activities, or in-house research activities, the corporation is treated as using such assets in the active conduct of a qualified trade or business. IRC §1202(e)(2). Similarly, assets that are held to meet reasonable working capital needs of the corporation, or are held for investment and are reasonably expected to be used within 2 years to finance future research and experimentation, are treated as used in the active conduct of a trade or business. IRC §1202(e)(6). With respect to assets held for investment and reasonably expected to finance future research, the corporation must use at least 50 percent of such assets in the actual conduct of a trade or business once the corporation has been in business for 2 years. IRC §1202(e)(6).

Ownership of QSBS Through Other Entities

The QSBS exclusion applies only to shares of C corporation stock issued by a qualified small business. However, ownership of QSBS is not confined to individuals. Gain from the disposition of QSBS by an LLC, partnership, trust, or S corporation is also eligible for the exclusion, provided that (IRC §1202(g))

- All eligibility requirements with respect to qualified small business stock are met;
- The stock was held by the entity for more than 5 years; and
- The owner of the entity held his or her interest in that entity on the date the entity acquired the stock and at all times thereafter and before the disposition of the stock.

Note, however, that a member, partner, or shareholder cannot exclude gain received from an entity to the extent that the member's, partner's, or shareholder's share in the entity's gain exceeded the member's, partner's, or shareholder's interest in the entity at the time the entity acquired the stock. IRC §1202(g)(3). In addition, QSBS cannot be owned by a C corporation; it can only be owned by a taxpayer "other than a corporation." IRC §1202(a)(1).

Because the 100 percent exclusion is now available for QSBS, practitioners should carefully consider the pass-through ownership provision of §1202(g). For example, when a taxpayer owns a variety of entities, including S corporations, and hopes to create a holding company, special care should be taken so that the QSBS exclusion is not lost. Often the knee-jerk reaction is to convert C corporations to S corporations and make QSub elections to hold each of the entities under a parent S corporation. See Treas Reg §§1.1361-2, 1.1361-3. However, if a C corporation meets the active business test, practitioners should consider whether the potential 100 percent gain exclusion outweighs the decision to convert a C corporation to an S corporation and make the QSub election.

Tax-Free Transfers of QSBS

A particularly interesting feature of IRC §1202 is the various advantages afforded QSBS owners on the tax-free transfer of their shares. For example, IRC §1202(h)(1) provides that when QSBS is transferred by gift or at death, the transferee is treated as having acquired the QSBS in the same manner as the transferor and as having held the stock during any continuous period immediately preceding the transfer during which it was held by the transferor.

Although each taxpayer is only allowed to exclude up to $10 million or ten times his or her basis, IRC §1202(h)(1) allows holders of QSBS to multiply the excludable amount through gifts or at death.

Example

Assume a mother has $20 million worth of QSBS (with a zero basis) and has held it for 5 years. If she sells it, she can exclude only $10 million of gain. However, if she gifts $10 million of the QSBS to her daughter, she and her daughter can each sell $10 million of the QSBS, allowing them to avoid tax on the whole $20 million. Oddly, with the tacked holding period, it appears the mother can gift the QSBS to her daughter on the 364th day of the 4th year of her holding period, and on the next day, the daughter should be able to sell the QSBS and enjoy the §1202 exclusion.

The QSBS provisions are also very beneficial in the context of tax-free reorganizations. When QSBS is transferred for other stock in an IRC §368 reorganization (or an IRC §351 exchange), the transferor treats the new stock received as QSBS, even if the new stock is not actually in a qualified small business. IRC §1202(h)(4). The holding period of the original QSBS is also added to the new stock received.

Example

Assume that a taxpayer is the founder of a start-up internet company that is a qualified small business under IRC §1202. In year 6 of the company's existence, the founder's shares are worth $8 million. Microsoft approaches the start-up internet company and proposes to acquire all of its stock, including the founder's shares, in a stock-for-stock B reorganization that would be tax-free under IRC §368(a)(1)(B). The reorganization occurs and the founder receives $8 million of Microsoft stock. Then in year 7, when the founder's Microsoft shares are worth $10 million, he sells. In accordance with IRC §1202(h)(4), the founder can exclude $8 million of gain on the $10 million of Microsoft shares sold because the Microsoft stock that corresponds to the founder's original start-up QSBS retains its QSBS character, despite the fact that Microsoft is not itself a qualified small business.

