SECTION 1202
QUALIFIED SMALL BUSINESS STOCK

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MORRISON | FOERSTER

David B. Strong
Partner
Direct Phone: (303) 592-2241
E-Mail: dstrong@mofo.com

5200 REPUBLIC PLAZA
370 SEVENTEENTH STREET
DENVER, COLORADO
80202-5638

TELEPHONE: 303.592.1500
FACSIMILE: 303.592.1510

WWW.MOFO.COM

MORRISON & FOERSTER LLP

NEW YORK, SAN FRANCISCO,
LOS ANGELES, PALO ALTO,
SACRAMENTO, SAN DIEGO,
DENVER, NORTHERN VIRGINIA,
WASHINGTON, D.C.

TOKYO, LONDON, BRUSSELS,
BEIJING, SHANGHAI, HONG KONG

MORRISON | FOERSTER

David B. Strong
Partner
Direct Phone: (303) 592-2241
E-Mail: dstrong@mofo.com

Dave Strong represents a wide range of corporate, pass-through, and individual clients in connection with the tax aspects of complex domestic and international transactional matters, including mergers and acquisitions, joint ventures, private equity and venture capital investments, restructurings, distressed situations, and initial public offerings and other capital markets transactions.

Mr. Strong currently serves as the vice chair of the Corporate Tax Committee of the Tax Section of the American Bar Association and he is scheduled to chair that committee beginning in 2013. Mr. Strong is also a frequent speaker on corporate and other tax matters at local, regional, and national seminars and continuing legal education programs.

Mr. Strong received his J.D. from Stanford Law School and his LL.M. in Taxation from New York University. Prior to moving to Denver, Mr. Strong worked for several years as both a transactional tax attorney and as an investment banker in New York City.

For an outline of prior publications and speaking engagements, as well as a listing of representative M&A and capital markets transactions on which Mr. Strong has served as lead tax advisor, consult Mr. Strong's complete professional biography at: www.mofo.com/david-strong

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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 a substantial portion (or possibly all) of the gain realized from the sale or exchange of QSB stock held for more than five years. 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. *100% Exclusion – Stock Acquired After 9/27/10 & Before 1/1/12.*

The Small Business Jobs Act of 2010[2] amended Section 1202 to provide for a temporary 100% exclusion from gross income for regular income tax purposes for QSB stock purchased after September 27, 2010 and before January 1, 2011, and comparable 100% exclusion from alternative minimum tax ("AMT") purposes. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,[3] extended the January 1, 2011 end-date for acquiring QSB stock eligible for the 100% regular income tax and AMT exclusion to January 1, 2012.

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

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

The Obama administration has proposed making these 100% exclusions permanent, but the status of this proposal is uncertain.[4]

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.

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 in a C-corporation which 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, or as compensation for services performed for such corporation (other than services performed as an underwriter of such stock).

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[4] Historically, Section 1202 provided for other exclusion percentages (50%, 60% or 75%), depending on when stock was acquired and the type of business, and also provided for varying percentages of the Section 1202 exclusion to be treated as a preference item for AMT purposes.

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. <u>Stock of a C-Corporation</u>.

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 corporation with respect to which an election under Section 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect; (iii) a RIC (regulated investment company), REIT (real estate investment trust), or REMIC (real estate mortgage investment conduit); and (iv) a cooperative.

B. <u>"Original Issuance" Requirement</u>.

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, or as compensation for services performed for such corporation (other than services performed as an underwriter of such stock).[5]

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).[6]

Although the Code does not specifically define the term "property" for purposes of Section 351(a),[7] courts have generally

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[5] 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).

[6] 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 an altogether different requirement for purposes of Section 1202.

[7] 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.

adopted a broad definition so as to encompass virtually anything that can be "*identified, valued, and transferred*."[8]

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

For example, in Rev. Rul. 69-156,[9] 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.[10] Similarly, in Rev. Rul. 71-569,[11] the IRS held that a transfer of rights to a patent for a

8 *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].

9 1969-1 C.B. 101.

10 *See also,* FSA 1998-481 (October 7, 1998).

11 1971-2 C.B. 179.

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.[12]

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*,[13] 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.[14] 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

[12] 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.

[13] 727 F.2d 1043 (11th Cir. 1984).

[14] 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.

major terms of a development project, constituted "property" for 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,[15] 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).[16]

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

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[15] 1979-2 C.B. 139.

[16] 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.

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.[17]

4. *Incorporation of a Partnership.*

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).[18]

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[17] 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.

[18] 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

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.[19] 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.[20] Furthermore, the determination as to whether the gross assets test is met is made at

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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.

