Section 1202:

Qualified Small Business Stock

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David B. Strong
Partner
Denver
david.strong@wilmerhale.com
+1 720 598 3469

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I. Executive Summary

This article provides general information regarding U.S. federal income tax incentives available to non-corporate holders of "qualified small business stock" ("QSB stock") as defined under Section 1202 of the Internal Revenue Code.[1]

In general, under current law, Section 1202 allows a non-corporate taxpayer to potentially exclude up to 100% of the amount of eligible gain realized from the sale or exchange of QSB stock held for more than five years.

The amount of gain that is eligible for exclusion by a taxpayer with respect to QSB stock held in a particular corporation is subject to an annual limitation equal to the greater of either:

> (i) $10 million (reduced by the aggregate amount of eligible gain taken into account by the taxpayer in prior taxable years with respect to dispositions of QSB stock of such corporation); or
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> (ii) 10 times the aggregate adjusted bases of QSB stock issued by such corporation and disposed of by the taxpayer during the taxable year.

In addition, Section 1045 allows a taxpayer to potentially roll-over gain from the sale of QSB stock that has been held for more than 6 months.

A. General Benefits and Eligibility

1. Potential 100% Exclusion for Stock Acquired After September 27, 2010

Section 1202 was originally enacted as part of the Omnibus Revenue Reconciliation Act of 1993 in order to encourage investments in small businesses.[2]

Pursuant to Section 1202(a)(4), the exclusion percentage for newly issued QSB stock is currently 100%, coupled with a corresponding 100% exclusion for alternative minimum tax

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[1] Unless otherwise specified, all "Section" references are to the U.S. Internal Revenue Code of 1986, as amended (the "Code"), or applicable Treasury Regulations promulgated thereunder.

[2] *See generally,* Pub. Law No. 103-66 (Aug. 10, 1993). The House Committee report accompanying the passage of Section 1202 specifically noted: "The committee believes that targeted relief for investors who risk their funds in new ventures, small businesses, and specialized small business investment companies, will encourage investments in these enterprises. This should encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing." H.R. Rep. No. 103-111, 600 (1993). Similarly, during a Senate hearing on the enactment of Section 1202, Senator Kerry of Massachusetts stated: "We want to reward the startup entrepreneur who will commercialize the next generation of technology in the United States, whether in artificial intelligence, microelectronics, biotechnology, advanced materials, or environmental engineering." 138 Cong. Rec. 27819 (1992).

("AMT") purposes. Excluded gains under Section 1202(a)(1) are also not subject to the 3.8% Medicare tax imposed under Section 1411.[3]

Historically, Section 1202 provided for other exclusion percentages (in general, 50% or 75%), depending on when a taxpayer's QSB stock was issued and the type of business conducted by the issuing corporation.[4] In addition, the excluded portion of a taxpayer's eligible gain was treated as a preference item that had to be added back to a taxpayer's taxable income for AMT purposes (in general, typically subject to a 7% add-back under Section 57(a)(7) and a maximum rate of 28%). The amount of a taxpayer's eligible gain that was not excluded under Section 1202(a)(1) was also generally subject to tax at a 28% rate (which was higher than otherwise prevailing capital gains rates).[5]

For additional details regarding the historic exclusion percentages, and resulting effective tax rates, that applied to QSB stock issued under old law (prior to September 28, 2010), see Part VI.A of this article.

2. Stock Held by a Non-Corporate Taxpayer In a Qualifying C-Corp.

In general, in order to qualify for the benefits of Section 1202 a non-corporate taxpayer must acquire and hold stock in a qualifying C-corporation. The benefits of Section 1202 do not directly apply to equity interests acquired and held in pass-through entities, such as S-corporations or partnerships. However, as discussed in more detail later in Part II.B.9 of this article, an individual taxpayer's allocable share of gain attributable to a sale of QSB stock by a pass-through entity may potentially qualify as gain eligible for the Section 1202 exclusion.

B. Overview of Requirements

There are four main requirements that must be satisfied before gain on the sale of stock is potentially eligible for the exclusion under Section 1202. Each of these requirements is briefly mentioned immediately below and then discussed in more detail in Parts II through V of this article.

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[3] The Section 1411 "net investment income tax" (or "NIIT") went into effect on January 1, 2013. In general, the NIIT applies at a rate of 3.8% to the "net investment income" of a taxpayer as defined in Section 1411(c). However, because Section 1202(a)(1) operates to completely exclude a percentage of a taxpayer's eligible gain from gross income, such excluded amount is not subject to the NIIT. *See generally,* Section 1411(c)(1)(A)(iii) and H.R. Rep. No. 103-213, 526 (1993) (Conf. Rep.) ("Any gain that is excluded from gross income under the bill is not taken into account in computing long-term capital gain or in applying the capital loss rules of sections 1211 and 1212.").

[4] Section 1202(a)(2) provided for a potential 60% exclusion for certain empowerment zone businesses.

[5] H.R. Rep. No. 103-213, 526 (1993) (Conf. Rep.) ("In addition, the taxable portion of the gain is taxed under section 1(h), which provides for a maximum rate of 28%.").

1. *Stock of a C-Corporation Acquired at "Original Issuance"*

Sections 1202(c)(1) (lead-in language) and (c)(1)(B) generally state that QSB stock means any stock held with respect to a C-corporation that is originally issued after the date of the enactment of the Revenue Reconciliation Act of 1993, if such stock is acquired by the taxpayer at "original issue" (directly or through an underwriter) in exchange for money or other property (not including stock), or as compensation for services performed for such corporation (other than services performed as an underwriter of such stock).

2. *Qualified Small Business Requirement*

Sections 1202(c)(1) (lead-in language) and (c)(1)(A) also generally require that as of the date of issuance the issuing corporation must be a "qualified small business."

3. *Active Business Requirement*

In general, pursuant to Section 1202(c)(2)(A), stock in a corporation shall not be treated as QSB stock unless, during substantially all of the taxpayer's holding period, such corporation meets the "active business requirements" of Section 1202(e) and such corporation is a C-corporation. Pursuant to Section 1202(c)(2)(B), this requirement is waived for certain specialized small business investment companies that are licensed to operate under Section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).

4. *Five-Year Holding Period*

Section 1202(b)(2) effectively requires that QSB stock must be held for more than five years in order for the amount of any gain realized from the sale or exchange of such stock to be eligible for the exclusion under Section 1202.

II. Stock of a C-Corporation Acquired at "Original Issuance"

A. Stock of a C-Corporation

For purposes of Section 1202(c)(1), the issuing corporation must be a C-corporation. In addition, it should be noted that for purposes of the "active business requirement" of Section 1202(e) the issuing corporation must also be an "eligible corporation" as defined in Section 1202(e)(4). Section 1202(e)(4) defines an "eligible corporation" as any domestic corporation other than: (i) a DISC (a "domestic international sales corporation" as defined in Section 992(a)) or former DISC; (ii) a RIC (regulated investment company), REIT (real estate investment trust), or REMIC (real estate mortgage investment conduit); and (iii) a cooperative.

B. "Original Issuance" Requirement.

1. In General

Pursuant to Section 1202(c)(1)(B), QSB stock must generally be acquired at "original issue" (directly or through an underwriter) in exchange for money or other property (other than stock), or as compensation for services performed for such corporation (other than services performed as an underwriter of such stock).[6]

2. The Concept of "Property"

For purposes of Section 1202(c)(1)(B), the concept of "property" should be consistent with prevailing judicial and administrative authorities that define the term "property" for purposes of exchanges under Section 351(a).[7]

Although the Code does not specifically define the term "property" for purposes of Section 351(a),[8] courts have generally adopted a broad definition so as to encompass virtually anything that can be "*identified, valued, and transferred*."[9]

However, in the case of intangible property, it should be noted that the historical litigating position of the Internal Revenue Service ("IRS") reflects a relatively narrow view that the

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[6] Section 1202(c)(1) (lead-in language) also requires that the stock be issued after the date of the enactment of the Revenue Reconciliation Act of 1993 (*i.e.,* after August 10, 1993).

[7] Section 1202(h)(4) contains several general references to Section 351, but there is no specific statutory definition of "property" for purposes of Section 1202. However, given that a transfer of an appreciated asset to a corporation in exchange for stock would need to satisfy the "property" requirement of Section 351 in order to be non-taxable, it does not seem possible that Congress intended for a taxpayer to be subject to a different requirement for purposes of Section 1202.

[8] The term "property" is only generally defined in the Code and Treasury Regulations by negative implication. In particular, pursuant to Section 351(d) and Treas. Regs. §§ 1.351-1(a)(1)(i) and (ii), stock that is issued in exchange for the following shall not be considered as issued in exchange for property: (i) services; (ii) indebtedness of the transferee corporation which is not evidenced by a security; or (iii) interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt.

[9] *See* U.S. v. Stafford, 727 F.2d 1043, 1052 (11th Cir. 1984) ("Although the Internal Revenue Code does not define property for purposes of § 721 or § 351, the courts have given the term rather broad application."); H.B. Zachary Co. v. Commissioner, 49 T.C. 73, 80 (1967) ("Sec. 351 does not contain a definition of the term "property." However, the known inclusions and exclusions strongly suggest that the term encompasses whatever may be transferred."); Hempt Bros., Inc. v. U.S., 409 F.2d 1172, 1176 (3rd Cir. 1974) ("Receivables possess the usual capabilities and attributes associated with jurisprudential concepts of property law. They may be identified, valued, and transferred."); E.I. du Pont de Nemours & Co. v. U.S., 471 F.2d 1211, 1218 (Ct. Cl. 1973) ("Unless there is some special reason intrinsic to the particular provision (as there is with respect to capital assets), the general word 'property' has a broad reach in tax law."); GCM 37178 (1977) ("Courts have advocated a rather generous definition of property for purposes of Code § 351. Nonrecognition treatment under the provision has been granted to transfers of inventory, of accounts receivable, of 'know-how,' and of non-exclusive patent rights. All of the above things possess several attributes associated with jurisprudential concepts of property law, i.e., each may be 'identified, valued, and transferred.') [Citations omitted].

transferor must transfer “all substantial rights” to the property to satisfy the requirements of Section 351.

For example, in Rev. Rul. 69-156,[10] the IRS held that the grant to a corporation of the exclusive right to import, make, use, sell, and sublicense a chemical compound under a patent will constitute a contribution of property within Section 351 only if the grant of those same rights in a taxable transaction would constitute a sale or exchange, which requires the transferor to relinquish all substantial rights, rather than merely a license.[11] Similarly, in Rev. Rul. 71-569,[12] the IRS held that a transfer of rights to a patent for a period less than the remaining statutory length of the patent does not satisfy the requirements of section 351 because the transferor has retained a remainder interest in the patent and therefore did not transfer “all substantial rights” to the property.[13]

Nevertheless, assuming “all substantial rights” to an intangible have clearly been transferred, it is also important to note that judicial and administrative authorities have generally been relatively taxpayer friendly and held that “inchoate” intangible assets (such as a non-binding letter of intent) or otherwise highly amorphous intangible assets (such as goodwill) may qualify as “property” for purposes of Section 351.

In particular, in *U.S. v. Stafford*,[14] a letter of intent outlining a proposed loan was transferred to a partnership in return for a limited partnership interest in the transferee entity. The Court of Appeals for the Eleventh Circuit held that the transfer met the requirements of Section 721, despite the fact that the letter of intent was not legally enforceable.[15] In so holding, the court relied on various factors, including the “morally” binding nature of the document, the transferor’s written acceptance of the essential terms of the letter, and the fact that the letter represented the transferor’s “full interest in the project.” According to the court, the absence of enforceability did not necessarily preclude a finding that the letter of intent, which substantially committed the parties to the major terms of a development project, constituted “property” for

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[10] 1969-1 C.B. 101.

[11] *See also,* FSA 1998-481 (October 7, 1998).

[12] 1971-2 C.B. 179.

[13] It should be noted that the IRS’ historical litigating position that “all substantial rights” to property must be transferred in order to qualify under Section 351 is a more restrictive view than that of several courts. For example, in E.I. du Pont de Nemours & Co. v. U.S., 471 F.2d 1211, 1218 (Ct. Cl. 1973), the United States Court of Claims held that a “carved out” right to a nonexclusive license would qualify for non-recognition treatment under Section 351. In its holding, the court rejected the IRS’ stated position in Rev. Rul. 69-156 and held that there is no basis for limiting non-recognition under Section 351 to transfers that would constitute sales or exchanges under Section 1001.

[14] 727 F.2d 1043 (11th Cir. 1984).

[15] Section 721(a) generally provides that no gain or loss shall be recognized to a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

purposes of Section 721. In the course of rendering its decision, the court also specifically referred to Section 351 as the counterpart provision to Section 721 and applied principles set forth in cases that interpreted the "property" requirement under Section 351 to support its holding.