While most tax-free transfers of stock preserve the QSBS character of the shares, taxpayers should carefully vet transfers of QSBS to partnerships or LLCs. When a partner or member transfers QSBS to a partnership or LLC in accordance with IRC §721, Treas Reg §1.1045-1(i), Example 12, appears to indicate that the contribution will remove the QSBS character of the transferred stock (even though the contribution itself is tax-free). See "Partnership QSBS Rollovers" below for more on QSBS owned by partnerships and other pass-through entities.

ROLLOVER OF GAIN FOR QUALIFIED SMALL BUSINESS STOCK

Rollover of QSBS Generally

In contrast to the gain exclusion under IRC §1202, which requires a 5-year holding period, IRC §1045 allows a taxpayer who has held QSBS for a mere 6 months to defer (rather than exclude) gain on the sale of that QSBS, provided the taxpayer purchases "replacement" QSBS within 60 days of the sale of the original QSBS. In other words, taxpayers who haven't held their QSBS for 5 years can still get a consolation prize of tax deferral on the sale of the shares (analogous to a §1031 exchange), even though they cannot obtain the complete gain exclusion.

The general qualification criteria of IRC §1202 apply to IRC §1045. For example, IRC §1045(b) provides that QSBS has the same meaning as in IRC §1202(c). Similarly, a taxpayer must elect to make the §1045 rollover by entering amounts deferred on Schedule D and Form 8949. The IRS previously issued Rev Proc 98–48, 1998–2 Cum Bul 367, with instructions for making the rollover election. However, the instructions for Schedule D (Form 1040) (Capital Gains and Losses) now provide guidance that is consistent with, but more detailed than, Rev Proc 98–48.

In the rollover context, a taxpayer will recognize taxable gain to the extent the amount realized on the sale of the original QSBS exceeds the cost of the replacement QSBS. Any gain not recognized (because of the valid rollover) reduces the shareholder's cost basis in the replacement QSBS.

Example

Assume that an investor has held QSBS with a basis of $1000 for 1 year. She sells the QSBS for $5 million and reinvests $3 million in new QSBS within 60 days. She recognizes $1,999,000 of long-term capital gain, and her basis in the replacement QSBS is $1000. She is able to defer gain on the remaining $3 million in proceeds from the stock sale.

In the fast-moving tech world of Silicon Valley, it is rare for companies to have life cycles as long as 5 years. For this reason, IRC §1045 is particularly important for founders and start-up employees. Many investors in Silicon Valley simply roll an investment in one small company over into a new small company. Because of §1045's flexibility, these investors can effectively defer gain indefinitely by selling their QSBS and investing in new QSBS within 60 days. When an investment may ultimately have some longevity, nothing prevents these investors from holding the QSBS for 5 years and enjoying the 100 percent gain exclusion.

Partnership QSBS Rollovers

Very few regulations have been issued on IRC §§1202 and 1045 generally, but Treas Reg §1.1045-1 consists of voluminous regulations and examples regarding the application of IRC §1045 to partnerships (including LLCs) and their partners (or members). Since the Treasury Department and the IRS have issued so little guidance about the operation of IRC §§1202 and 1045, it is surprising that such detailed regulations exist regarding such a relatively obscure application of the statute.

The regulations provide three general rules for the application of the IRC §1045 rollover for partnerships and their partners. First, when a partnership sells QSBS held for 6 months and purchases replacement QSBS, the individual partners themselves are treated as deferring the gain on the sale of the original QSBS. Treas Reg §1.1045-1(b). Second, a taxpayer who sells QSBS can meet the 60-day reinvestment requirement if a partnership (or LLC) of which he or she is a partner (or member) purchases QSBS within the requisite reinvestment period. Treas Reg §1.1045-1(c). Third, when a partnership sells QSBS, each partner may individually purchase replacement QSBS within the 60-day rollover period and defer gain on the sale of the partnership's original QSBS. Treas Reg §1.1045-1(c).

