INTERNAL REVENUE CODE §1202 AND YOU: ANALYZING EXCLUSION OF GAIN ON SALES OF SMALL BUSINESS STOCK

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Section 1202 of the Internal Revenue Code provides a way for taxpayers to exclude much, if not all, of the gain on the sale of stock in certain small businesses. With the deal volume of recent years, this issue has often arisen with owners of small businesses interested in whether they would qualify for the gain exclusion under I.R.C. §1202 when considering the terms of potential sales.

While the rigorous requirements of I.R.C. §1202 disqualify many taxpayers, with some foresight and planning businesses in the early or startup phases of their existence can plan for an eventual sale that fits within the I.R.C. §1202 framework. Given the tax savings available under I.R.C. §1202, planning to meet the statute's requirements may be a way to increase a business' value to its owners in the event of a qualifying sale.

In the more common case, a tax professional will be tasked with examining whether a particular taxpayer's stock ownership will qualify for gain exclusion under I.R.C. §1202 after the company has been up and running for years. This article provides a framework for this analysis given the requirements of I.R.C. §1202, and highlights issues tax professionals may come across in their examination of a potential sale.

Specifically, this article addresses the application of I.R.C. §1202 to businesses that engage in some form of "consulting" as a part of their operations. Because many businesses engage in some form of consulting, and "consulting" businesses are prohibited from enjoying the gain exclusion of I.R.C. §1202, the question of whether a business is truly engaged in disqualifying amounts of "consulting" will require close analysis by the tax professional.

I.R.C. §1202, In General

I.R.C. §1202 offers a way for qualifying taxpayers to exclude from their taxable income some or all of the gain realized from the sale or exchange of qualified small business stock (QSB stock), as long as the taxpayer has held the QSB stock for at least five years. I.R.C. §1202(c). Depending on the details, the exclusion amount can range from 50% to 100% of the gain.[1]

The general requirements for exclusion of gain under I.R.C. §1202 involve the following elements: 1) The taxpayer must have owned the stock for over five years prior to selling it[2]; 2) The stock must be "qualified small business stock" as that term is defined in I.R.C. §1202[3]; 3) The corporation in which the stock is issued must be a "qualified small business" as that term is defined in I.R.C. §1202[4]; 4) During the taxpayer's entire holding period, the corporation must meet the "active business" requirements of I.R.C. §1202, including the requirement that the corporation be involved in a "qualified trade or business."[5]

The tax practitioner examining a transaction for potential gain exclusion under I.R.C. §1202 must review each of these elements in detail to determine whether the statute will apply. A framework for that analysis follows below.

The Five-year Holding Period

The taxpayer must hold the QSB stock for five years prior to the sale to meet the requirements of I.R.C. §1202. While this is a straightforward requirement, I.R.C. §1202 accounts for the fact that taxpayers will often sell their stock before the five-year holding period has elapsed. Specifically, the statute provides that the period during which a taxpayer holds QSB stock can, in some instances, be "tacked on" to the periods that the taxpayer holds other stock following certain transactions.

For example, consider a taxpayer who originally acquires stock in a corporation (Corp 1) that is a "qualified small business" and holds it for less than a year. The stock owner later acquires stock in a second corporation (Corp 2) in exchange for the Corp 1 stock in a reorganization described in I.R.C. §368.[6]

When the stock received in a reorganization is issued by a qualified small business, then the stock so received *continues* to be treated as qualified small business stock acquired on the date the exchanged stock was acquired. In such a case, the stock owner would not be limited to applying I.R.C. §1202 to any gain at the time of the transaction, but instead, could continue to hold the stock and potentially apply I.R.C. §1202 to a later disposition of that stock.[7]

Practically speaking, this means that if Corp 2 was a qualified small business at the time of the transaction, then the client "tacks on" the original holding period and can continue to hold the Corp 2 stock for potential non-recognition once the required five years have elapsed.