With respect to goodwill, in Rev. Rul. 79-288,[16] the IRS determined that the transfer of a certificate of registration of a corporate name, all rights under common law and an international treaty to use the corporate name, all goodwill associated with the corporate name, as well as goodwill existing independent of the corporate name, to a newly formed foreign corporation by a domestic corporation constituted a transfer of "property" for purposes Section 351(a).[17]

Moreover, the treatment of goodwill as "property" for Section 351(a) purposes is also consistent with Section 197, which provides rules for amortizing a wide variety of intangible assets, including goodwill. In particular, Section 197(f)(2) provides special rules relating to the amortization of intangible assets acquired in connection with certain non-recognition transactions, "including any transaction described in ... section 351." The specific reference to Section 351 within the context of Section 197(f)(2) makes it clear that intangible property that is subject to the amortization provisions of Section 197, such as goodwill, should constitute property for purposes of Section 351.

3. Restrictions on Redemptions

In order to prevent circumvention of the requirement that the stock be newly issued, the issuing corporation may not redeem its stock within specified time periods. Pursuant to Section 1202(c)(3), stock acquired by the taxpayer is not treated as QSB stock if the issuer purchased stock from the taxpayer, or a person related to the taxpayer (within the meaning of Section 267(b) or 707(b)), at any time during the 4-year period beginning two years before the issuance of such stock. In addition, stock issued by a corporation will not be QSB stock if, during the 2-year period beginning on the date one year before the issuance of such stock, such corporation made one or more purchases of its stock with an aggregate value exceeding 5% of the aggregate value of all of its stock as of the beginning of such 2-year period.[18]

[16] 1979-2 C.B. 139.

[17] Similarly, in Rev. Rul. 70-45, 1970-1 C.B. 17, the IRS ruled that a partner in a professional services firm may make a partial sale of goodwill to newly admitted partners, thereby realizing capital gain on the transaction. As a result, if a partial sale of the goodwill of a professional firm is possible, presumably a taxpayer may also contribute goodwill to the capital of corporation in a Section 351(a) transaction.

[18] It should also be noted that these restrictions are subject to certain exceptions for *de minimis* redemptions and redemptions triggered by a termination of the services of an employee or director, or by death, divorce, disability or mental incompetence. *See generally,* Treas. Reg. § 1.1202-2. In addition, in certain cases, if one corporation acquires stock of a related corporation from a shareholder, this may also be treated as a stock redemption for purposes of Section 1202. *See generally,* § 1202(c)(3)(C) and § 304.

4. *Partnership Transfers*

Section 1202(h)(1) provides, among other things, that in the case of a transfer described in Section 1202(h)(2), the transferee shall be treated as (i) having acquired such stock in the same manner as the transferor, and (ii) having held such stock during any continuous period immediately preceding the transfer during which it was held by the transferor.

Section 1202(h)(2) describes transfers including, among other things, transfers from a partnership to a partner of stock with respect to which requirements similar to the "requirements" of Section 1202(g) are met at the time of the transfer (without regard to the 5-year holding period requirement).[19]

5. *Section 83(b) Elections*

Although not directly addressed anywhere in the statute, the legislative history to Section 1202 makes it clear that stock received in connection with the performance of services is treated as issued by the corporation and received by the taxpayer when included in the taxpayer's gross income in accordance with the rules of Section 83.[20] As a result, if a service provider receives restricted stock and makes a Section 83(b) election with respect to such stock, the service provider is treated as acquiring the stock as of the effective date of the election and the determination as to whether the relevant requirements of Section 1202 are satisfied by the issuing corporation is performed as of the same date.

6. *Convertible Securities, Options, Warrants*

Although Section 1202(f) directly addresses only the treatment of stock acquired upon conversion of QSB stock, the legislative history to Section 1202 makes it clear that stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is also treated as acquired at original issue.[21]

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[19] It should be noted that the "requirements" of Section 1202(g) are set forth in Section 1202(g)(2). In addition, it should also be noted that the plain statutory language of Section 1202(g)(2) addresses the "requirements" applicable to an amount of gain recognized by a pass-through (such that if the "requirements" are satisfied, the holder of an interest in the pass-through may treat its allocable share of income as being attributable to the disposition of QSB stock). As a result, for purposes of Section 1202(h) (and in particular a transfer of QSB stock by a partnership to a partner as described in Section 1202(h)(2)(C)), the "requirements" of Section 1202(g)(2) must be adapted to match the appropriate context, such that the applicable "requirements" become: (i) the stock must have been QSB stock in the hands of the partnership; and (ii) the partner must have held an interest in the partnership on the date such partnership acquired the QSB stock and at all times thereafter before the transfer of the QSB stock by the partnership to the partner.

[20] *See generally,* House of Representatives Report of the Committee on the Budget to Accompany H.R. 2264, Report No. 103-111, 1993-3 C.B. 163 (July 1993), accompanying the Omnibus Budget Reconciliation Act of 1993, which ultimately added Section 1202 to the Code (hereinafter, the "House Committee Report").

[21] *See generally,* House Committee Report.

Furthermore, the determination as to whether the gross assets test is met is made at the time of exercise or conversion, and the holding period of such stock is treated as beginning at that time.[22]

In the case of convertible preferred stock, the legislative history to Section 1202 also makes it clear that the gross assets determination is made at the time the convertible stock is issued.[23]

7. Stock Acquired by Gift or Upon Death of Holder

Pursuant to Sections 1202(h)(2)(A) and (B), any stock acquired by gift or by death is QSB stock provided that the stock is QSB stock in the hands of the transferor.

8. Stock Received in Certain Corporate Transactions

In limited cases, if QSB stock in one corporation (the "Original Issuer") is exchanged for stock of another corporation, the stock received may be treated as QSB stock.[24] The transactions to which this rule applies are (i) reorganization transactions described in Section 368 (that is, the Original Issuer is acquired by another corporation (the "Acquiring Corporation") and one or more shareholders of the Original Issuer exchange QSB stock for Acquiring Corporation stock), and (ii) corporate formation transactions described in Section 351 (that is, the shareholders of the Original Issuer transfer their QSB stock to a new corporation ("Newco") and after the transfer the transferring shareholders (and others transferring cash or property to Newco at the same time) "control" Newco).[25]

In these cases, stock of the Acquiring Corporation or of Newco is treated as QSB stock even though it would not normally so qualify. If the Acquiring Corporation or Newco is itself a qualified small business, then the stock of the Acquiring Corporation or Newco received in exchange for QSB stock is treated in full as QSB stock. If the Acquiring Corporation or Newco is not itself a qualified small business, then the stock of the Acquiring Corporation or Newco is treated as QSB stock only to the extent of the gain that would have been recognized at the time of the Section 368 or Section 351 transaction if the original QSB stock had been sold in a taxable transaction at that time. Special rules apply if there are successive transfers of QSB stock in multiple reorganizations or corporate formations.[26]

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[22] *Id.*

[23] *Id.*

[24] § 1202(h)(4).

[25] For purposes of these tests, "control" means ownership of 80 percent or more of the voting stock and 80 percent or more of each class of non-voting stock of Newco. *See* §§ 368(c), 1202(h)(4)(A) and 1202(h)(4)(D). *See also,* Rev. Rul. 59-259, 1959-2 C.B. 115.

[26] *See* § 1202(h)(4)(C).

9. Stock Held Through Pass-Through Entities

In certain circumstances, an individual taxpayer's share of gain attributable to holding an interest in a partnership can be counted as gain eligible for the Section 1202 exclusion in the hands of the individual taxpayer.[27]

In order for gain allocated to an individual by a partnership to qualify for this treatment, (i) the gain must be attributable to the partnership's sale or exchange of stock which is QSB stock in the hands of the partnership (*i.e.*, meets all of the requirements to be QSB stock—treating the partnership as an individual for this purpose—and was held by the partnership for more than 5 years), and (ii) the individual taxpayer's share of such gain must be attributable to a partnership interest held by such individual on the date on which the partnership acquired the QSB stock and at all times thereafter until the disposition of the QSB stock by the partnership.

If both the above conditions are satisfied, then, for purposes of the per-issuer limitation, the taxpayer must treat the gain as gain from a disposition of stock in the corporation issuing the stock that the partnership (or other pass-through entity) disposed of, and the taxpayer's basis in stock of that corporation includes the taxpayer's proportionate share of the partnership's (or other pass-through entity's) adjusted basis in the stock.[28]

Increases in the individual taxpayer's interest in the partnership after the date on which the partnership acquired the QSB stock are ignored in determining the amount of gain eligible for exclusion in the hands of the individual taxpayer.[29]

III. Qualified Small Business Requirement

A. In General

Section 1202(d)(1) defines a "qualified small business" as a domestic C-corporation if: (i) the aggregate gross assets of such corporation (or any predecessor thereof), at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 and before the issuance of the stock being tested for potential qualification as QSB stock, do not exceed $50 million; (ii) the aggregate gross assets of such corporation immediately after the issuance of the stock being tested for potential qualification as QSB stock (determined by taking into

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[27] *See generally,* § 1202(g). This "pass-through" rule also generally applies to S corporations, regulated investment companies, and common trust funds. § 1202(g)(4).

[28] § 1202(g)(1)(B).

[29] § 1202(g)(3). In addition, as discussed in Part VII.C.1, it appears that the IRS would likely interpret a taxpayer's "interest" in the partnership to refer solely to an interest in partnership capital, as compared with future profits. As a result, a typical "profits interest" or "carried interest" in a partnership may not enable a taxpayer to qualify for the benefits of Section 1202 if the taxpayer has a zero (0%) stated interest in partnership capital at the time the partnership acquires QSB stock.

account amounts received in the issuance) do not exceed $50 million; and (iii) such corporation agrees to submit to the IRS and its shareholders any “reports” that the IRS may “require to carry out the purposes of” Section 1202.

B. Aggregate Gross Assets Test

For purposes of Section 1202(d)(1), the term “aggregate gross assets” means the sum of the amount of cash and the aggregate adjusted bases of all other property of the corporation (with the adjusted basis of any property contributed to the corporation being determined as if the basis of the property contributed to the corporation were equal to its fair market value as of the time of such contribution).[30] However, stock that otherwise qualifies as QSB stock as of the date of issuance will not lose that status solely by virtue of the fact that a corporation subsequently exceeds the $50 million threshold.[31]

In addition, and also for purposes of the aggregate gross asset test of Section 1202(d)(1), certain aggregation rules under Section 1202(d)(3)(A) provide that corporations that are part of a “parent-subsidiary controlled group” shall be treated as one corporation. Section 1202(d)(3)(B) defines a “parent-subsidiary controlled group” as any controlled group of corporations as defined under Section 1563(a)(1) (except that “more than 50%” shall be substituted for “at least 80%” in each place where it appears and Section 1563(a)(4) shall not apply).[32]

In general, Section 1563(a)(1), as modified by Section 1202(d)(3)(B), effectively defines a “parent-subsidiary controlled group” as consisting of one or more chains of corporations connected with a common parent corporation through more than 50% stock ownership, as determined by voting power or by value. Section 1563(e)(2) also provides that, for purposes of Section 1563(a)(1), stock owned directly or indirectly by a partnership shall be considered as owned by any partner having an interest of 5% or more in the capital or profits of the partnership in proportion to his or her interest in capital or profits, which ever such proportion is higher.

C. Submission of Reports to the IRS

To date, the IRS has not promulgated any guidance relating to either the timing or required content of any reporting requirements that may apply for purposes of Section 1202(d)(1)(C).

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[30] *See* § 1202(d)(2). Note that the use of “aggregate adjusted bases” for any pre-existing property held by a corporation for purposes of the $50 million aggregate gross assets test (*e.g.,* such as self-created intangibles or goodwill with a zero tax basis), can potentially lead to a result that diverges significantly from the estimated current fair market value of such property.

[31] *See* House Committee Report.

[32] *See* § 1202(d)(3).

IV. *Active Business Requirement*

A. In General

For purposes of Section 1202(c)(2)(A), a corporation shall be treated as satisfying the "active business requirement" of Section 1202(e) for any period if during such period (i) at least 80% (by value) of the assets of such corporation are used by such corporation in the active conduct of one or more "qualified trades or businesses" (as defined in Section 1202(e)(3)) and (ii) such corporation is an "eligible corporation" (as defined in Section 1202(e)(4)).

Under Section 1202(e)(3), the term "qualified trade or business" means any trade or business other than:

(A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;

(B) any banking, insurance, financing, leasing, or similar business;

(C) any farming business (including the business of raising or harvesting trees);

(D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under Section 613 or 613A; and

(E) any business of operating a hotel, motel, restaurant, or similar business.

