Client Alert

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Private Ruling Endorses Taxpayer-Friendly Reading of "Qualified Small Business" Under Section 1202

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On September 5, 2014, the Internal Revenue Service ("IRS") released Private Letter Ruling 201436001 (the "Ruling"), which found that a company providing products and services primarily within the pharmaceutical industry was a "qualified trade or business" for purposes of Section 1202(e)(3).[1] The IRS had never before issued guidance on the definition of "qualified small business stock" ("QSBS") under Section 1202.[2] A private letter ruling is not binding on the IRS except as to the taxpayer that requested and received the ruling, and cannot be relied upon as precedent by other taxpayers. Nonetheless, a private letter ruling typically provides all taxpayers with some indication of the IRS position on the particular legal issue that was addressed in the context of the facts contained in the ruling.

BENEFITS OF SECTION 1202

Section 1202 allows an individual shareholder who has held QSBS for more than five years to receive tax-reduced or tax-free gain up to the greater of $10 million or 10 times the shareholder's basis in the QSBS.[3] In order for a shareholder's stock to qualify as QSBS, it must have been issued by a "qualified small business" ("QSB") and it must have been acquired by the shareholder at original issuance (or in certain limited non-recognition transactions).[4] Among other requirements, a corporation can be a QSB only if at least 80 percent of its assets are used in the active conduct of at least one "qualified trade or business."[5] The Ruling is of particular interest because it gives substantive consideration to the meaning of the term "qualified trade or business."

[1] P.L.R. 201436001 (May 22, 2014).

[2] All Section or § references herein are to sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[3] *See* Section 1202(a)(1). Provided all of the other requirements are met, taxpayers who acquired QSBS before 2009 or after 2013 are eligible to exclude 50 percent of their gain from tax, subject to the alternative minimum tax ("AMT") clawback; those who acquired QSBS between February 2009 and September 2010 are eligible for 75 percent exclusion, subject to AMT clawback; and those who acquired QSBS between September 2010 and December 2013 are eligible for 100 percent gain exclusion, with no AMT clawback. As noted in the text accompanying footnote 8, *infra*, pending legislative proposals would reinstate the 100 percent gain exclusion either permanently or temporarily.

[4] *See* Sections 1202(c)(1) and (h). For additional discussion of the requirements applicable to QSBS and Section 1202 generally, *see* MoFo Client Alert: Recent Changes Allow Tax-Free Receipt of up to $10 Million in Gain from the Sale of Small Business Stock, Jan. 17, 2013, available at http://media.mofo.com/files/Uploads/Images/130116-Sale-of-Small-Business-Stock.pdf; Bernie Pistillo and Maureen Linch, Recent Changes Make Qualified Small Business Stock Rules Attractive for Shares Acquired during 2013, NVCA Today, Feb. 25, 2013, available at http://nvcatoday.nvca.org/index.php/from-our-sponsors/recent-changes-make-qualified-small-business-stock-rules-attractive-for-shares-acquired-during-2013.html; David Strong, Section 1202 Qualified Small Business Stock, Aug. 11, 2011, available at http://media.mofo.com/files/Uploads/Images/110811-Section-1202-Qualified-Small-Business-Stock.pdf.

[5] Section 1202(e)(1).

QUESTIONS CONSIDERED IN THE RULING

The facts of the Ruling involved a company that operated in the pharmaceutical industry and aided clients in the commercialization of experimental drugs. The company's main business activities were researching the effectiveness of drug formulations, conducting clinical tests, and manufacturing drugs. The company also helped clients develop successful drug-manufacturing processes and solve other problems encountered in the pharmaceutical industry. The company's assets included manufacturing and clinical facilities along with intellectual property assets, such as a patent portfolio. The company also possessed several valuable relationships in the pharmaceutical industry.

The taxpayer in the Ruling had recently disposed of some stock in the company and asked the IRS to rule on whether the company was engaged in a "qualified trade or business" within the meaning of Section 1202(e)(3). Section 1202(e)(3) defines a "qualified trade or business" as any business *other than* a trade or business that:

- involves performing services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, athletics, financial services, brokerage services, or consulting;
- has as its principal asset the reputation or skill of one or more of its employees;
- operates in the field of finance, insurance, banking, investing, leasing, farming, or mining; or
- runs a hotel, motel, restaurant, or similar business.