Private Letter Ruling (PLR) 9810010 (1998) explained this treatment as follows:

> *Based solely on the taxpayer's representations that a portion of the Distributing stock owned by A through N was classified as qualified small business stock under § 1202 (Distributing QSBS), a proportionate amount of Controlled stock received by each of A through N in exchange for such individual's Distributing QSBS will be treated as qualified small business stock (§ 1202(h)(4)(A)). The holding period for the Controlled stock treated as qualified small business stock under §1202(h)(4)(A) includes the holding period for which each of A through N held the Distributing QSBS.*[8]

In this manner, subsequent exchanges of QSB stock can be "tacked" together for purposes of determining (and reaching) the five-year holding period.[9]

Qualified Small Business Stock

If a taxpayer meets the five-year holding period requirement, the next item for analysis is whether the stock at hand is QSB Stock. Under I.R.C. §1202, only sales of QSB stock will qualify for partial exclusion of the gain that would otherwise be included in gross income for tax purposes. There are a number of requirements set forth in I.R.C. §1202 that determine whether such stock is QSB stock to which the gain exclusion will apply. These requirements are as follows:

1) The stock must have been originally issued after the date of the enactment of the Revenue Reconciliation Act of 1993 (August 10, 1993).[10]

2) The corporation at issue must be a C corporation.[11]

3) The stock must be acquired at its original issuance for money or other property or as compensation for services provided to the corporation.[12]

4) During the four-year period beginning on the date two years before the issuance of the stock, the corporation cannot have purchased any of its stock from the taxpayer or a person related to the taxpayer.[13]

5) During the two-year period beginning on the date 1 year before the issuance of the stock, the corporation cannot have made one or more purchases of its own stock with an aggregate value exceeding 5% of the aggregate value of all its stock as of the beginning of the two-year period.[14]

6) The corporation must be a “qualified small business” as of the date the stock is issued. I.R.C. §1202(c)(1)(A).

7) If any qualified small business stock is *converted* to other stock in the same corporation, the stock so converted will retain its status as qualified small business stock after the conversion and the stock shall be treated as having been held during the period which the converted stock was held.[15]

These requirements are relatively straightforward. However, complication can arise when considering whether the corporation at hand is a “qualified small business” under I.R.C. §1202(c)(1)(A). This issue is discussed below.

Qualified Small Business

In order for the stock to be “qualified small business stock” it must be stock in a “qualified small business.” The requirements for determining whether a corporation will qualify as a qualified small business are as follows: 1) The corporation must be a domestic C corporation[16]; and 2) The corporation’s “aggregate gross assets” at all times on or after August 10, 1993, before the stock was issued, and immediately after the issuance of the stock cannot exceed $50 million.[17]

If the corporation at issue comes close to the $50 million figure, then a careful examination of the term “aggregate gross assets” will be required. This term is defined to include the “amount of cash and the aggregate adjusted basis of other property held by the corporation,” including amounts received by the corporation at issuance of the stock.[18]

If the corporation at issue is a member of a “parent-subsidiary controlled group,” then the assets of the entire group will be considered in calculating the $50 million threshold.[19] A “parent-subsidiary controlled group” in this context is defined by reference to I.R.C. §1563(a)(1), which provides definitions for “chains of corporations connected through stock ownership with a parent corporation.”[20] However, the I.R.C. §1202 definition provides a lower floor of voting interests (50%) to reach the status of a controlled group as compared to I.R.C. §1563(a)(1), which sets the floor at 80%.[21]

As with any code provision that hinges on the value of assets, a strong third-party valuation should be obtained by the taxpayer to support the reported value of the corporation’s assets. I.R.C. §1202(d)(1)(C) anticipates this, as it states that, in the context of the $50 million threshold, the corporation “agrees to submit such reports to the

secretary and to shareholders as the secretary may require to carry out the purposes of this section."[22] To date, the IRS has not issued guidance on what reports would be necessary in this context. Because of the tax savings involved with exclusion of gain under I.R.C. §1202, any taxpayer with QSB stock in a corporation close to the $50 million limit should be prepared to defend its valuation methodology.

Active Business Requirement

If a taxpayer meets the initial "holding period" and QSB stock requirements, the analysis will then turn to the "active business" requirement of the statute. Specifically, I.R.C. §1202(c)(2)(A) requires that, for "substantially all" of the taxpayer's holding period of the stock, the corporation must meet the "active business" requirements of I.R.C. §1202(e). These requirements are as follows:

1) At least 80% (by value) of the assets of the corporation must be used by the corporation in the active conduct of 1 or more "qualified trades or businesses."[23]

2) A "qualified trade or business" is *any* trade or business *other than* those businesses set forth in I.R.C. §1202(e)(3). These include:

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 1 or more of its employees.[24]

b) Any banking, insurance, financing, leasing, investing, or similar business. I.R.C. §1202(e)(3)(B).