For purposes of interpreting the nature and scope of the specific statutory exclusions contained within Section 1202(e)(3), it should generally be noted that there are a few helpful IRS private letter rulings ("PLRs") that address what it means to "perform services within the field of health."[33] In addition, although a PLR is generally only binding on the IRS with respect to the specific taxpayer to which such PLR was issued,[34] a PLR nevertheless provides other

[33] *See generally,* PLR 201436001 (Sept. 5, 2014) (company that operated in the pharmaceutical industry and assisted clients in the commercialization of experimental drugs was more akin to a manufacturer of parts and was not in the business of offering a health-related service in the form of individual expertise); PLR 201717010 (April 28, 2017) (corporation that used a patented technology to test for specific diseases, the results of which were analyzed and summarized in laboratory reports that did not diagnose or recommend treatment, was not engaged in a business involving the performance of services within the field of health, and the principal asset of the business was not the reputation or skill of one or more of its employees).

[34] *See generally,* § 6110(k)(3).

taxpayers with some indication of the IRS' likely position on the particular legal issue that was addressed in the context of the facts contained in the PLR.

It should also be noted that although Section 199A(d)(2)(A) specifically references the list of excluded businesses set forth in Section 1202(e)(3)(A) to determine what constitutes a disqualified "specified service trade or business" for purposes of the Section 199A "qualified business income" deduction, and although final Treasury Regulation Section 1.199A-5(b) provides further guidance as to the intended nature and scope of such excluded businesses, such rules are generally only applicable for purposes of Section 199A (except to the extent that another Code section expressly refers to either Section 199A(d) or related Treasury Regulation Section 1.199A-5(b)).[35]

Finally, Section 1202(e)(4) defines an "eligible corporation" as any domestic corporation other than: (i) a DISC (a "domestic international sales corporation" as defined in Section 992(a)) or former DISC; (ii) a RIC (regulated investment company), REIT (real estate investment trust), or REMIC (real estate mortgage investment conduit); and (iii) a cooperative.

B. Special Rules

1. Start-Up and R&D Activities

Section 1202(e)(2) provides a special "*per se*" active business rule if, in connection with any future qualified trade or business, a corporation is engaged in either start-up activities described in Section 195(c)(1)(A), research and experimental expenditures under Section 174, or in-house research expenses described in Section 41(b)(4).

2. Stock In Other Corporations

Section 1202(e)(5)(A) provides a "look-through rule" such that, for purposes of Section 1202(e), any "subsidiary" corporation (as defined in Section 1202(e)(5)(C)) shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities.[36]

Section 1202(e)(5)(B) provides a special rule for portfolio stock or securities such that a corporation shall not be treated as conducting an active trade or business for any period during which more than 10% of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not "subsidiaries" of such corporation (again as defined in Section 1202(e)(5)(C)) and which are not held as working capital.

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[35] *See* Treas. Reg. § 1.199A-5(b)(2)(i)(A).

[36] The Conference Agreement issued in connection with the passage of Section 1202 (which followed the House Bill and the House Committee Report) sought to clarify that a parent's ratable share of a subsidiary's assets (and activities) is based on the percentage of outstanding stock owned (by value).

Section 1202(e)(5)(C) provides that a corporation shall be considered a “subsidiary” if the parent owns either more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all the outstanding stock of the corporation.

3. Working Capital

Section 1202(e)(6)(A) provides that, for purposes of Section 1202(e)(1)(A), any assets which are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation shall be treated as used in the active conduct of a qualified trade or business.

Section 1202(e)(6)(B) provides that any assets which are held for investment and are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business, or for increases in working capital needs of a qualified trade or business, shall also be treated as used in the active conduct of a trade or business.

Finally, the flush language of Section 1202(e)(6) provides that, once a corporation has been in existence for two years, in no event may more than 50% of the assets of the corporation qualify as used in the active conduct of a qualified trade or business by reason of the exceptions set forth in Section 1202(e)(6).

4. Real Estate Holdings

Section 1202(e)(7) provides that a corporation shall not be treated as conducting an active business for purposes of Section 1202(e)(1) for any period during which more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business. For purposes of Section 1202(e)(7), the ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business.

5. Computer Software Royalties

Rights to computer software are treated as an active business asset if they produce “active business computer software royalties” within the meaning of Section 543(d)(1).[37]

Royalties will be treated as active business computer software royalties under Section 543(d)(1) if: (i) the corporation is engaged in the active conduct of a trade or business of developing, manufacturing, or producing computer software; (ii) the royalties are attributable to computer software developed, manufactured, or produced by the corporation; (iii) the licensing royalties constitute at least 50% of the corporation’s *ordinary* gross income (computed in

[37] § 1202(e)(8).

accordance with special rules applicable to "personal holding companies"[38]) for the taxable year; (iv) certain deductions relating to the production of the royalties equal at least 25% of the corporation's *ordinary* gross income for the taxable year, or average 25% of the corporation's average *ordinary* gross income for the corporation for the past 5 years; and (v) the corporation distributes, at a minimum, dividends equal to the amount by which the corporation's "personal holding company income" (certain types of passive income computed in accordance with special rules applicable to "personal holding companies") exceeds 10% the corporation's *ordinary* gross income for the taxable year.

V. Five-Year Holding Period Requirement

A. In General

In general, a taxpayer's holding period for QSB stock begins on the date of issuance. In the case of QSB stock received upon a transfer of property (other than money or stock), the acquisition date is the date of the exchange.[39]

Special "tacking" (continuation) rules apply to the computation of a taxpayer's holding period if the QSB stock is converted into other stock of the same corporation, or if the QSB stock is acquired as a gift, by inheritance, or as a transfer from a partnership.[40] Another similar rule may potentially apply to any QSB stock received in a transaction in which the taxpayer receives a "tacked" (continuing) holding period pursuant to Section 1223 (see flush language to Sections 1202(a)(3) and (a)(4), discussed in Part VI.C).

The holding period also "tacks" (continues) in the case of QSB stock that is exchanged in a transaction described under Sections 351 or 368 for stock of another corporation that is effectively treated as QSB stock.[41]

The holding period of stock acquired in a Section 1045 rollover transaction generally includes the holding period of the QSB stock disposed of in the rollover transaction.[42]

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[38] § 542 *et. seq.*

[39] § 1202(i)(1)(A).

[40] §§ 1202(f)(2) and 1202(h)(1)(B).

[41] § 1202(h)(4)(A).

[42] *See* House Report No. 105-220, p. 385, 1997-4 C.B. 1855. *See also* § 1223(13). This tacking rule does not apply for purposes of §§ 1202(a)(2), 1400B(b), and 1400F(b) (regarding empowerment zone businesses) and § 1202(c)(2)(A) (regarding satisfaction of the active business requirement and C corporation requirement).

B. Offsetting Short Positions

Section 1202(j) provides that if a taxpayer has an "offsetting short position" with respect to any QSB stock, Section 1202(a) shall not apply to any gain from the sale or exchange of such stock unless (i) such stock was held by the taxpayer for more than 5 years as of the first day on which there was such a short position, and (ii) the taxpayer elects to recognize gain as if such stock were sold on such first day for its fair market value.[43]

VI. Amount of Gain Subject to Exclusion

A. Section 1202(a) Exclusion

In general, Section 1202(a)(1) provides for a 50% exclusion from the amount of a taxpayer's gain realized from the sale or exchange of QSB stock held for more than 5 years. Section 1202(a)(2) provides a for a 60% exclusion for certain empowerment zone businesses, although the potential scope of this subsection is relatively limited.[44] Section 1202(a)(3) provides for a 75% exclusion for QSB stock issued after February 17, 2009 and before September 28, 2010. Section 1202(a)(4) provides for a 100% exclusion for QSB stock issued after September 27, 2010, coupled with a 100% exclusion from the AMT under Section 57(a)(7). A brief history of these provisions, along with a general overview of the effective tax rate implications for taxpayers holding QSB stock, follows below.

As originally enacted pursuant to the Omnibus Revenue Reconciliation Act of 1993,[45] Section 1202 allowed for a 50% exclusion of the amount of eligible gain realized from the sale of QSB stock issued after August 10, 1993. A subsequent amendment to Section 1202, pursuant to the American Recovery and Reinvestment Act of 2009,[46] increased this percentage to 75% for QSB stock issued after February 17, 2009 and before September 28, 2010.

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[43] Section 1202(j)(2) provides that the taxpayer shall be treated as having an "offsetting short position" with respect to any QSB stock if: (i) the taxpayer has made a short sale of substantially identical property; (ii) the taxpayer has acquired an option to sell substantially identical property at a fixed price; or (iii) to the extent provided in Treasury Regulations, the taxpayer has entered into any other transaction which substantially reduces the risk of loss from holding such QSB stock. In addition, for purposes of Section 1202(j)(2), any reference to the "taxpayer" includes a reference to any person who is "related" (within the meaning of Section 267(b) or Section 707(b)) to the taxpayer.

[44] Section 1202(a)(2) potentially applies to QSB stock issued after December 21, 2000 and before February 18, 2009 and does not apply to gain attributable to periods after December 31, 2018.

[45] Pub. Law No. 103-66 (Aug. 10, 1993).

[46] Pub. Law No. 111-5 (Feb. 17, 2009).

As a result, prior to September 28, 2010, a taxpayer's effective federal tax rate for eligible gains realized with respect to dispositions of QSB stock was typically either 14.98% (for purposes of the 50% exclusion)[47] or 8.47% (for purposes of the 75% exclusion).[48]

With respect to the 14.98% effective federal rate that often applied prior to February 18, 2009, it is worth noting that such rate was somewhat preferable to the otherwise applicable maximum capital gains rate of 20% that was in effect between 1998 and 2003 (with 1998 being the first year that a taxpayer could satisfy the 5-year holding requirement under Section 1202). However, it should also be noted that the 14.98% rate was just barely preferable to the maximum capital gains rate of 15% in effect between 2003 and 2009.[49]

The Small Business Jobs Act of 2010[50] then subsequently amended Section 1202 to provide for a temporary 100% exclusion from gross income, along with a 100% exclusion for AMT purposes, for QSB stock purchased after September 27, 2010 and before January 1, 2011.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,[51] further extended the 100% gross income and 100% AMT exclusions to January 1, 2012, thereby covering the 2011 tax year.

[47] The 14.98% rate accounts for a 7% AMT add-back with respect to the 50% of excluded eligible gain, taxable at a maximum AMT rate of 28%, and a 28% rate applicable to the 50% of non-excluded eligible gain ([1.00 x .50 x .07 x .28] + [1.00 x .50 x .28] = .1498, or 14.98%).

[48] The 8.47% rate accounts for a 7% AMT add-back with respect to the 75% of excluded eligible gain, taxable at a maximum AMT rate of 28%, and a 28% rate applicable to the 25% of non-excluded eligible gain ([1.00 x .75 x .07 x .28] + [1.00 x .25 x .28] = .0847, or 8.47%).

[49] The lack of a meaningful difference between the 14.98% rate that was effectively available under Section 1202 based on a 50% exclusion percentage, as compared with the 15% maximum capital gains rate that became available in 2003, was a significant factor that motivated Congress to pass an increased 75% exclusion percentage in 2009. *See, e.g.,* 155 Cong. Rec. 3341 (2009) (statement of Sen. Snow) ("As a 14-percent effective tax rate provides little incentive to hold small business stock, given that Fortune 500 company stock is taxed at 15 percent if held for only 1 year, the provision allows a 75-percent exclusion and 7 percent effective tax rate-for individuals [not accounting for the AMT add-back] on the gain from the sale of certain small business stock held for more than 5 years.").

[50] Pub. Law No. 111-240 (Sept. 27, 2010).

[51] Pub. Law No. 111-312 (Dec. 17, 2010).

This extension was then later effectively granted for the 2012 and 2013 tax years (pursuant to the American Taxpayer Relief Act of 2012),[52] and then again with respect to the 2014 tax year (pursuant to the Tax Increase Prevention Act of 2014).[53]

Finally, pursuant to the Protecting Americans from Tax Hikes Act of 2015 (which was included as part of the Consolidated Appropriations Act of 2016),[54] Section 1202 was permanently amended to make the 100% gross income and 100% AMT exclusions applicable to all QSB stock issued after September 27, 2010.

As a result of the 100% gross income and 100% AMT exclusions, which have now been made permanent and which apply to QSB stock issuances made after September 27, 2010, the effective federal tax rate for eligible gains realized upon a subsequent sale of QSB stock is potentially zero (0.00%), as compared with a current maximum federal capital gains rate of 20% (which can further rise to 23.8% when combined with the NIIT under Section 1411).

