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July 31, 2026

Hon. Kevin Salinger
Acting Assistant Secretary for Tax Policy, Department of the Treasury
Acting Chief Counsel, Internal Revenue Service
1500 Pennsylvania Avenue NW
Washington, DC 20220

Re: Comments addressing section 1202, exclusion for gain from the sale of certain small business stock

Dear Mr. Salinger:

Enclosed please find comments and requests for formal guidance with respect to the qualified small business stock (QSBS) rules of section 1202. The enclosed letter discusses the pressing need for guidance to clarify numerous ambiguities within section 1202, highlights several dozen specific issues that arise in practice often, and provides numerous detailed recommendations with respect to those items.

These comments represent the view of RSM US LLP (RSM). RSM is the fifth largest public accounting firm in the United States and is committed to guiding clients through their business challenges. RSM particularly focuses on serving clients in the middle market, which accounts for more than a third of U.S. employment and about 40% of the U.S. gross domestic product.

RSM has prepared and submits the attached comments on its own behalf. RSM has many clients that would be affected by the issuance of guidance on this topic. In authoring this letter, we draw from our collective experience advising thousands of clients on the intricacies of section 1202. That experience has brought to our attention the pressing need for guidance in this area, as well as those particular issues within section 1202 most in need of guidance.

We urge Treasury and the Service to consider our comments in this regard. We would be pleased to discuss these comments with you. To discuss these comments or related matters, please contact Nick Gruidl at Nick.Gruidl@rsmus.com, Stefan Gottschalk at

Stefan.Gottschalk@rsmus.com, Joseph Wiener at Joseph.Wiener@rsmus.com, or Nick McCreven at Nick.McCreven@rsmus.com.

Sincerely,

Nick Gruidl

Enclosure

cc:
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I. Executive Summary

This comment letter requests guidance from the Department of the Treasury (Treasury) and the Internal Revenue Service (the Service) on certain matters relating to section 1202 in order to promote certainty, administrability, and consistent reporting. Section 1202, the qualified small business stock (QSBS) provision, is an important incentive for investment in domestic small businesses, and its importance has increased following the amendments enacted as part of the One Big Beautiful Bill Act. However, section 1202 contains numerous unresolved interpretive questions. Existing regulations are limited, judicial authority is sparse, and taxpayers must often apply the rules without clear administrable standards. This uncertainty has spawned a tax landscape of widely divergent views among taxpayers and tax advisors regarding the meaning and application of many of section 1202's rules.

The above Table of Contents provides an outline of the issues addressed in this letter. We highlight here certain issues we believe warrant particular attention:

1. We recommend guidance on the gross assets rule of section 1202(d). Specifically, guidance should clarify how the "immediately after" requirement applies to related or staged stock issuances, and whether and how the step transaction doctrine applies to related closings or other related events. See section VI.A. Guidance should also clarify whether and to what extent, in a structure consisting of a corporate holding company and a corporate operating company, the Gross Assets Test (as defined below) applies to the assets of the operating company, the holding company, or both. See section VI.E.

2. We recommend guidance on the active business requirement and the excluded business categories of section 1202(e). Guidance should define the excluded categories by adopting administrable standards, including appropriate use of the section 199A regulations where the statutory terms overlap. See sections VII.B and VII.D through VII.F.

3. We recommend guidance clarifying whether a corporation satisfies the active business requirement where the corporation owns an interest in an entity taxed as a partnership, which in turn conducts the operating business. See section VII.G. Guidance should also clarify how the gross assets requirement applies in such a scenario. See section VI.F.

4. We recommend guidance clarifying whether a corporation satisfies the active business requirement where the corporation conducted an active business during substantially all of the shareholder's QSBS holding period but did not conduct an active business or participate in start-up activities at the time of the original issuance of such stock. See section VII.A.

5. We recommend guidance clarifying the availability of section 1202 benefits to indirect owners of corporate stock, including in tiered partnership structures, holders of profits interests, and following transfers of interests in partnerships that hold QSBS. See sections VIII.A through VIII.C.

6. We recommend guidance clarifying how the section 1202 gain exclusion limitation and holding period rules apply in common fact patterns, including whether married taxpayers filing jointly are entitled to one fixed gain exclusion cap or separate caps, and how the

section 1223 holding period rules apply when stock is received in exchange for contributed property. See sections III.A and III.C.