c) Any farming business (including the business of raising or harvesting trees). I.R.C. §1202(e)(3)(C).

d) Extraction of material from natural deposits (such as mining, oil wells, or gas deposits). I.R.C. §1202(e)(3)(D).[25]

e) Any business of operating a hotel, motel, restaurant, or similar business.[26]

3) The corporation must be an "eligible corporation."[27] An "eligible corporation" is any domestic corporation that is not a DISC or former DISC, a regulated investment company, REIT, or REMIC, or a cooperative.[28]

4) The corporation must not hold more than 10% of the total value of its assets in real property which is not used in the active conduct of a qualified trade or business.[29]

5) The corporation must not hold more than 10% of the value of its assets in excess of liabilities in stock or securities in other corporations that are not subsidiaries of the corporation.[30]

These requirements are, though detailed, relatively straightforward for the taxpayer analyzing its qualification under I.R.C. §1202. However, there may be a question as to whether a particular business is disqualified under I.R.C. §1202(e)(3)(A) as a "consulting" business. This issue is discussed below.

Consulting Firms and "Qualified Trade or Business"

Generally speaking, many companies perform "consulting" services in one form or another. However, whether the corporation's activities disqualify it from the active business requirements under I.R.C. §1202 requires closer analysis.

As noted above, the exclusion of gain under I.R.C. §1202 applies only to gain from the sale of "qualified small business stock."[31] Stock will only be treated as "qualified small business stock" if, during the taxpayer's entire holding period, the corporation meets the "active business requirements" set forth in I.R.C. §1202 (e).[32]

The "active business requirement" mandates that at least 80% (by value) of the corporation's assets are used in the active conduct of one or more "qualified trades or businesses."[33] In pertinent part, the term "qualified trade or business" is defined to exclude "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*."[34]

No Treasury Regulation has been promulgated expanding on I.R.C. §1202(e). This means that there are no regulations with deeper explanations of what types of businesses are disqualified under I.R.C. §1202(e)(3)(A). In the absence of a regulation, we are left with administrative authority and caselaw on the issue. These are instructive on how the IRS may look at the issue. This article discusses three such sources of authority: Private Letter Rulings, the *Owen* case, and the Treasury Regulations implementing I.R.C. §199A.

Private Letter Rulings

The IRS has issued certain private letter rulings (PLRs) addressing this issue. With the caveat that PLRs are not "precedent" pursuant to I.R.C. §6110(k)(3), they are nevertheless instructive about how the IRS has approached similar issues in the past.

• *PLR 201436001 (Sept. 5, 2014)* — This PLR examined whether a company that provides products and services to the pharmaceutical industry is a qualified trade or business under I.R.C. §1202(e)(3)(A). Addressing the law, the IRS explained as follows:

> *Section 1202(e)(3) excludes various service industries and specified non-service industries from the term "qualified trade or business." Thus, a qualified trade or business cannot be primarily within service industries, such as restaurants or hotels or the providing of legal or medical services. In addition, §1202(e)(3) excludes businesses where the principal asset of the business is the reputation or skill of one or more of its employees. This works to exclude, for example, consulting firms, law firms, and financial asset management firms. Thus, 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).*[35]

The key take-away from this is that the "principal asset" test is based on the personal services provided by highly trained employees. (The reference to hotels is based on the specific exclusion of the hospitality industry under I.R.C. §1202(e)(3)(D).)

• *PLR 201717010 (Apr. 28, 2017)* — This PLR examined whether a company that provides services to the healthcare industry is a qualified trade or business under I.R.C. §1202(e)(3)(A). The IRS found that the company *was* a qualified trade or business because the company's testing services were provided to healthcare companies by employees who were specifically trained to perform the company's tasks, and those skills "are not useful to other employers."

The key take-away from this PLR is that even though a company may be in the business of performing tasks that can be characterized as "services," those services can constitute a qualified trade or business if they are performed by employees trained by the business specifically for those tasks.

• *PLR 202144026 (Nov. 5, 2021)* — This PLR examined whether a company that develops and sells software to medical providers is a qualified trade or business under I.R.C. §1202(e)(3)(A). The IRS found that the company *was* a qualified trade or business, and

then described the "exclusion" under I.R.C. §1202(e) as applying to businesses that "offer value to customers primarily in the form of certain specified services, or in the form of individual expertise."