B. Section 1202(b) Limitation on Taxpayer's Eligible Gain

In general, Section 1202(a)(1) provides for a 50% exclusion from the amount of a taxpayer's gain realized from the sale or exchange of QSB stock held for more than 5 years. Section 1202(a)(2) provides a for a 60% exclusion for certain empowerment zone businesses, although the potential scope of this subsection is relatively limite

In general, Section 1202(b)(1) provides that the aggregate amount of potentially excludable "eligible gain" effectively allowable under Section 1202(a) with respect to QSB stock issued by a corporation and disposed of by a taxpayer in any given taxable year equals the greater of: (i) $10 million (reduced by the aggregate amount of any "eligible gain" previously taken into account by the taxpayer for prior taxable years as a result of dispositions of QSB stock issued by the corporation); or (ii) 10 times the aggregate adjusted bases of QSB stock issued by the corporation and disposed of by the taxpayer during the taxable year.

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[52] Pub. Law No. 112-240 (Jan. 2, 2013). It should also be noted that the American Taxpayer Relief Act of 2012 added new flush language to Section 1202(a)(3) (for purposes of the 75% exclusion) and Section 1202(a)(4) (for purposes of the 100% exclusion) which states: "In the case of any stock which would be described in the preceding sentence (but for this sentence), the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223." As a result, if a taxpayer receives new QSB stock in exchange for old QSB stock in a carryover basis / tacked holding period transaction (*e.g.,* pursuant to Section 1223(1) by reason of an exchange under Section 1045), the acquisition date of the new QSB stock will be the same as the old QSB stock for purposes of Section 1202(a).

[53] Pub. Law No. 113-295 (Dec. 19, 2014).

[54] Pub. Law No. 114-113 (Dec. 18, 2015).

For purposes of Section 1202(b), the term “eligible gain” means any gain from the sale or exchange of QSB stock held for more than 5 years.[55] In addition, gains in QSB stock attributable to post-issuance periods are generally eligible for exclusion, subject to the ceiling discussed above. However, as previously discussed, certain limitations may apply to gain recognized on stock that is received in exchange for QSB stock in a transaction described in Section 351 (corporate formation) or Section 368 (a tax-free reorganization).[56] The entire amount of any gain on a subsequent sale or exchange is eligible for the exclusion if the stock received is stock in another qualified small business. However, if the stock is not held with respect to a qualified small business, the exclusion only applies to the extent of the gain which would have been recognized at the time of the transfer if Section 351 or Section 368 had not applied.

C. Section 1202(i) Basis Rules

Section 1202(i) provides that, for purposes of Section 1202, when the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation, such stock shall (i) be treated as having been acquired by the taxpayer on the date of such exchange, and (ii) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.[57]

One critical aspect of the unique basis rule set forth in Section 1202(i) (that is not readily apparent from the plain statutory language of Section 1202) is that the amount of any previously unrecognized gain that is carried over to the QSB stock will be taxed in full at the time of the subsequent sale or exchange (such that only subsequent appreciation in the QSB stock constitutes “eligible gain” for purposes of Section 1202(b)(1)).[58]

Another important consideration under Section 1202(i) arises in connection with how a taxpayer’s acquisition date is generally determined under Section 1202(i)(1)(A), versus how a taxpayer’s acquisition date is otherwise determined in certain situations pursuant to the flush language of Sections 1202(a)(3) and (a)(4).

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[55] § 1202(b)(2).

[56] § 1202(h)(4)(B).

[57] It should be noted that the “no less than fair market value” rule is contained in Section 1202(i)(1)(B) and the relevant statutory language, at least on its face, does not seem to preclude the possibility that a taxpayer’s Section 1202(i) QSB stock basis could potentially be _**greater**_ than the fair market value of the property transferred (*e.g.,* in recognition of a control premium or other factor that could conceivably apply to enhance the value of the taxpayer’s QSB stock received in the exchange). However, it should also be noted that such a construction would need to reasonably account for the fact that, simultaneously on the other side of the exchange, it is the fair market value of the property transferred that must be used for purposes of determining the corresponding adjusted basis and resulting “aggregate gross assets” of the transferee corporation under Section 1202(d)(2)(B).

[58] *See* House Committee Report.

Specifically, a taxpayer's acquisition date for QSB stock as determined under Section 1202(i)(1)(A) is the date of the relevant exchange. By comparison, the American Taxpayer Relief Act of 2012, which extended the 100% exclusion for acquisitions of QSB stock until December 31, 2013, also added new flush language to Sections 1202(a)(3) and (a)(4) (for purposes of the 75% and 100% exclusions, respectively) which states: "In the case of any stock which would be described in the preceding sentence (but for this sentence), the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223."

As a result, a potential question could arise as to whether a taxpayer that receives QSB stock in exchange for property (other than money or stock) in a Section 1223(1) carryover basis / tacked holding period transaction (*e.g.,* under Section 351) can safely apply Section 1202(i), such that the acquisition date is the date of the exchange, or whether the flush language of Sections 1202(a)(3) or (a)(4) could instead somehow apply, such that the acquisition date would be based on the taxpayer's holding period for the exchanged property. If the latter rule applied, then a taxpayer that, for example, originally acquired property prior to September 28, 2010, and then later contributed that property to a corporation in exchange for QSB stock after September 27, 2010, might not be availed of the 100% exclusion available under Section 1202(a)(4).

Fortunately, this question regarding the potential interplay between Section 1202(i) and the flush language of Sections 1202(a)(3) and (a)(4) was addressed in the relevant legislative history.

In particular, the Joint Committee Report states the following with respect to the flush language of Sections 1202(a)(3) and (a)(4):

> "The provision clarifies that in the case of any qualified small business stock acquired (determined without regard to the tacked holding period) after February 17, 2009, and before January 1, 2014, the date of acquisition for purposes of determining the exclusion percentage is the date the holding period for the stock begins. Thus, for example, if an individual (i) acquires qualified small business stock at its original issue for $1 million on July 1, 2006, (ii) sells the stock on March 1, 2012, for $2 million in a transaction in which gain is not recognized by reason of section 1045, (iii) acquires qualified replacement stock at its original issue on March 15, 2012, for $2 million, and (iv) sells the replacement stock for $3 million, 50 percent (and not 100 percent) of the $2 million gain on the sale of the replacement stock is excluded from gross income."[59]

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[59] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 112th Congress*, 184–5 (JCS-2-13) at pp. [184-5] (February 2013) (the "Joint Committee Report").

The Joint Committee Report also went on to specifically state that the addition of the flush language "is not intended to change the acquisition date determined under section 1202(i)(1)(A) for certain stock exchanged for property."[60] Consequently, based on the relevant legislative history, it is clear that Congress intended for the acquisition date rule under Section 1202(i)(1)(A) to continue to apply to contributions of property (other than money or stock), whereas the flush language of Sections 1202(a)(3) and (a)(4) was generally intended to apply to certain "rollover" transactions involving exchanges of previously issued QSB stock (*e.g.,* under Section 1045).

VII. Potential Rollover of Gain (Section 1045)

A. In General

Section 1045 allows a taxpayer to defer recognition of gain from the sale of QSB stock if the taxpayer purchases replacement QSB stock within a 60 day period beginning on the date of the sale.

Provided that all the requirements of Section 1045 are satisfied, gain recognized from the sale of QSB stock is limited to the extent to which the amount realized on the sale exceeds the cost of replacement QSB stock purchased by the taxpayer, and the basis of the replacement QSB stock is reduced by the amount of the unrecognized gain.[61]

Section 1045 also incorporates by reference the special basis rules in Section 1202.[62] Thus, in general, the amount of any gain attributable to periods prior to the receipt of the QSB stock is not eligible for rollover and must be recognized at the time of the sale or exchange. Only gain accrued after the time of receipt of the QSB stock can be deferred.

Further, if QSB stock is exchanged in a Section 351 or Section 368 transaction for stock of Newco or the Acquiring Corporation, and Newco or the Acquiring Corporation is not itself a qualified small business, the amount of gain which may be rolled over under Section 1045 is limited to the gain that would have been recognized at the time of the Section 351 or Section 368 transaction if the original QSB stock had been sold in a taxable transaction at that time.[63]

[60] *Id.* at p. 185, fn. 490.

[61] § 1045(b)(3).

[62] § 1045(b)(5) and § 1202(i).

[63] *See generally,* § 1045(b)(5) and § 1202(h)(4)(B).

B. Specific Requirements

A taxpayer's gain can be rolled over under Section 1045 only if the following six conditions are satisfied:

1. Non-Corporate Taxpayer

The taxpayer cannot be a corporation.[64]

2. Sale of QSB Stock

The taxpayer must sell QSB stock.[65]

3. Six-Month Holding Period

In general, the holding period of stock does not tack for purposes of the 6-month holding period requirement of Section 1045. Thus, each time a taxpayer acquires replacement QSB stock, the taxpayer must hold the replacement QSB stock for a period of 6 months in order to be eligible for another use of the roll-over provision.[66]

Section 1045 also incorporates the special tacking rules of Section 1202 by reference, so that holding period will tack for purposes of the 6-month holding period where QSB stock is received upon conversion, by gift, by death, or from a partnership in which the taxpayer is a partner.[67] A taxpayer's holding period also appears to tack if QSB stock is exchanged for other stock in either a Section 351 or Section 368 transaction. It also appears that the holding period in QSB stock received in a transaction to which Section 1045 applies will include the holding period of the stock sold in the rollover transaction for purposes of the 5-year holding period requirement under Section 1202.[68]

4. Section 1045 Election

A taxpayer must make an election on or before the due date (including extensions) for filing the income tax return for the taxable year in which the QSB stock is sold. The election can be

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[64] § 1045(a) (lead-in language).

[65] *Id.*

[66] § 1045(b)(4)(A).

[67] § 1045(b)(5).

[68] *See* House Report No. 105-220, at page 385, 1997-4 C.B. 1855. *See also,* flush language of Sections 1202(a)(3) and (a)(4) in relation to determining the proper acquisition date, and related exclusion percentage, for stock received in a transaction to which Section 1045 applies.

made by reporting the gain on Schedule D ("Capital Gains and Losses") of the return, in accordance with the instructions for Schedule D.[69]

5. Character of Gain

The taxpayer's gain that would be recognized in the absence of Section 1045 cannot be ordinary income.[70]

6. Purchase of Replacement QSB Stock Within 60-Day Period

The replacement stock must be acquired by "purchase," (*i.e.*, in a transaction in which the taxpayer receives a "cost" basis for the new QSB stock).[71]

In order for the Section 1045 non-recognition rule to apply with respect to the QSB stock that is sold, the corporation issuing the replacement stock must meet the active business requirement for the 6-month period following the purchase of the replacement stock.[72] Section 1045 does not require a clear tracing of funds from the QSB stock sold to the replacement QSB stock acquired.

C. Rollover of Gain In Partnership Context

In 2007, Treasury Regulations were finalized that provide specific rules for application of Section 1045 in the context of partnerships ("Section 1045 Regulations").[73]

1. Rollover by Partnership

A partnership that holds QSB stock for more than 6 months,[74] sells such QSB stock, and purchases "replacement QSB stock" (*i.e.,* QSB stock purchased within 60 days beginning on the date of a sale of QSB stock) may elect to apply Section 1045.[75] The Section 1045

[69] *See* Rev. Proc. 98-48, 1998-2 C.B. 367.

[70] § 1045(a) (ending flush language).

[71] § 1045(b)(2).

[72] § 1045(b)(4).

[73] Treas. Reg. § 1.1045-1, T.D. 9353, 8/13/2007. The Section 1045 Regulations apply to sales of QSB stock on or after August 14, 2007, and supersede Rev. Proc. 98-48, 1998-2 C.B. 367 with respect to such sales.

[74] The Section 1045 Regulations define "month(s)" as a period commencing on the same numerical day of any calendar month as the day on which the QSB stock is sold and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no corresponding day, with the last day of the succeeding calendar month. Treas. Reg. § 1.1045-1(g)(4).

[75] Treas. Reg. § 1.1045-1(b)(1). The partnership must notify partners of its Section 1045 election, its purchase of replacement stock, and of each partner's distributive share of "partnership section 1045 gain." Treas. Reg. § 1.1045-1(b)(5)(i). The partnership must make the election on its timely filed (including extensions) return

Regulations provide rules regarding adjusting the tax basis of a partnership's replacement QSB stock as a result of a Section 1045 election and reporting such adjustments in the partnership's returns.[76]

If a partnership makes a Section 1045 election, then each "eligible partner" does not recognize its distributive share of the partnership's capital gain that is unrecognized under Section 1045.[77] In general, an eligible partner's distributive share of unrecognized gain is in the same proportion as the partner's distributive share of the partnership's gain from the sale of the QSB stock.