7. We recommend guidance clarifying the scope of transactions treated as a "purchase" or "redemption" under the section 1202(c)(3) redemption rules, including the treatment of dividend-equivalent redemptions, recapitalizations, recapitalizations with boot, and founder redemptions that merely return excess start-up capital. See section V.A.

8. We recommend guidance on tax-free transactions involving QSBS, including the application of section 1202(h) to section 355 transactions, recapitalizations, and F reorganizations. See sections IX.B and IX.C.

Additionally, we understand that Treasury and the Service are contemplating guidance addressing a practice known as "stacking," which generally involves forming or funding multiple trusts in a manner intended to augment the section 1202 gain exclusion that will apply to specific shares of stock.[1] We recommend that any such guidance, perhaps promulgated under the anti-avoidance provision of section 1202(k), be confined to stacking and not be drafted so broadly as to potentially encompass unrelated (and perhaps unintended) transactions or structures.

II. Background

A. Overview of Section 1202

Section 1202 provides an exclusion of capital gain from the gross income of a noncorporate taxpayer who meets the qualification requirements. The exclusion can apply to as much as 100% of the gain on the sale of qualified small business stock (QSBS).[2] As originally enacted in 1993, section 1202 requires that the taxpayer hold the stock for five years.[3] Most recently, section 1202 was amended pursuant to P.L. 119-21 (the FY2025 Reconciliation Law, commonly known as the One Big Beautiful Bill Act or OBBBA), effective July 4, 2025. Under the OBBBA, a taxpayer who acquires stock after July 4, 2025, and holds it for three years is eligible for a partial gain exclusion, assuming other requirements are met.[4]

The taxpayer must have acquired the stock directly from the issuing corporation for money, property other than stock, or services, known as the original issuance requirement.[5] The corporation issuing QSBS must also be a qualified small business (QSB).[6] Under the QSB requirement, the corporation must be a domestic C corporation with aggregate gross assets that

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[1] *See* Beeby, "Kies Says Anti-Stacking Regulations Are Likely," Tax Notes Federal, May 21, 2026.

[2] Section 1202(a)(4).

[3] Section 1202(a)(1).

[4] Section 1202(a)(5).

[5] Section 1202(c)(1). As a result of the original issuance requirement, if a shareholder that acquired stock at its initial issuance subsequently transfers the stock in a nonrecognition transaction, the transferee in some cases does not qualify for the section 1202 capital gain exclusion. *See generally* section 1202(c), (f), (g), and (h).

[6] Section 1202(c)(1)(A).

have not exceeded $50 million (or $75 million, for stock issued after July 4, 2025) at any time before and immediately after the stock's issuance (the Gross Assets Test).[7]

During substantially all the taxpayer's holding period, the issuing corporation must remain a domestic C corporation and must conduct a qualified trade or business (QTOB), defined as any trade or business other than those providing services in health, law, engineering, architecture, accounting, consulting, and other businesses specified in the statute.[8]

The amount of gain a taxpayer may exclude for a tax year is limited. For stock issued prior to July 5, 2025, the maximum amount excludable for a tax year is equal to the greater of: (1) $10 million, reduced by the aggregate amount of gain previously taken into account for section 1202 by the taxpayer for stock of the corporation, and (2) 10 times the aggregate adjusted basis of QSBS issued by the corporation and disposed of by the taxpayer during the tax year.[9] The $10 million limitation (the Gain Exclusion Fixed Cap) was increased to $15 million for stock issued after July 4, 2025.[10]

Despite the statute's longstanding role in encouraging investment in domestic corporations and the recent statutory amendments enacted by the OBBBA, the practical application of section 1202 continues to present significant interpretive uncertainty for taxpayers and practitioners. The existing Treasury Regulations under section 1202 are very limited in scope, and there is relatively sparse judicial authority addressing many of the operative requirements and limitations of the provision.[11] As a result, many taxpayers must apply section 1202 in the absence of clear regulatory guidance or administrable standards. This lack of clarity results in inconsistent interpretations and diversity of practice among tax practitioners and unintended compliance burdens for taxpayers.