The key take-away from this PLR is the focus on "individual expertise" as the value proposition of the company. If a company is specifically selling its employees' expertise (legal, financial, or similar consulting services), then it will be disqualified under the statute. If the company sells something else that is not specifically barred under the statute, even if that "something else" is aided by employee specialization, then the company is not barred from being a qualified trade or business under I.R.C. §1202(e).

The *Owen* Case

Thus far, only one case has addressed the issue of what types of businesses are disqualified under I.R.C. §1202(e) due to the reputation or skill of their employees. That case, *Owen v. C.I.R.*, T.C. Memo 2012-21 (2012), considered whether a taxpayer was eligible to defer recognition of gain on "qualified small business stock" under I.R.C. §1045, which refers to I.R.C. §1202 to define what "qualified small business stock" is for purposes of the deferral.

The IRS argued in *Owen* that the company's stock was not "qualified small business stock" because the company was not a "qualified trade or business" under I.R.C. §1202(e)(3), as one of the principal assets of the company was the skill of its main employee/owner.[36] The Tax Court disagreed, holding that "[w]hile we have no doubt that the success of the Family First Companies is properly attributable to Mr. Owen and Mr. Michaels, *the principal asset of the companies was the training and organizational structure* [of the companies]."[37]

Under *Owen*, even if a company's success is attributable to the efforts of one or more key employees, that, in itself, is *not* evidence that the company's *principal asset* is the reputation or skill of those employees under I.R.C. §1202(e)(3)(A). This conclusion is similar to the one reached in PLR 201717010 (referenced above).

Though *Owen* is the only published case on this matter, the IRS has described the portion discussed above as "dicta."[38] Practically, this means that the IRS may not consider *Owen* binding authority on the terms of I.R.C. §1202(e)(3). Whether or not the case truly is dicta on this matter, *Owen* remains instructive on how the issue can be viewed by a tribunal considering the issues.

Treasury Regulations Implementing I.R.C. §199A

I.R.C. §199A provides deductions for certain qualifying taxpayers. In defining which taxpayers do *not* qualify for the deduction, I.R.C. §199A(d)(2)(A) cites to I.R.C. §1202(e)(3)(A) for part of its definition. Practically, this means that the regulations promulgated under I.R.C. §199A are instructive for an examination of I.R.C. §1202(e) as they flesh out the types of services that are excluded from favorable treatment.

The pertinent regulation is Treas. Reg. §1.199A-5(b)(2). This regulation provides detailed descriptions of the types of services that are *excluded* from the deduction under I.R.C. §199A(d)(2) (which, as above, incorporates I.R.C. §1202(e)(3)(A) in its definition).

Pertinent to our purposes here, the regulation provides a detailed description of what "consulting" services are under I.R.C. §199A (and by extension I.R.C. §1202(e)(3)(A)):

> *For purposes of section 199A(d)(2) and paragraph (b)(1)(vi) of this section only, the performance of services in the field of consulting means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales (or economically similar services) or the provision of training and educational courses. For purposes of the preceding sentence, the determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided. Performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services. Services within the fields of architecture and engineering are not treated as consulting services.*[39]

This definition makes it clear that "consulting" means providing advice or counsel to clients as the primary economic transaction and does not include advice or counsel that is ancillary to a different product or service.

As with the PLRs, the regulation is only directly applicable to I.R.C. §199A.[40] However, the regulation is certainly instructive as it *interprets* I.R.C. §1202(e)(3)(A) *as applied to* I.R.C. §199A. It, therefore, cannot be disregarded in an analysis of how I.R.C. §1202(e)(3)(A) may be applied to a taxpayer's operations.[41] The ultimate take-away from these authorities is that if the primary economic transaction is not consulting *as such*, the corporation will not be disqualified under the "active business" requirement of I.R.C. §1202.

Conclusion

I.R.C. §1202 offers taxpayers a large potential tax savings if the stock sold by a taxpayer meets the requirements of the statute. The tax practitioner reviewing a potential or completed transaction is well advised to closely examine each element of I.R.C. §1202 to determine whether partial or complete gain exclusion may apply.

[1] QSB stock acquired after 2010 will generally qualify for gain exclusion of 100% under I.R.C. §1202(a)(4). Because of this, the particular circumstances under which gain exclusion percentages would be less than 100% are not addressed in detail in this article. The "floor" on gain exclusion is 50% pursuant to I.R.C. §1202(a)(1).

