Incorporating a partnership to obtain section 1202 eligibility

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IRC section 1202, originally enacted in 1993, currently provides for a 100% exclusion from gain on the sale of qualified small business stock (QSBS). For a summary of the key provisions of section 1202, see our article "Understanding the qualified small business stock gain exclusion."

Partners in a partnership (including an LLC electing partnership status for federal tax purposes) operating a business are not eligible for the section 1202 gain exclusion upon the sale or exchange of their partnership interest. However, if the partnership incorporates (including an election to treat the partnership as a corporation for federal tax purposes), the stock issued (or deemed issued) in the incorporation can qualify as QSBS stock. With the 100% gain exclusion on QSBS stock issued after Sep. 27, 2010, and the possibility of a capital gain rate increase, partners should consider incorporating their partnership if they believe they can satisfy the requirements of section 1202.

This item discusses issues to consider when contemplating such a conversion.

Basics of section 1202

Section 1202 provides an exclusion from income for non-corporate taxpayers that realize capital gain on the sale of QSBS they held for more than five years. One hundred percent of the gain on the sale of stock acquired after September 27, 2010 is excluded from gross income, while 75% or 50% (depending on the date of acquisition) of gain on the sale of stock acquired prior to September 28, 2010 is excluded. The amount of gain a taxpayer may exclude is subject to a limitation, the greater of: (a) $10 million for all of the taxpayer's QSBS issued by the corporation; and (b) 10 times the aggregate adjusted bases of the corporation's QSBS disposed of by the taxpayer in the tax year.[1] For stock held by a pass-through entity, the limitation is computed on a partner/shareholder-level basis and not an entity-level basis.[2]

The taxpayer must have acquired the stock directly from the issuing corporation.[3] The aggregate gross assets of the QSB corporation, including amounts received through the issuance, must not have exceeded $50 million at all times prior to the stock issuance and up through immediately after the issuance.[4] The corporation must conduct a qualified trade or business (QTOB), which is defined as any trade or business other than those specified in the statute.[5]

[1] Section 1202(b)(1).
[2] Section 1202(g)(1)(B).
[3] Section 1202(c)(1).
[4] Section 1202(c)(1).
[5] Section 1202(e)(3).

Tax consequences of partnership incorporation generally

A partnership incorporation generally constitutes a section 351 tax-deferred contribution of business assets to the corporation in exchange for its stock.

A business taxed as a partnership can choose to be taxed as a corporation in one of several methods:

1. **Formless Conversion:** In many states, the partnership can file a form to convert to a corporation under a state-law formless conversion statute.
2. **Check-the-box:** The partnership can "check the box" to be taxed as a corporation.[6] In such a case, the entity retains partnership status for non-tax legal purposes, but is treated as a corporation for tax purposes.
3. **Merger:** The partnership can merge into a corporation under a state law cross-entity merger statute.
4. **Contribution:** The partnership or its partners can form a new corporation and contribute the business assets to the newly formed corporation. This can take one of three forms, as described in Rev. Rul. 84-111:[7]
   a. **The "assets-over" method:** The partnership transfers partnership assets to a newly formed corporation in exchange for stock of the corporation and the corporation's assumption of the partnership liabilities. The partnership then liquidates by distributing the corporate stock received to the partners in proportion to their partnership interests.
   b. **The "assets-up" method:** The partnership distributes all partnership assets and liabilities to the partners in liquidation of the partnership. The partners then transfer the assets to the corporation in exchange for the corporation's stock and the corporation assumes the liabilities that the partners had assumed from the distributing partnership.
   c. **The "interests-over" method:** The partners transfer their partnership interests to a newly formed corporation in exchange for corporate stock. The transfer terminates the partnership (since the partnership will then have a single owner), and the partnership's assets and liabilities become the assets and liabilities of the corporation.

Rev. Rul. 84-111 describes how the specific method used affects basis, gains or losses, and holding periods. However, irrespective of the method chosen, the incorporation generally constitutes a section 351 contribution of assets or interests to the corporation in exchange for its stock.[8]

Regulations state that where the partnership checks the box, the "assets over" method is deemed to occur.[9] Similarly, where the partnership converts into a corporation under a formless conversion statute, the "assets over" method is deemed to occur.[10]

Note also that where the partnership's aggregate liabilities are greater than its aggregate basis in its assets, the incorporation can generate gain under section 357(c).