However, the unrecognized gain of an eligible partner cannot exceed (i) the partnership's realized gain from the sale of the QSB stock multiplied by (ii) the eligible partner's smallest percentage interest in partnership capital.[78] The baseline for the eligible partner's percentage share of capital is the partner's percentage of capital when the QSB stock is acquired by the partnership, and is not increased by future capital contributions by the partner or income allocations to the partner. As a result, this rule will adversely affect partners with carried interests.[79]

The Section 1045 Regulations permit an "eligible partner" to opt out of a partnership's Section 1045 election.[80] For purposes of these rules, an "eligible partner" is a taxpayer (other than a

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for the taxable year in which the QSB stock sale occurs in accordance with applicable forms and instructions. Treas. Reg. § 1.1045-1(h)(1).

[76] Treas. Reg. § 1.1045-1(b)(3).

[77] Treas. Regs. § 1.1045-1(b)(1), (2). The Section 1045 Regulations refer to this unrecognized gain as "partnership section 1045 gain." An eligible partner's share of unrecognized gain does not increase the partner's basis for its partnership interest. Treas. Reg. § 1.1045-1(b)(3)(i). Any partner that must recognize all or part of the partner's distributive share of partnership section 1045 gain (*e.g.,* not an eligible partner) must notify the partnership, in writing, of the amount of "partnership section 1045 gain" that is recognized by the partner. Treas. Reg. § 1.1045-1(b)(5)(ii).

[78] Treas. Reg. § 1.1045-1(d)(1). An eligible partner's smallest percentage interest in partnership capital is the eligible partner's percentage share of capital determined at the time of the acquisition of the QSB stock, as adjusted prior to the time the QSB stock is sold, to reflect any reduction in the capital of the eligible partner, including a reduction as a result of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the eligible partner, or the transfer of an interest by the eligible partner, but excluding income and loss allocations. Treas. Reg. § 1.1045-1(d)(2). Percentage interest is also further appropriately adjusted to reflect tiered partnerships. Treas. Reg. § 1.1045-1(d)(3).

[79] In general, the IRS has stated that it views the smallest percentage interest in partnership capital approach as being consistent with the "continuous economic interest" requirements set forth in Sections 1202(g)(2) and (g)(3) regarding pass-through entities, as well as the application of those requirements in Section 1202(c)(1)(B), and would presumably take the same position regarding a partner's share of gain eligible for exclusion under Section 1202(a). *See generally,* preamble to final Treasury Regulations under Section 1045 as applied to partnerships (T.D. 9353, 72 Fed. Reg. 45346, August 14, 2007). *See also,* Treas. Reg. § 1.1045-1(i), Example 9.

[80] Treas. Reg. § 1.1045-1(b)(4). Opting out of a partnership's Section 1045 election does not revoke the partnership's election, which continues to apply to the other partners of the partnership. An eligible partner

C-corporation) that holds an interest in a partnership on the date the partnership acquires the QSB stock and at all times thereafter for more than 6 months until the partnership sells or distributes the QSB stock.[81]

2. *Rollover by Partner*

An "eligible partner" of a partnership that sells QSB stock may elect to apply Section 1045 if the eligible partner either purchases replacement QSB stock directly or through a "purchasing partnership." For purposes of this rule, a "purchasing partnership" is a partnership in which the taxpayer is a partner (directly, or through an upper-tier partnership) on the date on which the partnership acquires the replacement QSB stock.[82] An eligible partner can utilize this partner rollover rule to defer additional gain to the extent the partnership does not fully defer gain under Section 1045, or to the extent that the partner opts out of a partnership's Section 1045 election.[83]

3. *Rollover of Directly Held QSB Stock Through a Purchasing Partnership*

A taxpayer (other than a C-corporation) that holds QSB stock directly for more than 6 months, sells such QSB stock, and purchases replacement QSB stock through a purchasing partnership, may elect to apply Section 1045.[84]

4. *Other Partnership Transactions*

If QSB stock is distributed to a partner, the holding period tacks and the partner is treated as having acquired the stock in the same manner as the partnership, provided all eligibility requirements with respect to QSB stock as defined in Section 1202(c) are met by the

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that opts out of a partnership's Section 1045 election must so notify the partnership in writing. Treas. Reg. § 1.1045-1(b)(5)(ii).

[81] Treas. Reg. § 1.1045-1(g)(3)(i). A taxpayer who acquires from a partner (other than a C corporation) by gift or at death an interest in a partnership that holds QSB stock is treated as having held the acquired interest in the partnership during the period the partner (other than a C corporation) held the interest in the partnership. Treas. Reg. § 1.1045-1(e)(3)(ii). The regulations generally look through tiers of partnerships and treat a partner of an upper-tier partnership as owning an interest in a lower-tier partnership during the period in which both (A) the partner of the upper-tier partnership held an interest in the upper-tier partnership; and (B) the upper-tier partnership held an interest in the lower-tier partnership. Treas. Reg. § 1.1045-1(e)(3)(iii). Similar principles apply to multi-tier situations. Treas. Reg. § 1.1045-1(e)(3)(iv). Each partner must determine its eligible partner status. Treas. Reg. § 1.1045-1(b)(5)(i).

[82] Treas. Reg. § 1.1045-1(c)(1). A partner making a rollover or opt-out election must do so on its timely filed (including extensions) return for the taxable year during which the partner takes into account under Section 706 its distributive share of the partnership's gain from the sale of the QSB stock. Treas. Reg. § 1.1045-1(h)(2).

[83] Treas. Reg. § 1.1045-1(i), Example 8. Treas. Reg. § 1.1045-1(b)(4).

[84] Treas. Reg. § 1.1045-1(c)(1). Detailed rules are provided regarding (i) an eligible partner's share of amounts realized by a partnership and the cost of QSB stock purchased by a purchasing partnership, and (ii) basis adjustments to partnership interests and replacement QSB stock, including with respect to later gain recognition transactions. Treas. Regs. §§ 1.1045-1(c)(2), (3), (4), (5).

distributing partnership with respect to its investment in QSB stock.[85] The amount of gain an eligible partner does not recognize under Section 1045 on a subsequent sale of the distributed QSB stock cannot exceed the partner's "section 1045 amount realized" reduced by the partner's "section 1045 adjusted basis."[86]

The Section 1045 Regulations provide that a partner must recognize gain upon a distribution of replacement QSB stock to another partner that reduces the partner's share of the replacement QSB stock held by a partnership.[87]

The gain/loss non-recognition rule of Section 721(a) applies to a contribution of QSB stock to a partnership. Except as provided in Section 721(b) (transfer to a partnership that would be an investment company if incorporated), any gain that was not recognized by the taxpayer under Section 1045 is not recognized when the taxpayer contributes QSB stock to a partnership in exchange for a partnership interest. However, stock that is contributed to a partnership is not QSB stock in the hands of the partnership.[88]

VIII. Practical Planning Considerations

A. Pre-Investment Planning

In addition to the wide variety of traditional factors (both tax and non-tax) that should be evaluated when structuring an investment, the potential benefits that may be available under Section 1202 should be seriously considered for any new investment.

In general, attempting to plan into Section 1202 may make sense in a potential situation where, among other things: (i) a five-year holding period is at least a possibility; (ii) the aggregate gross asset value of the business is expected to be equal to or less than $50 million; (iii) the general profile of the expected business operations are such that the "active business requirement" of Section 1202(e) should be satisfied; (iv) there is not a current need to extract after-tax cash flow from the business during the operational phase (such that a potential "double" corporate-level tax on distributions would not be an issue); (v) the expected overall equity growth of the business, and related potential benefits under Section 1202 on exit, are sufficient to overcome any corporate-level tax during the operational phase (which has been reduced substantially in recent years to a maximum federal corporate rate of 21%, following the passage of the Tax Cuts and Jobs Act in December of 2017); (vi) the expected investor base is composed of at least one or more non-corporate taxpayers that can actually

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85 Treas. Reg. § 1.1045-1(e)(1), (2).

86 Treas. Reg. § 1.1045-1(e)(3) provides detailed rules regarding the non-recognition limitation. *See also* Treas. Reg. § 1.1045-1(i), Examples 10 and 11.

87 Treas. Reg. § 1.1045-1(e)(4).

88 Treas. Reg. § 1.1045-1(i), Example 12.

potentially benefit from Section 1202; and (vii) the expected investor base and/or management has the ability to commit the necessary amount of time and resources to ensure that the applicable requirements of Section 1202 are satisfied at all relevant times prior to exit.

B. Making the Investment

Once a decision has been made to affirmatively structure an investment with a view toward potentially obtaining the benefits of Section 1202, the parties should consult with their tax and other advisors to ensure that the relevant requirements are satisfied and that important information is properly documented at the outset.

For example, a third-party valuation of the business would generally be advisable, both for purposes of ensuring that the $50 million aggregate asset value threshold is not exceeded and to establish a fair market value basis with respect to any property contributions being made by investors.

In addition, service providers that receive restricted stock should also use any valuation data to assess whether it may be advantageous to make a Section 83(b) election with respect to such stock.

Finally, the parties should also decide whether they wish to be bound by any operational covenants that are intended to facilitate the preservation of the requirements of Section 1202.

C. Issues Requiring Ongoing Evaluation / Operational Covenants

1. In General

In general, following an investment the investor base and/or management must continue to monitor the ongoing operations of the business in order to ensure that the requirements of Section 1202 are continuously satisfied (along with any specific operational covenants that the parties may have agreed to in connection with such requirements).

In addition, sufficient records should be maintained in the event that any information requests are ultimately made by the IRS pursuant to Section 1202(d)(1)(C).

Although the parties are likely to focus upon the general satisfaction of the “active business requirement” of Section 1202(e), there are a variety of subsidiary issues embedded in Section 1202(e) (as well as other issues) that the parties may inadvertently overlook. These issues are briefly outlined below.

2. Availability of Look-Through Rule for Subsidiaries

If the issuing corporation is a "holding company" that generally holds no assets other than the stock of its operating subsidiaries, then care must be taken to ensure that the "look-through" rules of Section 1202(e)(5) are continuously satisfied.

3. No Portfolio Stock or Securities

Pursuant to Section 1202(e)(5)(B), any portfolio stock or securities held by a corporation or a subsidiary may prevent the satisfaction of the "active business requirement" of Section 1202(e)(1). As a result, if any stocks or securities will be potentially acquired, care must be taken to consider the potential impact on the status of QSB stock issued to investors.

4. Subsequent Infusions of Cash; Working Capital

Section 1202(e)(6) provides special rules that enable reasonable amounts of working capital to qualify as assets used in a qualifying trade or business. As a result, if extraordinary subsequent infusions of cash may occur, care must be taken to ensure that such infusions do not jeopardize the status of QSB stock issued to investors.

5. Maximum Real Estate Holdings

Section 1202(e)(7) places limitations on the amount of any real property that may be held without potentially preventing the satisfaction of the "active business requirement" of Section 1202(e)(1). As a result, and particularly in light of the fact that many businesses have some kind of non-core real estate component, the real estate limitation must be closely monitored.

6. Shareholder Holding Periods

Each holder of QSB stock must closely monitor the required 5-year holding period and also ensure that the "short sale" rules of Section 1202(j) are not somehow triggered.

7. Redemptions

Section 1202(c)(3) imposes limitations on when an issuing corporation may engage in certain redemption transactions without potentially affecting the status of any QSB stock. In general, assuming there were no redemptions prior to the issuance of QSB stock, the redemption limitation should continue to exist for two years following the date on which the QSB stock was issued. In this regard, parties often enter into restrictive covenants that prevent the issuing corporation from redeeming its stock.

8. Subsequent Transactions / Restructurings

Section 1202(h)(4) contains certain rules that apply to stockholders that engage in exchanges of QSB stock as part of certain incorporation transactions under Section 351 or reorganization transactions under Section 368. These rules should be consulted in the event of any such transactions in order to determine whether and to what extent the benefits of Section 1202 will continue to apply to any affected stockholders.

9. Subsequent Changes In Law or Changes In Interpretation

In the current economic and political environment, potential further changes to Section 1202 are possible and any such changes may affect the ability of a stockholder to obtain the benefits allowable pursuant to Section 1202 under present law. In addition, at the present time, there is virtually no administrative guidance or judicial precedent that interprets or clarifies certain aspects of Section 1202 (including, for example, the specific procedures associated with applying the greater of $10 million or 10-times-basis limitation on eligible gain under Section 1202(b), as discussed in more detail below). As a result, the actual subsequent issuance of administrative guidance or the rendering of subsequent judicial decisions that affect the current interpretation and application of Section 1202 may affect the ability of a stockholder to obtain the benefits that are perceived to be allowable under current law.