Given the pass-through nature of partnerships, the rules provided at Treas Reg §1.1045-1 make perfect sense. However, for practitioners dealing with private equity or venture capital funds or other investment vehicles established as partnerships, these rules may provide particularly valuable advantages. If an investor in a fund has adequate information and knows that the fund is going to dispose of QSBS not held for 5 years, that investor could purchase replacement QSBS and defer gain on the QSBS originally held by the fund. This would be true even if other investors in the fund did not make similar investments in the replacement QSBS.

CASE LAW AND ADMINISTRATIVE GUIDANCE

Internal Revenue Code §§1202 and 1045 provide clear benefits to taxpayers; however, there is surprisingly little case law and administrative guidance to help taxpayers take advantage of these rules. The lack of guidance may be due in part to the fact that QSBS shareholders could only obtain the 100 percent exclusion beginning in September 2015. Presumably more cases and IRS guidance will develop as more taxpayers begin to claim the exclusion. As of this writing, however, only three Tax Court cases and seven pieces of IRS administrative guidance exist to help taxpayers determine whether they qualify for QSBS treatment.

IRC §§1202 and 1045 Case Law

The three Tax Court cases regarding QSBS are helpful in showing exactly how a taxpayer should not seek to defer or claim an exclusion from gain on the sale of QSBS. In fact, the taxpayers in each case made strained—if not outright desperate—arguments that their shares qualified as QSBS. But the three cases all help demonstrate which criteria the Tax Court and, presumably, the IRS will use when reviewing a claim for exclusion or deferral of gain under IRC §§1202 and 1045.

In *Natkunanathan v Commissioner,* TC Memo 2010-15, aff'd (9th Cir 2012) 479 Fed Appx 775, the taxpayer owned options on stock of a C corporation, Cognet, which were converted to options on Intel stock after a merger in 2001. The taxpayer exercised his Intel options and sold the Intel stock 2 years after the merger (in 2003), taking the position that the Intel stock qualified as QSBS. The taxpayer sought to exclude 50 percent of the gain under IRC §1202(a)(1) by arguing that the Intel options acquired in the merger retained the QSBS character of Cognet under an equivalent provision of IRC §1202(f).

[S]tock in S corporations and equity in other pass-through entities do not qualify for the QSBS exclusion.

The Tax Court dismissed the taxpayer's arguments on a number of grounds. First, the taxpayer was unable to show that Cognet was a "qualified small business" under IRC §1202(d) or that the taxpayer had held his interest in Cognet (or Intel) for 5 years. Second, the Tax Court pointed out that the legislative history of IRC §1202 makes clear that the QSBS rules apply only to *stock* held for 5 years, not options. The taxpayer had not sold Cognet stock (which might have been QSBS). In fact, the taxpayer had sold his Intel stock 1 day after he exercised his Intel options. Therefore, he had held that stock "at most . . . 1 day" rather than the required 5 years. Of course, even if that taxpayer had held the Intel stock for 5 years, he still couldn't have proved that Intel met the $50 million gross asset test for QSBS qualification.

The two other Tax Court cases involve taxpayers who sought unsuccessfully to show that they qualified for gain deferral under IRC §1045. In *Owen v Commissioner,* TC Memo 2012-21, taxpayers owned interests in a variety of companies, among them a C corporation named Family First Advanced Estate Planning (FFAEP), which sold "prepaid legal service policies, including estate planning services." TC Memo 2012-21 at *8. On June 17, 2002, the taxpayers sold FFAEP and, seeking to defer gain under IRC §1045, formed a retail jewelry business, J & L Gems, on August 12, 2002. The taxpayers contributed close to $2 million to J & L Gems from the proceeds of the FFAEP stock sale.

During its first 6 months of business, J & L Gems purchased 16 pieces of jewelry for approximately $150,000. By July 2003, J & L Gems had only sold six pieces of jewelry for $12,000, some to individuals or entities related to the taxpayers. As of August 2004 (2 years after its formation), J & L Gems apparently had not purchased any more jewelry or made any more sales.

The Tax Court ruled that the taxpayers could not defer gain under IRC §1045 because J & L Gems was never engaged in an "active trade or business" within the meaning of IRC §1202(e). The case itself illuminates much of the confusion associated with QSBS.