Incorporation and the original issuance requirement

Under section 1202, corporate stock satisfies the original issuance requirement if the disposing shareholder acquired the stock after Aug. 10, 1993 at its original issue directly from the issuing corporation, or through an underwriter, in exchange for money, property other than stock, or services provided to the issuing corporation.[11] Generally, the term original issue refers to an issuance of stock directly from the corporation to a qualified shareholder, and not to the timing of the issuance of stock. In other words, it does not mean that only a corporation's first issuance of stock upon its incorporation is considered QSB stock.

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[6] See Reg. section 301.7701-3(g)(1)(i).
[7] 1984-2 CB 88.
[8] Section 351 applies even where the "interests-over" form is chosen, even though it involves the contribution to the corporation of partnership interests and not assets. The Code does not define "property" for section 351 purposes, but the courts have interpreted the term broadly. One court stated that "the term encompasses whatever may be transferred." *Hempt Bros., Inc.,* 354 F Supp 1172 (MD PA 1973). Additionally, the IRS has ruled that an interest in a partnership or an LLC taxed as a partnership is property for section 351 purposes. See Rev. Rul. 81-38, 1981-1 CB 386; Rev. Rul. 84-111.
[9] Reg. section 301.7701-3(g)(1)(i).
[10] Rev. Rul. 2004-59, I.R.B. 2004-24.
[11] Section 1202(c)(1)(B).

Incorporation of a partnership satisfies this original issuance requirement. Irrespective of the method or form of incorporation chosen, an incorporation involves shareholders who acquire their corporate stock directly from the issuing corporation in exchange for money or property other than stock.[12]

> **Example 1:** ABC LLC (ABC) was formed in 2010 and is taxed as a partnership. In 2015, ABC incorporates via any of the aforementioned methods. For purposes of section 1202, ABC's equity/stock is treated as "originally issued" in 2015.

Incorporation and the gross assets test

A QSB must meet the gross assets test as of the date of the stock issuance. To satisfy the gross assets test, the aggregate gross assets of the corporation (and any of its predecessors) must not have exceeded $50 million at any time after Aug. 10, 1993 and through the date of the issuance of the stock for which preferential treatment is sought.[13] Additionally, the aggregate gross assets of the corporation immediately after the issuance must not exceed $50 million.[14] Accordingly, any cash the company acquires as a result of the stock issuance is included in gross assets for purposes of this test, even if it is immediately utilized to pay down debt.[15]

All corporations that are members of the same parent-subsidiary controlled group are treated as one corporation for purposes of the gross assets test.[16] A parent-subsidiary controlled group for this purpose is generally one or more chains of corporations connected through stock ownership of 50% in vote or value with a common parent corporation.[17]

A special rule applies to the asset tax basis measurement where property other than cash is contributed to the corporation (the fair market value (FMV) adjusted basis rule): When determining gross assets, the adjusted basis of any property contributed to the corporation is determined as if the basis of the property contributed to the corporation was equal to its FMV as of the time of the contribution.[18] Under this rule, a corporation's tax basis in its assets for purposes of section 1202 may exceed its tax basis applicable for other purposes.

Since the incorporation of a partnership generally constitutes a section 351 contribution, the corporation generally takes a carryover basis in the assets, which means the FMV adjusted basis rule comes into play. Accordingly, the $50 million asset threshold will look to the FMV of the assets of the company, including unrealized built-in-gain attributable to self-created intangibles and goodwill.

> **Example 2:** ABC LLC (ABC), a partnership for tax purposes, has assets with a tax basis of $15 million. ABC would like to incorporate and become eligible for QSB status. However, ABC believes its equity value is $43 million, based on a firm offer it has received. ABC also has liabilities of $10 million. The value of ABC's gross assets (including goodwill) appears to be $53 million (equity plus liabilities); ABC appears to have exceeded the $50 million threshold.

This raises questions regarding the appropriate method to determine and document that the company has not exceeded the $50 million threshold prior to the conversion. If the owners believe the value of the company upon incorporation is near the $50 million threshold then the company may want to consider a third-party valuation to confirm the value.