D. Planning for Exit

1. Exits Before the Expiration of the Five-Year Holding Period

In general, if an exit opportunity arises prior to the end of the requisite five-year holding period for QSB stock, the parties should potentially consider whether some form of transaction (other than an all cash deal) is available that might enable investors to effectively "tack" their holding period in their QSB stock and still obtain some or all of the benefits under Section 1202 (such as through a Section 351 transaction or a reorganization under Section 368).

2. Exits After the Expiration of the Five-Year Holding Period

As previously noted, Section 1202(b) provides that the aggregate amount of excludable "eligible gain" effectively allowable under Section 1202(a) with respect to QSB stock issued by a corporation and disposed of by a taxpayer in any given taxable year equals the greater of: (i) $10 million (reduced by the aggregate amount of any "eligible gain" taken into account by the taxpayer for prior taxable years as a result of dispositions of QSB stock issued by the corporation); or (ii) 10 times the aggregate adjusted bases of QSB stock issued by the corporation and disposed of by the taxpayer during the taxable year.

In addition, for purposes of the Section 1202(b) exclusion, it should be noted that the plain language of Section 1202(b) appears to effectively allow a stockholder to use basis in one class or block of stock to be taken into account for purposes of determining the amount of gain excludable with respect to another class or block of stock disposed of in the same taxable year.

Specifically, the lead-in language of Section 1202(b)(1) effectively aggregates the eligible gain of a taxpayer realized with respect to one or more sales of QSB stock within the same taxable year.[89] Moreover, the basis limitation set forth in Section 1202(b)(1)(B) refers to "*10 times the <u>aggregate adjusted bases</u> of qualified small business stock issued by [a] corporation and disposed of by the taxpayer during the taxable year.*" As a result, it seems clear that the Section 1202(b) exclusion was designed to allow a taxpayer that disposes of multiple blocks, or classes, of QSB stock in any given taxable year to effectively "aggregate" its bases in all of the blocks or classes of stock disposed of to determine the applicable limitation.

The significance of the foregoing construction is that the limitation set forth in Section 1202(b)(1)(B) is effectively determined by combining a taxpayer's separate basis in each block or class of QSB stock that was sold in the taxable year to determine its "aggregate bases" in all of its QSB stock, which will in turn determine which of the two limitations is applicable.

For example, consider the following basic hypothetical facts: (i) T has two separate blocks of 1,000 shares of QSB stock; (ii) one block has a basis of $1 million (worth $1,000 per share at the time of acquisition) and the other block has a basis of $4 million (worth $4,000 per share at the time of acquisition); and (iii) in year 5 the QSB stock is worth $20,000 per share (or $20 million per block, with $19 million of gain associated with the low-basis block and $16 million of gain associated with the high-basis block).

If T sells both blocks of QSB stock in year 5, then it seems clear that T may exclude all $35 million of aggregate gain (based on a maximum exclusion equal to the greater of the minimum "lifetime" exclusion of $10 million or 10 times T's aggregate adjusted bases in its QSB stock sold in year 5 of $5 million x 10 = $50 million). Also note that in this basic example, T may effectively use a portion of the exclusion associated with its high-basis shares to offset some of the gain associated with the low-basis shares (due to the operation of the "aggregate" language of Sections 1202(b)(1) and (b)(1)(B)). In effect, $9 million of the $24 million excess exclusion associated with the high-basis shares can be used to offset the remaining gain associated with the low-basis shares after the $10 million exclusion associated with the low-basis shares is utilized (leaving $15 million of unused excess exclusion from the high-basis shares).[90]

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[89] The lead-in language of Section 1202(b)(1) states: "If the taxpayer has eligible gain for the taxable year from 1 or more dispositions of stock issued by any corporation, the *<u>aggregate amount of such gain from dispositions of stock</u>* issued by such corporation which may be taken into account under subsection (a) for the taxable year shall not exceed the greater of..." [Emphasis added].

[90] In this regard, it should be noted that at one point the IRS informally agreed with such a result, based upon what appears to be a plain reading of the statute; however, to date, the IRS has not issued any formal guidance or a PLR on the topic. *See* "ABA Section of Taxation Meeting: IRS Reads 'Interesting Feature' Into Stock Gain Exclusion," Tax Notes Today (2011 TNT 90-4) (May 16, 2011).

If, however, T sells the high-basis shares in year 5 and then later sells the low-basis shares in year 6, what is the result? Based on the plain language of Section 1202(b)(1) it seems that T would have to recognize substantially more gain than if T sold both blocks in the same year; namely, it appears that T would be still able to exclude all $16 million of gain inherent in the high-basis shares in year 5 (greater of a previously unused "lifetime" exclusion of $10 million or 10 times T's aggregate adjusted bases in its QSB stock sold in year 5 of $4 million x 10 = $40 million), but that T would only be able to exclude $10 million of the $19 million of gain inherent in the low-basis shares sold in year 6 (greater of a $10 million "lifetime" exclusion that has now apparently been reduced to zero, by reason of the $16 million of eligible gain taken into account in year 5, or 10 times T's aggregate adjusted bases in its QSB stock sold in year 6 of $1 million x 10 = $10 million). As a result, T would therefore effectively have $9 million of gain associated with the low-basis shares that is not excludable simply because T sold such shares in a different year than the year in which the high-basis shares were sold.

In the end, it should generally be noted that a statutory construction of Section 1202(b) that effectively results in a taxpayer's QSB-stock-related gain being determined on an "aggregate" basis, rather than a block-by-block or class-by-class basis, appears to be consistent with the Congressional purposes underlying Section 1202.[91]

In particular, Section 1202 was enacted as part of the Omnibus Budget Reconciliation Act of 1993 and was based on a proposal by Senator Bumpers of Arkansas.[92] In his outline describing his proposal, Senator Bumpers indicated that the incentive was intended to apply to "all types of stock, including common, preferred and convertible preferred stock," and that a "[c]ompany may issue more than one round of qualified stock, as long as the total aggregate capitalization does not exceed specified limits." The clear reference by Senator Bumpers to more than one type (or class) of stock and the clear contemplation of multiple rounds (or blocks) of stock, without any statement as to the basis limitation applying using a class-by-class or a block-by-block formulation, strongly supports the plain language of Section 1202(b).

Furthermore, the House Committee Report relating to Section 1202 sought to clarify that "the $10 million limitation on eligible gain is applied on a shareholder-by-shareholder basis" and "for purposes of the 10-times-basis limitation, basis is determined by valuing any contributed property at fair market value (at the date of contribution)." In this regard, the House Committee

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[91] In general, the goal of statutory construction is to give effect to the Congressional intent behind the statute's enactment. Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–43 (1984). The first step to that end "is to determine whether the language at issue has a plain and unambiguous meaning." Robinson v. Shell Oil Co., 519 U.S. 337, 340 (1997). If so, the analysis ends and the court applies the statute's plain meaning. Bartman v. Commissioner, 446 F.3d 785, 787–88 (8th Cir. 2006). If, however, the language of the statute is ambiguous, the court may examine legislative history and other authorities to determine legislative intent. Burlington N. R.R. Co. v. Okla. Tax Commissioner, 481 U.S. 454, 461 (1987). With respect to Section 1202(b), the "aggregate" concepts contained within the statutory language appear to be unambiguous. However, if a court were to determine that Section 1202(b) was ambiguous in any respect, the legislative history to Section 1202 would become potentially relevant.

[92] *See generally,* 139 Con. Rec. S. 1593 (February 16, 1993).

Report's clarification only in relation to a ***shareholder-by-shareholder*** determination, again without any indication that Congress intended for Section 1202 to be applied using a block-by-block or class-by-class methodology, lends further support to the plain "aggregate" language of Section 1202(b).

E. Tax Filing Requirements and Document Retention

As a final note, an individual taxpayer claiming the benefits of Section 1202 should generally do so by following the instructions for Schedule D ("Capital Gains and Losses") to IRS Form 1040. Furthermore, as previously noted above, taxpayers should be certain to retain all documentation that may be potentially relevant to a request by the IRS for reports and information pursuant to Section 1202(d)(1)(C).

F. Selected Potential Planning Opportunities and Traps for the Unwary

What follows below is a general overview of some common potential planning opportunities, as well as some potential traps for the unwary, that can arise in connection with stock issuances that are intended to qualify under Section 1202.

1. Potential Funding Rounds May Exceed $50 Million

For purposes of Section 1202(d)(1)(B), the aggregate gross assets of a corporation are tested "immediately after" the relevant issuance (taking into account amounts received in the issuance). In some situations, a potential investment arrangement may contemplate additional funding rounds that could, under certain circumstances, ultimately exceed the $50 million threshold, even though the $50 million threshold will not be exceeded initially. In these cases, a conservative reading of the statute in light of the potential application of the "step-transaction doctrine"[93] would suggest that the specific facts and circumstances must be carefully evaluated in order to determine whether the "immediately after" requirement of Section 1202(d)(1)(B) will be satisfied.

For example, assume the following general set of facts: (i) C corporation is in the process of developing a variety of related drugs, including a very early-stage drug X that will require several phases of development and various regulatory approvals; (ii) C has minimal (close to zero) historic adjusted tax basis in its assets and $5 million of cash on hand; (iii) individual investor T would like to make an initial investment of $40 million in cash in exchange for a new round of C's preferred stock; and (iv) if C successfully accomplishes a relatively difficult and highly uncertain first phase of development and regulatory approval with respect to drug X, T may potentially invest an additional $10 million in cash.

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[93] In general, the judicially created "step-transaction doctrine" permits a series of formally separate steps to be potentially collapsed and treated as a single transaction if the steps are, in substance, integrated, interdependent, and focused toward a particular result. *See, e.g.,* Penrod v. Comm'r, 88 T.C. 1415, 1428 (1987).

On these general facts, it seems that the "immediately after" requirement of Section 1202(d)(1)(B) should be satisfied with respect to T's initial investment of $40 million and C's $5 million of cash on hand (totaling $45 million of aggregate gross assets), because T's potential subsequent round of $10 million of financing should not be effectively combined with T's initial investment. In particular, the fact that C has other drugs in its pipeline that make it a viable investment and T may or may not subsequently decide to invest an additional $10 million, depending upon future facts and circumstances related solely to drug X that are highly uncertain and beyond T's and C's absolute control, should be sufficient in order to prevent the application of one of the generally recognized judicial formulations of the "step-transaction" doctrine."[94]

2. Low Tax Basis In Assets Relative to Equity Value

Pursuant to the statutory language of Section 1202(d)(2)(A), the term "aggregate gross assets" generally means the amount of cash and the aggregate adjusted bases of any other pre-existing property already held by the corporation. However, in the case of property that is newly contributed to a corporation, the fair market value of such property must be used in accordance with Section 1202(d)(2)(B).

For purposes of these rules, it should be noted that the concept of "aggregate gross assets" does not generally depend upon, or necessarily correlate to, either the pre-money or post-money equity valuation of a corporation. As a result, in certain situations where a corporation has a relatively low aggregate adjusted tax basis in its assets, as compared with the current fair market value of the corporation's outstanding equity, a new investor may be able to obtain the benefits of Section 1202 even though both the pre-money and post-money equity value of the corporation is in excess of $50 million.

For example, assume the following general set of facts: (i) C corporation is a technology enterprise that is engaged in the development of a rapidly growing software application; (ii) C's software application is entirely self-created and C has always had a minimal (close to zero) historic adjusted tax basis in its pre-existing assets, which consist primarily of intellectual property rights and goodwill or going concern value; and (iii) C has cash on hand of $5 million and T would like to invest $25 million for a 25% equity stake in C, as determined on a fully-diluted, post-money basis.

Based on these facts, the 25% of C's stock that T receives should qualify as QSB stock, because the amount of C's aggregate gross assets as determined immediately after T's

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[94] *See, e.g.,* Reef Corp. v. Comm'r, 368 F.2d 125 (5th Cir. 1966) (series of transactional steps not integrated because court held that such steps were functionally unrelated); Weikel v. Comm'r, 51 T.C.M. 432 (1986) (incorporation transaction not integrated with subsequent stock acquisition because court found that taxpayer intended to incorporate regardless of whether stock acquisition later occurred). *See also,* Andantech L.L.C. v. Comm'r, 83 T.C.M. 1476 (2002) (providing a detailed explanation of the "binding commitment test," the "end result test," and the "interdependence test," which represent the three generally accepted judicial formulations of the step-transaction doctrine).

investment will equal $30 million ($25 million of new cash, plus $5 million of cash on hand). The fact that C's pre-money implied equity valuation was $75 million, and C's post-money implied equity valuation will be $100 million (with T taking a 25% fully-diluted stake in C), generally has no impact upon the aggregate gross asset determination for purposes of Section 1202(d)(2).