First, with much explanation, the Tax Court ruled that FFAEP was a qualified small business that met the active business test under IRC §1202(e). The Tax Court determined that while the success of FFAEP was properly attributable to the taxpayers (TC Memo 2012-21 at *52),

> the principal asset of the companies was the training and organizational structure; after all, it was [the Taxpayers] in their commission sales hats, who sold the policies that earned the premiums, not [their] personal capacity.

The court appeared to ignore evidence that FFAEP was in the legal and insurance businesses, neither of which are qualified trades and businesses under IRC §1202(e). Presumably, the taxpayers were able to convince the court that, notwithstanding the nature of the company's business, FFAEP's principal asset was not "the reputation or skill of 1 or more of its employees." IRC §1202(e)(3)(a).

IRC §1045 allows a taxpayer who has held QSBS for a mere 6 months to defer (rather than exclude) gain on the sale of that QSBS, provided the taxpayer purchases "replacement" QSBS within 60 days of the sale of the original QSBS.

The Tax Court also agreed that the taxpayers met the 60-day rollover requirement to invest gains from the sale of FFAEP (a qualified small business) in J & L Gems (a putative qualified small business) under IRC §1045. But the court found that J & L Gems did not constitute a qualified trade or business since "92 percent of J & L Gems' assets were held in cash" (TC Memo 2012-21 at *54) and were not actively used in a trade or business. Recall that under IRC §1202(e)(6), a C corporation may meet the "active business" test even when its assets are held for its "reasonably required working capital needs" during the company's first 2 years of existence. After the second year, at least 50 percent of the assets must be actively used in a qualified trade or business. In the case of J & L Gems, the taxpayers had spent only 8 percent of their initial investment after 2 years. This was simply too little for the Tax Court to conclude that the taxpayers were actively conducting a jewelry business.

In this respect, *Owen* provides a cautionary tale for taxpayers who hope to rely on the working capital and investment exception to the active trade or business test under IRC §1202(e)(6). Like the taxpayers in *Owen,* many investors will sell QSBS, form a new C corporation with the proceeds from the original QSBS, and essentially let that corporation sit dormant for 2 years. If, immediately before year 3, the corporation begins to engage in a qualified trade or business, the taxpayers may adopt the position that the corporation should meet the qualified trade or business requirement and, after 5 years, the sale of the stock should qualify for the exclusion under IRC §1202. *Owen* makes clear that taxpayers must be very careful to ensure that they actually put their reinvested stock proceeds to work within the required time frame to meet the IRC §1202(e)(6) safe harbor.

The final case involving IRC §§1045 and 1202 demonstrates the many pitfalls for taxpayers who don't adequately plan for QSBS rollovers. In *Holmes v Commissioner,* TC Memo 2012-251*,* aff'd (9th Cir 2015) 593 Fed Appx 693, the taxpayer cofounded two companies, MacroPore and LeonardoMD. Between 2000 and 2004, the taxpayer sold more than $3 million worth of MacroPore shares and make 36 separate investments in LeonardoMD. The taxpayer, apparently advised by a friend that the IRC §1045 rollover was available, omitted the gain from the MacroPore stock sales on his return.

The taxpayer's accountant attempted to bribe the revenue agent examining the MacroPore sales, and then the taxpayer's legal counsel requested a late IRC §1045 election under Treas Reg §301.9100-1. The taxpayer finally ended up in Tax Court arguing that LeonardoMD was a qualified small business and he had properly rolled over the proceeds of the MacroPore to LeonardoMD. The Tax Court had little sympathy for the taxpayer. First, the taxpayer provided no evidence to demonstrate that he had received the shares of LeonardoMD at original issuance as required under IRC §1202(c). In fact, the taxpayer testified that he had purchased the shares from the president of LeonardoMD, rather than directly from the company. Second, the taxpayer provided no evidence that the value of LeonardoMD was less than $50 million, apart from a claim that he had "looked at its corporate financial documents." TC Memo 2012-251 at *22. Finally, the taxpayer failed to provide any evidence showing that LeonardoMD met the active business requirement under IRC §1202(e).