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[12] Even where the assets-over method is chosen — in which the partnership transfers its assets to the corporation in exchange for stock after which the partnership distributes the corporate stock to its partners in liquidation — the stock issued by the corporation is considered "originally issued" to its shareholders even though it is momentarily held by the partnership prior to the partnership's liquidation. Section 1202(h)(2)(C) provides that when a partnership distributes stock to a partner, the partner is treated as having acquired the stock in the same manner as the partnership, provided the partner was a partner in the partnership from the partnership's acquisition of the stock through the date of distribution. Because in the assets over form the incorporation and liquidation happen simultaneously, the partner satisfies these requirements and is treated as having received the stock at original issuance.

[13] Section 1202(d)(1)(A).

[14] Section 1202(d)(1)(B).

[15] Note that if a company raises cash to pay off debt and its asset basis increases beyond $50 million prior to the debt payoff, this could potentially cause the company to fail the gross assets test.

[16] Section 1202(d)(3)(A).

[17] Sections 1202(d)(3)(B) and 1563(a)(1).

[18] Section 1202(d)(2)(B).

Can a partnership with greater than $50 million in assets strategically incorporate in a way that would enable it to satisfy the gross assets test?

If a partnership planning to convert into a corporation has more than $50 million in gross FMV of assets, can it hold back certain assets (and perhaps liabilities) in hopes of satisfying the Gross Assets Test?[19]

> **Example 3:** ABC LLC (ABC) is taxed as a partnership and has assets with a FMV of $60 million. Included in those assets are cash and accounts receivable (A/R) of $15 million. ABC holds back the cash and A/R to reduce the FMV of assets transferred to the new corporation to $45 million. Could the members claim that ABC meets the Gross Assets Test?

In this case, substance over form principles require consideration and could dictate that the cash and A/R were in fact transferred to the corporation despite legally remaining outside the corporation. This is a highly factual determination. Factors that must be examined include but are not limited to:

- Can the business operate without the assets?
- Are the assets pledged by the business against debts? If so, did negotiations take place with the creditors regarding splitting the assets and the debt between different legal owners?
- Were the assets truly held back, or were the entries just paper entries (e.g., who will collect the receivables)?
- Were the assets or proceeds from the assets later transferred to the business?

Variations on the above may change the result:

> **Example 4:** What if, in addition to the cash and A/R, ABC also had accounts payable (A/P) of $15 million? Could ABC hold back both the assets and A/P of $15 million? This would result in lower gross assets but the same net value included with the incorporation.

In this example, satisfaction of the gross assets test appears more plausible than in the prior example, as the company has not extracted value prior to incorporation. Nevertheless, many of the same questions arise as in the prior example, and substance over form principles must be considered.

What if the LLC retains ownership in the business's real estate?

> **Example 5:** What if, of the total $60 million in assets, $15 million relate to real estate used in the business? Could ABC hold back the real estate alone and include all other assets in the incorporation? This would result in corporate gross assets of $45 million. The LLC could then rent the real estate to the corporation, which would use it in the business.

In this example, satisfaction of the gross assets test appears even more plausible than in the previous example. It is not uncommon for real estate used in a closely held business to be owned by a different legal entity than the corporation operating the business.

If a partnership has two business lines, which separately are each worth less than $50 million, but together are worth more than $50 million, can it incorporate only one of the two business lines? If it incorporates both business lines as two separate corporations, will each constitute an eligible QSB?

> **Example 6:** ABC LLC (ABC), taxed as a partnership, manufactures landscaping equipment and snow removal equipment. The total FMV of ABC's assets is $70 million, split roughly equally between its two business lines. If ABC's members create two new corporations, ABC LawnCo and ABC SnowCo, and contribute to them the respective assets of ABC's business lines, would each be an eligible QSB?

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[19] Although section 1202(d)(1)(a) states that the aggregate gross assets of the corporation "or any predecessor thereof" cannot have exceeded $50 million at any time since 1993, "predecessor" likely refers to a predecessor corporation and not a predecessor partnership or disregarded entity.

Here too, substance over form principles would control. Factors that taxpayers must examine include:

- Are the business assets and employees commingled before and after the conversion?
- After the conversion, will the two corporations operate as a single business or as two?
- Did negotiations take place with creditors regarding splitting the business between two legal entities?

Note that section 1202(d)(3)(B), which aggregates the assets of parent-subsidiary controlled groups of corporations, does not apply in this case, as it only applies where two corporations are owned by a parent corporation, which is not the case here.