3. Shareholder That Is More Than 50% Controlled by a C Corporation

For purposes of the aggregate gross asset test of Section 1202(d)(1), certain aggregation rules under Section 1202(d)(3)(A) provide that corporations that are part of a "parent-subsidiary controlled group" shall be treated as one corporation. In turn, Section 1202(d)(3)(B) defines a "parent-subsidiary controlled group" as any controlled group of corporations as defined under Section 1563(a)(1) (except that "more than 50%" shall be substituted for "at least 80%" in each place where it appears and Section 1563(a)(4) shall not apply).

In general, Section 1563(a)(1), as modified by Section 1202(d)(3)(B), effectively defines a "parent-subsidiary controlled group" as consisting of one or more chains of corporations connected with a common parent corporation through more than 50% stock ownership, as determined by voting power or by value. Section 1563(e)(2) also provides that, for purposes of Section 1563(a)(1), stock owned directly or indirectly by a partnership shall be considered as owned by any partner having an interest of 5% or more in the capital or profits of the partnership in proportion to his or her interest in capital or profits, which ever such proportion is higher.

As a result of these rules, a corporation that does not undertake to inquire as to any upper-tier ownership structures that may be maintained by its shareholders, or that fails to inquire as to any potential relationships that may exist as between different shareholders, may be unexpectedly disqualified from Section 1202.

For example, assume the following general set of facts: (i) C corporation has several individual and unrelated founding shareholders that, in the aggregate, collectively own 20% of C's stock; (ii) at the same time, an investment partnership owns the other 80% of C's outstanding stock; (iii) Z corporation holds a 70% interest in capital and profits of the investment partnership; (iv) Z corporation is relatively large and has an aggregate adjusted basis in its property substantially in excess of $50 million; (v) C has minimal (close to zero) historic adjusted tax basis in its assets and $5 million of cash on hand; and (vi) T would like to invest $10 million in C in exchange for a 10% fully-diluted, post-money equity interest, as determined after diluting the founders and the investment partnership on a pro-rata basis (down to 18% and 72%, respectively).

Based on these facts, and after accounting for the aggregation rules set forth in Section 1202(d)(3), it appears that C and Z would be treated as "one corporation" for purposes of the aggregate gross assets test of Section 1202(d)(2), such that C would substantially exceed the $50 million threshold both before and after T's investment (based on the inclusion of Z's aggregate adjusted basis in its property for purposes of C's determination).

Specifically, Z would be deemed to own 56% of C's stock before T's investment (70% of the investment partnership's 80%, on a pre-money basis), as well as 50.4% of C's stock after T's investment (70% of the investment partnership's 72%, on a post-money basis). In addition, this result may come as a significant surprise to T, assuming T otherwise expected to obtain the benefits under Section 1202 based on a stand-alone analysis of C's aggregate gross assets (which would be only $15 million after accounting for T's investment of $10 million and cash on hand of $5 million).

4. QSB Stock Subsequently Transferred to a Partnership

In general, pursuant to Section 1202(g)(2), stock held by a partnership may potentially qualify as QSB stock if, among other things, the stock is QSB stock in the hands of the partnership (determined by treating such partnership as though it was an individual). As a result, a partnership, like an individual, must acquire stock at "original issuance" within the meaning of Section 1202(c)(1)(B), such that qualifying QSB stock which is subsequently transferred to a partnership becomes "tainted" and can no longer qualify.[95] This rule often serves as a significant trap for the unwary, particularly in a case where a pre-existing group of individual shareholders that each hold QSB stock may seek to consolidate ownership and control within an upper-tier partnership (or LLC taxable as a partnership), in connection with a new investment being made by an unrelated shareholder.

5. Holding Companies

Section 1202(e)(5)(A) generally provides for a "look-through rule" such that, for purposes of satisfying the "active business requirement" of Section 1202(e), any "subsidiary" corporation (as defined in Section 1202(e)(5)(C)) shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities. In turn, Section 1202(e)(5)(C) provides that a corporation shall be considered a "subsidiary" if the parent owns either more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all the outstanding stock of the corporation.

Based on these rules, it is clear that Section 1202 generally contemplates the potential use of a "holding company" type structure, such that shareholders of a holding company may receive QSB stock that qualifies for the benefits of Section 1202. However, taxpayers should generally exercise caution in a situation where the use of a particular holding company structure may

[95] *See generally,* Treas. Reg. § 1.1045-1(i), Example 12 (QSB stock originally acquired by an individual and subsequently transferred to a partnership does not qualify as QSB stock in the hands of the partnership).

potentially subvert an otherwise operative provision of Section 1202 or a clear policy imperative, such that a transaction may, for example, be subjected to challenge under Section 7701(o) (which clarifies the "economic substance doctrine") or perhaps the judicial "substance over form doctrine."[96] Moreover, these risks may be particularly acute where the use of a holding company is merely transitory, or where basic corporate formalities for the holding company are not otherwise implemented and observed.[97]

6. Stock Held In S Corporations

In general, for purposes of Section 1202, if a taxpayer acquires stock in a corporation that has a valid "S" election in effect pursuant to Section 1362(a), it seems clear that such stock cannot qualify as QSB stock. Such stock cannot qualify as QSB stock because Sections 1202(c)(1) and (c)(1)(A), when read together, generally state that QSB stock means "*any stock in a C corporation*" which is originally issued after the date of enactment of the Revenue Reconciliation Act of 1993 (August 10, 1993) if, as of the date of issuance, such corporation is a "qualified small business" (as defined in Section 1202(d)). In turn, Section 1202(d)(1) defines a "qualified small business" as any domestic corporation "*which is a C corporation*…"[98]

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[96] *See generally,* Gregory v. Helvering, 293 U.S. 465, 469-470 (1935) ("The substance over form doctrine applies when the transaction on its face lies outside the plain intent of the statute and respecting the transaction would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.").

[97] For example, consider whether a taxpayer that formed a new holding company and capitalized it solely with cash, could then cause the holding company to use the cash to acquire the stock of a target company as an alternative to the taxpayer otherwise acquiring the stock of the target directly from the target shareholders. Although it appears that the form of the transaction may generally be respected, in the end, a thoughtful analysis of this kind of fact pattern would depend upon the particular facts and circumstances, with potentially negative weight being applied to cases where the taxpayer, for example, immediately merged the holding corporation (or possibly the target) out of existence as part of a plan, or failed to take meaningful actions designed to support the independent and separate corporate existence of the holding company. *See generally, e.g.,* Moline Properties, Inc. v. Comm'r, 319 U.S. 436 (1943) (establishing a relatively low threshold for the amount of corporate activity that is generally required in order to substantiate the separate existence of a corporation for U.S. federal income tax purposes); Esmark, Inc. v. Comm'r, 90 T.C. 171 (1988) (taxpayer's choice of transactional steps respected; IRS cannot "invent" steps that never occurred); Rev. Rul. 68-349, 1968-2 C.B. 143 (disregarding a newly formed corporation as an effective continuation of a prior corporation that sought to acquire appreciated assets from a third party); Rev. Rul. 85-197, 1985-2 C.B. 120 (historic business of a holding company, which held no assets other than 100% of the stock of a single operating subsidiary, was the business of the operating subsidiary for purposes of the "continuity of enterprise" requirement under Section 368). *See also,* Section 1202(c)(2)(B) (which contains a special rule that waives the "active business requirement" of Section 1202(e) for certain "specialized small business investment companies" that are licensed to operate under Section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993)).

[98] It should be noted that although there are clear references set forth in Section 1202(c)(1) and in Section 1202(d)(1) to "*C corporation*" status, which must be satisfied as of the time of original issuance, a special rule in Section 1202(c)(2)(A) confuses matters somewhat by separately stating that "[s]tock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of [Section 1202(e)] *and such corporation is a C corporation*." [Emphasis added]. The statutory language of Section 1202(c)(2)(A) is potentially confusing because it is not entirely clear whether the phrase "*substantially all*" effectively modifies only the need to satisfy the active business requirements of Section 1202(e), or whether the phrase applies equally to the corporation's status as a C-corporation (with the result that the corporation could, for example, be an S corporation during some portion of the taxpayer's holding period, as some commentators have

With respect to an S-corporation that subsequently revokes its S-election and converts to C-corporation, it also seems clear that subsequent stock issuances by the new C-corporation may potentially qualify as QSB stock (*i.e.,* there is no general prohibition with respect to stock issuances by former S-corporations). In addition, pursuant to the provisions of Section 1202(g), it is also clear that an S corporation may generally hold QSB stock that was acquired at original issuance (in the same way that a partnership may hold QSB stock acquired at original issuance).[99]

Finally, in the same way that a partnership may potentially incorporate its assets, and thereby potentially receive newly issued QSB stock (see the discussion that follows under the next heading below), an S-corporation may similarly incorporate its assets and receive QSB stock. However, a subsequent distribution of any QSB stock received by the S-corporation in the incorporation transaction would generally subject any built-in gain to taxation under Section 311(b) (operating in conjunction with Section 1371(a)), and, at the same time, also apparently cause the distributed stock to lose its character as QSB stock.[100]

7. Partnership Incorporations

Recall that Section 1202(i)(1) provides that, for purposes of Section 1202, when a taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation, such stock: (i) shall be treated as having been acquired by the taxpayer on the date of such exchange; and (ii) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged. This "fair market value" basis rule is designed to prevent holders from using Section 1202 to exclude pre-contribution gain from income. In this regard, the House Committee Report explains: "If property (other than money or stock) is transferred to a corporation in exchange for its stock, the basis of the stock received is treated as not less than the fair market value of the property exchanged. Thus, only gains that accrue after the transfer are eligible for the exclusion."[101]

In addition, also recall that pursuant to Sections 1202(b)(1)(A) and (B), the amount of a taxpayer's "eligible gain," as defined under Section 1202(b)(2), that may be taken into account

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apparently suggested). However, despite the separate reference to C-corporation status in Section 1202(c)(2)(A) for purposes of the active business requirement (and regardless of whether C-corporation status may only need to be satisfied for "*substantially all*" of a taxpayer's holding period), it does not appear as though such reference should otherwise modify the original issuance requirement in Section 1202(c)(1). As a result, it would seem clear that QSB stock must be C-corporation stock at the time of original issuance.

[99] *See generally,* §§ 1202(g)(1), (g)(2), (g)(3), and (g)(4)(B) (referring specifically to S corporations as a qualifying "pass-thru entity").

[100] By comparison, if a partnership effectively incorporates its assets and distributes the QSB stock received to its partners, the QSB stock may potentially retain its character in the hands of the partners, provided that the requirements of Section 1202(h)(2)(C) are satisfied.

[101] House Report No. 2264, at p. 603 (1993).

under Section 1202(a) with respect to a particular corporation is generally limited to the greater of either: (i) $10 million (as reduced by the aggregate amount of any "eligible gain" previously taken into account by the taxpayer under Section 1202(a) for prior taxable years in connection with any sales of QSB stock in such corporation); or (ii) 10 times the aggregate adjusted bases of any QSB stock issued by such corporation and that was disposed of by a taxpayer during the taxable year.

As a result, Section 1202(i) operating in conjunction with Section 1202(b), may have the effect of creating a substantial amount of potentially excludable eligible gain for taxpayers that incorporate a partnership by effectively transferring their interests in the partnership (or possibly the partnership's property) to a newly formed corporation in exchange for QSB stock (equal to 10 times the fair market value of the property transferred).

For example, assume the following general set of facts: (i) T1 and T2 each own 50% of the capital and profits of P, an historic partnership, which holds assets with minimal (close to zero) adjusted tax basis and a fair market value of $20 million; (ii) on August 1, 2020, T1 and T2 cause P to effectively incorporate by each contributing their respective partnership interests in P to C, a newly formed corporation, in exchange for newly issued stock of C; and (iii) as a result of the transfers by T1 and T2, all of the former assets of P become assets of C, and P terminates as a partnership. [102]

Based on these facts, and pursuant to Section 1202(i) working together with Sections 1202(a)(1) and (a)(4), as well as Section 1202(b)(1)(B), each of T1 and T2 should obtain a fair market value basis of $10 million in respect of their QSB stock received, which may allow for the potential exclusion of up to 100% of $100 million of eligible gain under Section 1202(a) (with the $10 million of pre-contribution gain potentially being subject to tax at normal capital gains rates).

8. Primary Issuance Followed by a Redemption

If some of the proceeds of a new funding round will be used to provide liquidity to pre-existing shareholders by undertaking a primary issuance followed by a redemption, then the redemption rules under Section 1202(c)(3) should be carefully evaluated in order to determine their potential impact upon any prior, current, or future share issuances.