In short, the Tax Court found that the taxpayer could not demonstrate that LeonardoMD was a qualified small business under IRC §1202, so the court did not even reach the question of whether the taxpayer could have properly rolled over proceeds from the MacroPore stock sale in accordance with IRC §1045.

IRC §§1202 and 1045 Administrative Guidance

Apart from the Tax Court cases, only six IRS Letter Rulings and one IRS Chief Counsel Advice Memo address QSBS issues (no revenue rulings or other administrative guidance exist). Of course, IRS Letter Rulings and Chief Counsel Advice are not precedential. IRC §6110(k)(3). However, they provide useful insight into how the IRS may address particular factual situations. The existing guidance breaks down into four general categories:

(1) Situations when the IRS might agree to a late IRC §1045 election under Treas Reg §301.9100-2 and §301.9100-3;

(2) The effect of the IRC §1202 excluded gain on the 6-year extended statute of limitations;

(3) The potential for stock to retain QSBS character in tax-free reorganizations; and

(4) The definition of an active trade or business under IRC §1202(e).

Late IRC §1045 Rollovers

Internal Revenue Service Letter Rulings 200521021 (May 27, 2005), 200604004 (Jan. 27, 2006), and 200906009 (Feb. 6, 2009) provide contrasting examples of taxpayer requests for late elections to defer gain under IRC §1045. In general, Treas Reg §§301.9100-1–301.9100-3 allow taxpayers to request an extension of time to make a regulatory election, such as the rollover provided in IRC §1045. Section 301.9100-3(a) states that requests for relief will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if, among other things, the taxpayer (1) requests relief before failure to make the regulatory election is discovered by the IRS or (2) reasonably relied on a qualified tax professional who failed to make, or failed to advise the taxpayer to make, the election. Treas Reg §301.9100-3(b)(1).

In IRS Letter Ruling 200521021, the taxpayers succeeded in demonstrating that they were entitled to make a late §1045 election. The taxpayers sold QSBS and reinvested in new QSBS within 60 days. However, their accountants failed to recognize that the gain could be deferred under §1045. Since the taxpayers had not yet been audited and the only change to their return would have been the §1045 deferral (for which they would have qualified), the IRS granted the taxpayers an extension to make the election and allowed them to file amended returns deferring the gain.

In contrast, the IRS denied late elections in the other two rulings. In Letter Ruling 200604004, the taxpayers could not demonstrate that they relied on advice of the return preparer in failing to make the §1045 election. In Letter Ruling 200906009, the taxpayer sought to make the late election after the IRS had already commenced an audit of the tax years in question. The taxpayer also sought to use the §1045 rollover argument only after the IRS found that he could not substantiate his capital losses and zero-gain reporting positions.

Statute of Limitations and Excluded Gain Under IRC §1202

In general, the IRS must assess tax within 3 years after a taxpayer files his or her tax return. IRC §6501(a). However, IRC §6501(e)(1) provides that if the taxpayer omits from gross income an amount that is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed at any time within 6 years after the return was filed. IRS Chief Counsel Advice Memo 200609024 (Mar. 3, 2006) considers whether gain excluded under IRC §1202 should be counted when determining whether a taxpayer has omitted more than 25 percent of his or her gross income.

Citing *Maloy v Commissioner* (1941) 45 BTA 1104, the Advice Memo concludes that "gross income" for purposes of IRC §6501(e) does not include the portion of capital gain excluded by IRC §1202. With the 100 percent exclusion now available for QSBS, Advice Memo 200609024 may be an important piece of guidance for taxpayers. If a taxpayer properly excludes a significant amount of gross income under §1202, these excluded amounts will not be counted in determining whether a taxpayer has omitted more than 25 percent of his or her gross income, and the IRS is not entitled to the 6-year statute of limitations to assess tax.