[19] *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").

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

the time of exercise or conversion, and the holding period of such stock is treated as beginning at that time.[21]

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.[22]

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.[23] 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 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).[24]

In these cases, stock of the Acquiring Corporation or of Newco is treated as QSB stock even though it would not normally

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[21] *Id.*

[22] *Id.*

[23] § 1202(h)(4).

[24] 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).

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.[25]

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.[26]

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

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25 *See* § 1202(h)(4)(C).

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

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.[27]

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.[28]

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 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

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[27] § 1202(g)(1)(B).

[28] § 1202(g)(3).

of the time of such contribution).[29] 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.[30]

In addition, and also for purposes of 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 appears and Section 1563(a)(4) shall not apply).[31]

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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[29] *See* § 1202(d)(2). Note that the use of adjusted tax bases for purposes of the "aggregate gross assets" test can potentially lead to results that diverge significantly from fair market value.

[30] *See* House Committee Report.

[31] *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;
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> (C) any farming business (including the business of raising or harvesting trees);
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> (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.

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 corporation with respect to which an election under Section 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect; (iii) a RIC (regulated investment company), REIT (real estate investment trust), or REMIC (real estate mortgage investment conduit); and (iv) 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.[32]

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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[32] 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).[33]

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 accordance with special rules applicable to "personal holding companies"[34]) 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 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. <u>In General</u>.

In general, the holding period of QSB stock begins on the date of issuance whether or not the QSB stock was received in a taxable or non-taxable transaction.[35]

Special tacking rules, however, apply to the computation of the 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,

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33 § 1202(e)(8).

34 § 542 *et. seq.*

35 § 1202(i)(1)(A).

by inheritance, or as a transfer from a partnership.[36] In particular, the holding period of stock received in a conversion includes the holding period for the converted stock and the holding period of stock received by gift, inheritance or from a partnership includes the period the stock was held by the donor, decedent or partnership.

The holding period also tacks in the case of QSB stock exchanged for stock of another corporation that is treated as QSB stock in a transaction described under Sections 351 or 368.[37]

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.[38]

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.[39]

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[36] §§ 1202(f)(2) and 1202(h)(1)(B).

[37] § 1202(h)(4)(A).

[38] *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).

[39] 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

VI. AMOUNT OF GAIN SUBJECT TO EXCLUSION

A. Section 1202(a) Exclusion.

Section 1202(a)(1) provides that in the case of a taxpayer other than a corporation gross income shall not include 50% of any gain from the sale or exchange of QSBS held for more than five years. Section 57(a)(7) treats 7% of the amount excluded under Section 1202 as a preference item for alternative minimum tax purposes. Section 1202(a)(4), added by the Small Business Jobs Act of 2010, provides that in the case of stock acquired after September 27, 2010 and before January 1, 2011: (i) the Section 1202(a) exclusion shall be 100%; (ii) Section 1202(a)(2) (dealing with certain empowerment zone businesses) shall not apply; and (iii) Section 57(a)(7) (providing that 7% of the amount excluded under Section 1202 shall be treated as a preference item for alternative minimum tax purposes) shall not apply.[40]

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

In general, Section 1202(b)(1) 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" previously excluded 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.

For purposes of Section 1202(b), the term "eligible gain" means any gain from the sale or exchange of QSB stock held for

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"taxpayer" includes a reference to any person who is "related" (within the meaning of Section 267(b) or Section 707(b)) to the taxpayer.

[40] It should also again be noted that on December 17, 2010, pursuant to Pub. Law No. 111-312, the benefits afforded under Section 1202(a)(4) were extended through December 31, 2011.

more than 5 years.[41] 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).[42] 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 in 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.

One critical aspect of the "basis equals fair market value" rule of 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)).[43]

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41 § 1202(b)(2).

42 § 1202(h)(4)(B).

43 *See* House Committee Report.

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 (*i.e.*, gross proceeds) 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.[44]

Section 1045 also incorporates by reference the special basis rules in Section 1202.[45] Thus, in general, the amount of any gain attributable to periods prior to the receipt of the QSB stock is not eligible for roll over 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.[46]

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44 § 1045(b)(3).

45 § 1045(b)(5) and § 1202(i).

46 *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.[47]

2. *Sale of QSB Stock.*

The taxpayer must sell QSB stock.[48]

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.[49]

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.[50] 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

47 § 1045(a) (lead-in language).

48 *Id.*

49 § 1045(b)(4)(A).