For example, assume a founding shareholder S1 was originally issued 100% of the common shares of C in exchange for a contribution of property in connection with C's initial formation. Also assume that one year later S1's common shares have an established pre-money valuation of $10 million at the time of a new financing and that S2 will purchase $5 million of

[102] *See generally,* Rev. Rul. 84-111, 1984-2 C.B. 88 (Situation 3, addressing a so-called "interests over" incorporation). *See also,* PLR 201505001 (addressing an "assets-over" conversion of an LLC taxed as a partnership into a newly formed corporation).

newly issued convertible preferred shares (representing 33.33% of C’s outstanding shares on a post-money, fully-diluted basis). Finally, assume that $0.75 million of the newly raised funds will be used by C to redeem 7.5% of S1’s common shares (equal to 5% of C’s post-money, fully-diluted equity), thereby leaving S1 with $9.25 million of common shares and S2 with $5 million of preferred shares (representing approximately 65% and 35% of C’s outstanding equity on a post-money, post-redemption, fully-diluted basis, respectively).

Based on the assumed facts outlined above, and pursuant to the operation of the two different sets of redemption rules set forth in Sections 1202(c)(3)(A) and (B), respectively, the redemption of 7.5% of S1’s common shares (equal to approximately 5% of C’s post-money, fully-diluted equity), determined as of the date of the new financing, would cause both S1’s remaining common shares and S2’s newly issued preferred shares to fail to qualify as QSB stock. In the case of S1, the 7.5% redemption occurring one year after the original issuance of the common stock is in excess of the applicable $10,000 or two percent (2%) *de minimis* threshold under Section 1202(c)(3)(A) and, in the case of S2, the redemption occurring after the issuance of the convertible preferred stock is similarly in excess of the applicable $10,000 or two percent (2%) *de minimis* threshold under Section 1202(c)(3)(B), as well as the five percent (5%) aggregate stock value threshold (even assuming that C may have had a potential valuation at the time of its initial formation that was equal to the $10 million pre-money valuation ultimately established in connection with the new financing).[103] In addition, future issuances of C shares to S1 may fail to qualify as QSB stock for up to four years following the redemption, and future issuances of C shares to S2 or potentially other new shareholders may similarly fail to qualify as QSB stock for up to 2 years following the redemption.

9. Secondary Sale Followed by a Recapitalization

Building on the preceding example which involves a primary issuance followed by a redemption, assume the same general set of facts except that S2 purchases $0.75 million of S1’s common shares directly in a secondary sale, followed by S2’s exchange of the purchased common shares for $0.75 million of C’s convertible preferred shares (with the exchange treated as a non-taxable recapitalization under Section 368(a)(1)(E)). At the same time as the exchange, S2 will also simultaneously deliver $4.25 million in cash to C for additional newly issued convertible preferred shares in a primary transaction. As a result of the secondary purchase and subsequent exchange, coupled with the concurrent primary cash purchase, S1

[103] For purposes of determining the two percent (2%) *de minimis* threshold under Section 1202(c)(3)(A) (the “taxpayer or related person” rule), the percentage of stock acquired in any single purchase that occurs over the relevant 4-year testing period is determined by dividing the stock’s value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons (within the meaning of Section 267(b) or 707(b)) immediately before the purchase. At the same time, a similar valuation approach (determined as of the time of each purchase) applies to all outstanding stock for purposes of determining the two percent (2%) *de minimis* threshold under Section 1202(c)(3)(B) (the “significant redemption” rule), although it should be noted that once the *de minimis* threshold is exceeded the separate and independent five percent (5%) aggregate threshold is determined by reference to the aggregate value of all of the issuing corporation’s stock determined as of the beginning of the relevant 2-year testing period. *See generally,* Treas. Reg. § 1.1202-2.

will receive $0.75 million in cash from S2 and retain $9.25 million of C's common shares and S2 will effectively acquire a total of $5 million of newly issued convertible preferred shares from C.

As compared with the preceding example, the form chosen by the parties does not involve a redemption by C of any of S1's shares and so the redemption rules under Section 1202(c)(3) would not appear to potentially apply, absent a possible assertion by the IRS that a fictional "deemed redemption" may have somehow occurred as between C and S1 in respect of the $0.75 million of S1's common shares purchased by S2. However, notwithstanding the fact that the IRS could conceivably attempt to challenge the actual form chosen by the parties based on one or more broad judicial doctrines (such as the "step-transaction" or "substance over form" doctrines), there is strong authority that could potentially be relied upon to prevent the IRS from trying to "invent" a deemed redemption that never occurred.

In particular, a leading Tax Court case that addresses the same general type of issue on somewhat similar facts is *Esmark, Inc. v. Commissioner* (previously noted above in connection with the prior discussion regarding the use of a holding companies).[104] In *Esmark*, two publicly held corporations, Esmark and Mobil, entered into a binding agreement by which (i) Mobil would purchase for cash 53% of Esmark's outstanding stock from Esmark's existing shareholders in a public tender offer and (ii) immediately thereafter Esmark would redeem all of Mobil's newly purchased Esmark stock in exchange for 97% of the stock of Esmark's wholly owned subsidiary, Vickers. Under the law in effect at the time, a redemption of Esmark stock in exchange for the stock of its subsidiary, Vickers, was tax-free to Esmark, but a sale of Vicker's stock by Esmark to Mobil for cash would have been taxable to Esmark.

Seeking to tax the built-in gain inherent in the Vicker's shares held by Esmark, the IRS proposed several alternative characterizations of the transactions which would have effectively resulted in a deemed taxable sale by Esmark of the Vickers shares to Mobil for cash, followed by a deemed cash redemption of the Esmark public shareholders by Esmark. The court rejected each of the IRS's theories, stating that although the transaction could have potentially been cast in any of three possible ways (each involving two steps), the parties were entitled to have the transaction taxed in accordance with the form that had been selected where (i) the chosen transactional form was equally as "direct" an explanation of the facts as the alternative characterization proposed by the IRS, (ii) the alternative characterizations asserted by the IRS required the construction of facts that did not, in fact, occur, and which were inconsistent with the legal relationships created by the transactional form, and (iii) each step chosen by the parties had "permanent economic consequences" and there were no steps without independent function.[105]

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[104] Esmark v. Comm'r, 90 T.C. 171 (1988), *aff'd per unpublished order*, 866 F.2d 1318 (7th Cir. 1989).

[105] *Id.* at 198.

In addition, the court went on to state that the proper role of the step-transaction doctrine is to "combine a series of individually meaningless steps into a single transaction,"[106] not to "invent new ones," and that the step-transaction doctrine may not be applied "to generate events which never took place just so an additional tax liability might be asserted."[107]

Regarding Mobil's alleged "transitory" ownership of the Esmark stock, the court emphasized that (i) the tender offer was "an essential element" in Esmark's plan to redeem its shares,[108] (ii) Mobil's tender offer created legal relationships between Mobil and the tendering Esmark shareholders,[109] and (iii) by virtue of the tender offer, the tax ownership of the Esmark shares passed from the tendering public shareholders to Mobil.[110] The Seventh Circuit affirmed the Tax Court's decision in *Esmark* in an unpublished order.[111]

10. Use of Non-Taxable Reorganization to Satisfy Holding Period Requirement

In a case where a target shareholder has not yet satisfied the five-year holding period requirement of Section 1202(b)(2), it may be possible to structure the terms of an acquisition transaction such that the shareholder can use the provisions of Section 1202(h)(4) to effectively "rollover" any potential QSB stock benefits into shares of the acquiring corporation.

For example, assume the following basic facts: (i) S1 owns 100% of the stock of T and has held such stock for 4 years; (ii) with the exception of the five-year holding period requirement of Section 1202(b)(2), S1's stock otherwise qualifies as QSB stock; (iii) S1 has a zero adjusted tax basis and $25 million of built-in gain inherent in the T shares, $10 million of which is potentially eligible for exclusion under Section 1202 if the five-year holding period can be satisfied.

In addition, further assume that P, a large publicly traded corporation (with aggregate gross assets far in excess of $50 million), is interested in acquiring all of S1's shares and has

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[106] *Id.* at 195.

[107] *Id.* at 196-198 (citing *Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973), and *Sheppard v. United States*, 386 Ct. Cl. 982, 361 F.2d 972).

[108] *Id.* at 198.

[109] *Id.* at 195.

[110] *Id.* at 193.

[111] 866 F.2d 1318 (7th Cir. 1989). *See also,* Tracinda Corp. v. Comm'r, 111 T.C. 315 (1998) (Tax Court citing to the *Esmark* case and refusing to adopt the IRS' proposed recharacterization of a series of transactions in a manner that would have required the creation of steps that never occurred). It should also be noted that the IRS has previously expressed its general agreement with the *Esmark* holding and its prohibition on inventing steps. *See, e.g.,* IRS Field Service Advice 200122007 (June 1, 2001) ("Even if it is found that a transaction is part of an overall plan, the step transaction doctrine will usually not create additional steps that never occurred.") (quotation followed by a discussion of the *Esmark* case and the IRS' refusal to recharacterize a series of transactions in a manner that required fictional steps).

proposed a typical "reverse triangular merger" structure in which S1 will receive $20 million in cash and $5 million in P common stock.

Under the proposed terms, P's transaction structure would be fully taxable to S1 because the "acquisition of control" requirement under Section 368(a)(2)(E) would not be satisfied.[112] Furthermore, because the five-year holding period has not yet been satisfied, no amount of S1's built-in gain inherent in the T shares would be eligible for exclusion under Section 1202.

However, if P were willing to change the proposed transaction terms to no more than $15 million in cash and no less than $10 million in P common stock,[113] and if some form of a "forward merger" structure under the reorganization provisions of Section 368 could be utilized rather than a reverse triangular merger,[114] then S1 could potentially use the provisions of Section 1202(h)(4) to create a substantial benefit.

Specifically, if a forward merger structure (such as a relatively common "two-step" forward merger structure) was utilized,[115] and if the parties agreed to a consideration package consisting of $15 million in cash and $10 million in P common stock, then S1 could cause the $10 million of built-in gain and the full amount of related potential QSB stock benefits inherent in the T shares to effectively transfer over to the P common shares received.

Furthermore, S1's holding period for the old T shares would also transfer over to the newly acquired P shares, such that if S1 held the P shares for at least one more year following the closing of the transaction, and then sold such P shares in the open market, the first $10 million

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[112] *See generally,* § 368(a)(2)(E)(ii) (requiring the target corporation shareholders to surrender an amount of target corporation stock in the transaction that is sufficient to constitute "control" of the target in exchange for voting stock of the acquiring corporation). *See also,* § 368(c) (defining "control" for purposes of the reorganization provisions as stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of non-voting stock); Rev. Rul. 59-259, 1959-2 C.B. 115 (interpreting the non-voting stock aspect of Section 368(c) to mean that 80% of *each* separate class of outstanding non-voting stock of the target corporation must be acquired in exchange for voting stock of the acquiring corporation).

[113] The receipt by S1 of at least $10 million in P common stock would amount to 40% of the total consideration package of $25 million, thereby facilitating the satisfaction of the "continuity of shareholder interest requirement" that is generally applicable to the corporate reorganization provisions under Section 368. *See generally,* Treas. Reg. § 1.368-1(e).

[114] As compared with a "reverse triangular merger" structure under Section 368(a)(2)(E), in which the target corporation continues its existence as a wholly-owned subsidiary of the acquiring corporation under state law, a "forward merger" structure under either Section 368(a)(1)(A) or Section 368(a)(2)(D) results in the target corporation effectively ceasing its separate corporate existence along with a simultaneous transfer of all of its assets and liabilities to the acquiring corporation (or a subsidiary of the acquiring corporation) under state law.

[115] In a typical "two-step" forward merger structure, a first-step reverse triangular merger is followed by a second-step forward merger, whereby the target corporation merges with and into a wholly-owned limited liability company / "disregarded entity" of the acquiring corporation in the second step (with the two mergers being integrated together for U.S. federal income tax purposes as part of a plan and effectively treated as a direct forward merger of the target corporation with and into the acquiring corporation under Section 368(a)(1)(A)). *See generally,* Rev. Rul. 2001-46, 2001-2 C.B. 321.

of any built-in gain would generally be eligible for exclusion under Section 1202 (even though P itself failed the $50 million in aggregate gross assets requirement at the time of the acquisition, such that P's shares could not independently qualify as QSB stock when issued to S1). [116]

[116] *See generally,* § 1202(h)(4)(A) (relating to a transfer of QSB stock for non-QSB stock pursuant to a transaction qualifying under Section 351 or Section 368 and treating the non-QSB stock received as QSB stock acquired as of the date on which the exchanged QSB stock was originally acquired by the taxpayer) and § 1202(h)(4)(B) (limiting the amount of the potential QSB stock benefit to the amount of gain that would have been recognized if Section 351 or Section 368 had not applied at the time of the transfer, except in a case where the acquiring corporation's stock would have independently qualified as QSB stock).

Author

David B. Strong
PARTNER

david.strong@wilmerhale.com
+1 720 598 3469