QSBS and Tax-Free Reorganizations

In the context of tax-free reorganizations, two IRS Letter Rulings describe scenarios involving IRC §1202(h) and show how the QSBS benefits can be preserved even after a reorganization. Letter Ruling 9810010 (Dec. 3, 1997) involved a divisive D reorganization (under IRC §§368(a)(1)(D) and 355), in which a qualified small business (Distributing) formed a new corporation (Controlled), dropped one of Distributing's lines of business into Controlled, and then spun Controlled off to certain Distributing shareholders in exchange for the Distributing stock. The Letter Ruling indicates that the Controlled stock received by Distributing shareholders would be treated as QSBS under IRC §1202(h)(4)(A). In addition, shareholders of Controlled could tack their holding period for the Controlled stock to their prior holding period for the Distributing stock. The Letter Ruling shows that as long as a qualified small business exists, a divisive D reorganization should not undermine the potential IRC §1202 exclusion or IRC §1045 deferral benefits, even if that qualified small business is broken up as part of the reorganization.

In Letter Ruling 201603010 (Jan. 15, 2016) (reduplicated at IRS Letter Rulings 201603011–201603015), the IRS examined an F reorganization (IRC §368(a)(1)(F)) involving the change in form of an entity. The shareholders of a C corporation, which was a qualified small business under IRC §1202, converted the corporation to an LLC but checked the box so that the LLC would continue to be taxed as a corporation. The Letter Ruling states that under IRC §1202(h)(3), by reference to IRC §1244(d)(2), a successor corporation in an F reorganization is treated as the same corporation as its predecessor. Therefore, the Letter Ruling concludes, the original stock of the corporation retains its QSBS characteristics even after its conversion to an LLC.

Active Trade or Business Under IRC §1202

Finally, IRS Letter Ruling 201436001 (Sept. 5, 2014) provides the most valuable IRS administrative guidance regarding QSBS. The Letter Ruling considers whether a corporation meets the "qualified trade or business" requirement of IRC §1202(e)(3) and is a qualified small business. Recall that IRC §1202(e)(3) only defines what are not qualified trades or businesses. Under this definition, most service-related businesses—including restaurants, hotels, and businesses providing legal or medical services—are not qualified trades or businesses. In addition, a business the principal asset of which is the reputation or skill of one or more of its employees is not a qualified trade or business.

Letter Ruling 201436001 (2014 PLR Lexis 597) involved a business that, while arguably engaged in one or more of the proscribed industries (health and consulting), still met the requirements to be a qualified trade or business under IRC §1202(e)(3). The corporation provided products and services in the pharmaceutical industry, working with clients to commercialize experimental drugs. Its business activities consisted specifically of (1) research on drug formulation effectiveness; (2) pre-commercial testing procedures, such as clinical testing; and (3) manufacturing of drugs. In addition, the corporation worked with clients to solve problems in the pharmaceutical industry, such as developing successful drug manufacturing processes. The corporation used its manufacturing and clinical facilities, as well as its intellectual property assets, to perform services for clients.

The Letter Ruling concludes that the corporation was engaged in a qualified trade or business for purposes of IRC §1202 because it was not in the business of "offering service in the form of individual expertise." 2014 PLR Lexis 597 at *4. Rather, the company created value for its customers using its specific manufacturing assets and intellectual property. According to the IRS, the corporation was "a pharmaceutical industry analogue of a parts manufacturer in the automobile industry." 2014 PLR Lexis 597 at *4.

This recent Letter Ruling is good news for taxpayers who are concerned that their corporations may not meet the qualified trade or business requirement. Even if a company is ostensibly engaged in one of the trades or businesses proscribed by IRC §1202(e)(3), it appears that it can still be a qualified small business if it uses its assets—whether tangible or intangible—as part of the services provided to its customers. As more taxpayers seek to exclude gain under §1202, this Letter Ruling will serve as a valuable reference point in helping to establish that a service-related company is a qualified trade or business.

CONCLUSION

With the current 100 percent exclusion from gain for QSBS held for more than 5 years, the advantages of IRC §1202 are hard to overstate. Business and tax advisors should be on the lookout for avenues to maximize the QSBS benefits for their clients. This is especially true in California, where many founders and their investors may be forming and funding qualified small businesses under §1202.

However, the paucity of case law and administrative guidance leaves many questions unanswered about how the QSBS rules will apply in untested situations. Practitioners should counsel their clients carefully on meeting the QSBS requirements, bearing in mind the existing case law and administrative guidance described in this article.