[2] I.R.C. §1202(a)(1).

[3] I.R.C. §1202(c)(1).

[4] I.R.C. §1202(d)(1).

[5] I.R.C. §§1202(c)(2)(A), (e)(1)-(8).

[6] The federal income tax consequences of reorganizations described in I.R.C. §368 are governed by I.R.C. §354-362. A reorganization described under I.R.C. §368 will generally result in nonrecognition of gain or loss to the stockholder or the corporation involved in such a reorganization.

[7] I.R.C. §1202(h)(4)(B).

[8] *Id*. (emphasis added).

[9] A somewhat related concept suggested by this example is found in I.R.C. §1045, which allows non-recognition of gain from the sale of QSB stock that is rolled over into the purchase of new QSB stock. A taxpayer that is not able to exclude 100% of the gain from

the sale of QSB stock may benefit from such a rollover. The detailed operation of I.R.C. §1045 is not addressed in this article.

[10] I.R.C. §1202(c)(1).

[11] *Id.*

[12] I.R.C. §1202(c)(1)(B).

[13] I.R.C. §1202(c)(3)(A).

[14] I.R.C. §1202(c)(3)(B).

[15] I.R.C. §1202(f).

[16] I.R.C. §1202(d)(1).

[17] I.R.C. §1202(d)(1)(A)-(B).

[18] I.R.C. §§1202(d)(2), (d)(1)(A).

[19] I.R.C. §1202(d)(3)(B).

[20] *Id.*

[21] A taxpayer in this situation should closely examine the rules under I.R.C. §1563 to determine the extent of an imputed parent-subsidiary controlled group relationship given the modification of I.R.C. §1563 set forth in I.R.C. §1202. For example, I.R.C. §1563(e) sets forth constructive ownership rules, including attributions from partnerships, that impact the "controlled group" analysis under I.R.C. §1563(a). One could expect that these attribution rules would apply in the aggregation analysis under I.R.C. §1202(d)(3).

[22] I.R.C. §1202(d)(1)(C).

[23] I.R.C. §1202(e)(1)(A).

[24] I.R.C. §1202(e)(3)(A).

[25] I.R.C. §1202(e)(3)(D) cites to I.R.C. §§613 and 613A for definitions of the types of "extraction" businesses that do not meet the active business requirements of I.R.C. §1202. The practitioner is advised to review I.R.C. §§613 and 613A in analyzing any extraction-related business that may otherwise qualify under I.R.C. §1202.

[26] I.R.C. §1202(e)(3)(E).

[27] I.R.C. §1202(e)(1)(A).

[28] I.R.C. §1202(e)(4).

[29] I.R.C. §1202(e)(7).

[30] I.R.C. §1202(e)(5)(B).

[31] I.R.C. §1202(a)(1).

[32] I.R.C. §1202 (c)(2).

[33] I.R.C. §1202(e)(1)(A).

[34] I.R.C. §1202(e)(3)(A) (emphasis added).

[35] PLR 201436001 (emphasis added).

[36] *Id*. at **16-17.

[37] *Id*. at *17 (emphasis added).

[38] *IRS Proposed Rules*, 83 FR 40884-01, *40898-99 (Aug. 16, 2018) (proposed rules under I.R.C. §199A, which cites I.R.C. §1202(e)(3)(A); stating that "Guidance on the meaning of the 'reputation or skill' clause in §1202(e)(3)(A) is limited to dicta in one case."; discussing *Owen*).

[39] Treas. Reg. §1.199A-5(b)(2)(vii) (emphasis added); The acronym "SSTB" refers to the term "specified service trade or business," which is defined in I.R.C. §199A(d)(2)(A) to include businesses that are described in I.R.C. §1202(e)(3)(A).

[40] *See* Treas. Reg. §1.199A-5(b)(2)(i) ("The rules of this paragraph (b)(2) apply solely for purposes of section 199A and therefore may not be taken into account for purposes of applying any provision of law or regulation other than section 199A and the regulations thereunder, except to the extent such provision expressly refers to section 199A(d) or this section.").

[41] The regulation does address the "reputation or skill" portion of I.R.C. §1202(e)(3)(A), but only specifically in the context of businesses involving endorsements, appearance fees, and similar transactions. Treas. Reg. §1.199A-5(b)(2)(xiv).

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