50 § 1045(b)(5).

stock sold in the rollover transaction for purposes of the 5-year holding period requirement under Section 1202.[51]

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 made by reporting the gain on Schedule D ("Capital Gains and Losses") of the return, in accordance with the instructions for Schedule D.[52]

5. *Character of Gain.*

The taxpayer's gain that would be recognized in the absence of Section 1045 cannot be ordinary income.[53]

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).[54]

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.[55] Section 1045 does not require a clear tracing of funds from the QSB stock sold to the replacement QSB stock acquired.

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51 *See* House Report No. 105-220, at page 385, 1997-4 C.B. 1855.

52 *See* Rev. Proc. 98-48, 1998-2 C.B. 367.

53 § 1045(a) (ending flush language).

54 § 1045(b)(2).

55 § 1045(b)(4).

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").[56]

1. *Rollover by Partnership.*

A partnership that holds QSB stock for more than 6 months,[57] 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.[58] The Section 1045 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.[59]

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

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[56] 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.

[57] 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).

[58] 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 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).

[59] Treas. Reg. § 1.1045-1(b)(3).

1045.[60] 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.[61] 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.[62]

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[60] 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).

[61] 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 appropriately adjusted to reflect tiered partnerships. Treas. Reg. § 1.1045-1(d)(3). The IRS views the smallest percentage interest in partnership capital approach as being consistent with the requirements of Section 1202(g) regarding pass-through entities and would presumably take the same position regarding a partner's share of gain eligible for exclusion under Section 1202.

[62] Treas. Reg. § 1.1045-1(i), Example 9.

The Section 1045 Regulations permit an "eligible partner" to opt out of a partnership's Section 1045 election.[63] For purposes of these rules, an "eligible partner" is a taxpayer (other than a 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.[64]

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.[65] An

[63] 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 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).

[64] 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).

[65] 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

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.[66]

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.[67]

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 distributing partnership with respect to its investment in QSB stock.[68] 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

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).

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

[67] 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 of the cost of QSB stock purchased by a purchasing partnership, and (ii) basis adjustments to partnership interests and replacement QSB stock, and taking such adjustments into account in later gain recognition transactions. Treas. Regs. § 1.1045-1(c)(2), (3), (4), (5).

[68] Treas. Reg. § 1.1045-1(e)(1), (2).

amount realized" reduced by the partner's "section 1045 adjusted basis."[69]

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.[70]

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.[71]

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 that may be made before January 1, 2012 (assuming the provisions of currently law are not further extended).

In general, attempting to plan into Section 1202 may make sense in a situation where, among other things: (i) a five-year holding period is at least a possibility (particularly given the longer investment "holds" experienced in recent years during the economic downturn); (ii) the aggregate gross asset value of the

[69] 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.

[70] Treas. Reg. § 1.1045-1(e)(4).

[71] Treas. Reg. § 1.1045-1(i), Example 12.

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 "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 a corporate-level tax during the operational phase; (vi) the expected investor base is composed of non-corporate taxpayers that can actually 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.

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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. <u>Planning for Exit</u>.

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" previously excluded 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.[72] 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 QSBS 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.

[72] 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].

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 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 QSBS 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 Section 1202(b)(1) and (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).[73]

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

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[73] In this regard, it should be noted that the IRS has at least tentatively agreed with such a construction of the statute. *See* "ABA Section of Taxation Meeting: IRS Reads 'Interesting Feature' Into Stock Gain Exclusion," Tax Notes Today (2011 TNT 90-4) (May 16, 2011).

would have a far worse result than if T sold both blocks in the same year; namely, it appears that T would be able to exclude all $16 million of gain inherent in the high-basis shares in year 5 (greater of $10 million or 10 times T's aggregate adjusted bases in its QSBS 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 $10 million or 10 times T's aggregate adjusted bases in its QSBS sold in year 6 of $1 million x 10 = $10 million). As a result, would T therefore 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?

Finally, assume the same facts as the example immediately above, except assume that T only sells 500 of the low basis shares in year 6 (worth $10 million with $9.5 million of gain) and then sells 500 of the low basis shares in year 7 (again, worth $10 million with $9.5 million of gain). What is the result? In particular, is T now better off? Specifically, can T exclude all $9.5 million in year 6 (greater of previously unused "lifetime" exclusion of $10 million or 10 times T's aggregate adjusted bases in its QSB stock sold in year 6 of $500k = $5 million) and $5 million in year 7 (greater of $500k remaining from "lifetime" exclusion of $10 million or 10 times T's aggregate adjusted bases in its QSB stock sold in year 7 of $500k = $5 million)?

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.[74]

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[74] 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

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.[75] 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 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).

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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.

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

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).