Incorporation and the 5-year holding period requirement

As noted above, the section 1202 exclusion is only available on the sale of QSBS that was held for more than five years.[20] As originally enacted, the gain exclusion was 50 percent (for stock acquired after August 10, 1993), but it was increased to 75 percent for QSB stock acquired after February 17, 2009 and before 2010, and to 100 percent for QSB stock acquired after September 27, 2010.[21]

When a partnership incorporates, the relevant date for purposes of the five-year holding period and the exclusion periods is the date of incorporation.[22]

> **Example 7:** ABC LLC (ABC), taxed as a partnership, issues several rounds of equity, including Series 1 (in 2012) and Series 2 (in 2014). In 2017, the company incorporates, and equity holders receive stock in exchange for their equity units pro rata. In 2020, Series 1 equity holders sell their stock. They are not eligible for section 1202's exclusion because they held their stock since 2017, which is less than five years.

> **Example 8:** ABC LLC (ABC), taxed as a partnership, issues several rounds of equity, including Series 1 in 2005, and Series 2 in 2008. In 2011, the company incorporates, and equity holders receive stock in exchange for their LLC units. In 2021, Series 1 and 2 equity holders sell their stock. They are eligible for the full 100% — and not 50% — exclusion because they received their shares in an original issuance in 2011, the date of the incorporation. The same result would occur if ABC did not legally incorporate and instead elected corporation status via a check-the-box election.

Incorporating a partnership and the ten times basis limitation

The aggregate amount of gain eligible for exclusion under section 1202 for the taxable year is the greater of:

1. $10 million reduced by the aggregate amount of eligible gain taken into account for this purpose for prior taxable years and attributable to dispositions of Company stock (the aggregate limitations), or

2. 10 times the aggregate adjusted bases of QSB stock issued by the Company and disposed of by the taxpayer during the taxable year (the annual limitation).[23]

If a taxpayer received QSB stock in a partnership incorporation, the taxpayer's exclusion under the 10 times basis limitation appears to be based upon the FMV of the stock received and not the taxpayer's carryover tax basis in the stock.[24]

> **Example 9:** In 2012, ABC LLC (ABC), taxed as a partnership, issues 100,000 equity units to Jane Doe for $10 per unit ($1 million total purchase price). In 2015, the company incorporates, and equity holders receive stock in exchange for their equity units pro rata. At the time, each unit is worth $40 (Jane's 2012 investment is worth $4 million.) In 2021, Jane sells her 100,000 shares. Jane can exclude up to $40 million of gain (10 times $4 million).

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[20] Section 1202(a)(1).
[21] Section 1202(a)(4).
[22] Based on a literal reading of the flush language of sections 1202(a)(3) and 1202(a)(4) and section 1223(1), some have argued that the acquisition date for purposes of the exclusion period should reach back to periods earlier than the stock issuance. Section 1202's legislative history, however, supports the conclusion that the flush language only applies for section 1045 rollover purposes. See Andolina and Lemaster, *Candy Land or Sorry: Thoughts on Qualified Small Business Stock*, Tax Notes (Jan. 2018).
[23] Section 1202(b)(1).
[24] Section 1202(i)(1)(B) states that for purposes of the 10 times basis limitation, the basis of stock received in exchange for property is no less than the fair market value of the property contributed.

Incorporating a partnership and stock basis

If a taxpayer received QSB stock in a partnership incorporation, the taxpayer's basis in such stock is treated for section 1202 exclusion purposes as no less than the FMV of the property exchanged. As a result, the taxpayer's excludable gain is limited to the gain that accrues after the business's incorporation.

Example 10: Under the facts of the example immediately above, Jane's stock basis is $4 million for purposes of determining the gain exclusion. While Jane can exclude up to $40 million of gain (10 times $4 million), she must first recognize $3 million of taxable gain attributable to the built-in gain at the date of incorporation.

Conclusion

Section 1202 can represent a significant tax benefit to qualifying investors holding QSB stock. Where an otherwise qualifying business is operated as a partnership, it may make sense to consider incorporating in hopes of excluding up to 100% of the gain on exit of the investment. Due to the complexities involved, we recommend that taxpayers consult with their tax advisers prior to such a transaction.

[25] Section 1202(i)(1)(B). See also H. Rept. No. 103-111 (PL 103-66), 603 ("only gains that accrue after the transfer are eligible for the exclusion").

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