In analyzing whether the company was engaged in a "qualified trade or business" under Section 1202(e)(3), the IRS explained that "the thrust of § 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners)." The IRS noted that the company in the Ruling used its specific manufacturing and intellectual property assets to create value for customers, and was akin to a manufacturer of parts in the automobile industry. Accordingly, despite recognizing the company's clear connections to the pharmaceutical industry, which is a component of the "health" industry (a clearly prohibited field), the IRS ruled that the company's activities did not amount to the performance of services in the health industry within the meaning of Section 1202(e)(3). The Ruling specifically noted that the "Company is not in the business of offering service in the form of individual expertise."

POTENTIAL USEFULNESS OF THE RULING TO TAXPAYERS

The Ruling is significant because it should offer some insight into the government's general view of the meaning of "qualified trade or business" under Section 1202(e)(3). The plain language of the statute might have been read more broadly to exclude clinical testing and drug research as activities equivalent to the performance of services in the health industry. The Ruling's narrower interpretation of the exclusions in Section 1202(e)(3) at a minimum should provide many pharmaceutical companies with a favorable outlook as to their QSB eligibility.

The Ruling does not directly address the meaning of the language in Section 1202(e)(3) which excludes from the definition of "qualified trade or business" a company whose "principal asset . . . is the reputation or skill of one or

more of its employees."[6] Taxpayers frequently question the scope of this provision, wondering whether this phrase might encompass all start-up companies with few hard assets on their books because they must rely heavily on key employees to establish and maintain business value, or whether the term is limited to companies engaged in inherently service-based businesses.[7] Although the Ruling does not provide a direct answer to this question, it does explain that the "reputation or skill" provision "works to exclude, for example, consulting firms, law firms, and financial asset management firms" and that the "thrust" of Section 1202(e)(3) is to exclude businesses whose primary value generator is services. Given the *Owen* case discussed in footnote 7 above, and the rationale of the Ruling, in appropriate circumstances it would seem reasonable for a start-up that is not engaged in one of the specifically excluded businesses to argue that it is a QSB even though it relies heavily on the skill and expertise of its employees, particularly where their efforts are necessary in order to develop valuable intangible assets that ultimately will go on to represent the bulk of the value of the company.

CONCLUSION

Section 1202 has often been criticized by commentators as not offering sufficient benefits to investors to justify its substantial limitations. However, legislative changes made in 2010 allow taxpayers who acquired QSBS between September 2010 and December 2013 to exclude 100 percent of their gain when they sell their QSBS, subject to the $10 million or 10-times-basis limits described above (and to avoid the AMT clawback). In addition, bills that have been introduced recently in the Senate would extend the 100 percent exclusion either temporarily or permanently.[8] A temporary or permanent extension of the 100 percent gain exclusion, combined with a favorable definition of "qualified trade or business," definitely would make Section 1202 a more beneficial provision for entrepreneurs and investors who are considering how to form a new business venture.

[6] Section 1202(e)(3)(A).

[7] The legislative history of Section 1202 also does not answer this question. The only authority we are aware of that discusses the point is a Tax Court memorandum opinion, *John P. Owen*, T.C. Memo. 2012-21, which in dicta dismisses an attempt by the government to disqualify a corporation as a QSB because of the importance of the founder's skill to the business. The case involved a company that created and sold insurance-related financial products. The founder was a seasoned insurance salesman with 40 years of experience in insurance sales. The IRS argued that the company did not qualify because of the "reputation or skill" language in Section 1202(e)(3) since the founder's skill was one of its principal assets of the business, but the court disagreed, explaining that even though the founder's skill did contribute to the success of the business, it was not an asset of the company.

[8] The Expiring Provisions Improvement, Reform, and Efficiency Act of 2014, introduced on April 28, 2014, would extend the 100 percent gain exclusion to QSBS acquired until January 2016. S. 2260, 113th Cong. § 136 (2d Sess. 2014). The Buy it in America Act, introduced on July 29, 2014, would permanently extend the 100 percent gain exclusion to QSBS acquired any time after September 2010. S. 2680, 113th Cong. § 4 (2d Sess. 2014).

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