In light of these challenges, and given the expanded importance of section 1202 following passage of the OBBBA, we respectfully submit that additional guidance from the Department of the Treasury and the Internal Revenue Service (the Service) would be both timely and beneficial. This comment letter outlines specific areas in which we believe clarification would

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[7] Section 1202(d)(1). This aggregate Gross Assets Test generally focuses on the corporation's tax basis in assets, including assets transferred to it in the relevant stock issuance transaction. Section 1202(d)(2)(A). In the case of assets contributed to the corporation, however, the assets' fair market value (FMV) at the time of the contribution (rather than the assets' tax basis) is included in aggregate gross assets. Section 1202(d)(2)(B).

[8] Section 1202(c)(2)(A) and (e)(3). Additionally, the corporation generally must use at least 80% of its assets, measured by value, in the active conduct of one or more qualified trades or businesses for "substantially all" of the shareholder's holding period. Section 1202(e)(1). There is an allowance for reasonably required working capital. Section 1202(e)(6). More stringent asset value-based tests apply regarding portfolio stock or securities held by the corporation and real property that is not used in the active conduct of a QTOB. Section 1202(e)(5)(B) and (e)(7).

[9] Section 1202(b)(1). The adjusted basis of stock is determined for this purpose regardless of any addition to basis after the date on which the stock was originally issued. Section 1202(b)(1)(B).

[10] Section 1202(b)(4)(B).

[11] Published tax literature on section 1202 addresses only some of the unanswered questions. *See, e.g.,* Lee, Long, Comeau, Kwon, "Qualified Small Business Stock: Quest for Quantum Exclusions," *Tax Notes State*, July 6, 2020, p. 25 ("Quest," part 1); Lee, Long, Comeau, Kwon, "Qualified Small Business Stock: Quest for Quantum Exclusions Part 2," *Tax Notes State*, July 13, 2020, p. 133; and Lee, Long, Comeau, Kwon, "Qualified Small Business Stock: Quest for Quantum Exclusions Part 3," *Tax Notes*, July 20, 2020, p. 255. *See also* Gottschalk and Wiener, "Travels through 1202*." Tax Notes State 101*, September 27, 2021, p. 1391-1407.

promote greater certainty, improve administrability, and further the policy objectives underlying section 1202.

III. Exclusion Amounts, Limitations, and Holding Period – Section 1202(b)

The capital gain exclusion generally applies to 50% of the gain on sale of QSBS acquired after August 10, 1993, and before February 18, 2009, and held for five years.[12] The gain exclusion was increased to 75% for QSBS acquired after February 17, 2009, and before September 28, 2010, and then again to 100% for QSBS acquired after September 27, 2010.[13] For stock acquired after July 4, 2025, and held for three years but less than four years, a 50% gain exclusion applies; if such stock is held for four years but less than five years, a 75% gain exclusion applies.[14]

A. Gain exclusion limitation applied to married taxpayers filing jointly

For purposes of the gain exclusion limitation under section 1202(b)(1)(A), are married taxpayers filing jointly entitled only to a single Gain Exclusion Fixed Cap ($10 million or $15 million, depending on the acquisition date), or is each spouse entitled to a separate Gain Exclusion Fixed Cap, effectively doubling the exclusion (to $20 million or $30 million, depending on the acquisition date)? A close read of section 1202(b)(3) reveals that the answer to this question is unclear, highlighting the need for regulatory or administrative clarification.

The statutory text refers to “the taxpayer” in the singular throughout section 1202(b). The Gain Exclusion Fixed Cap is likewise imposed on “the taxpayer’s” eligible gain from the disposition of QSBS. Under section 7701(a)(14), a “taxpayer” is defined as any person subject to any internal revenue tax, and section 7701(a)(1) defines “person” to include an individual.

Section 1202(b)(3) provides an explicit rule for married individuals filing separate returns. Under that rule, the Gain Exclusion Fixed Cap is reduced for each spouse to one-half the otherwise applicable amount. However, there is no parallel provision for married individuals filing jointly.[15]

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[12] Section 1202(a)(1).

[13] Sections 1202(a)(3) and (a)(4).

[14] Section 1202(a)(5).

[15] Section 1202(b)(3) states:

> Treatment of married individuals
>
> (A) Separate returns
>
> In the case of a separate return by a married individual for any taxable year—
>
> (i) paragraph (4)(A) shall be applied by substituting “$5,000,000” for “$10,000,000”, and
>
> (ii) paragraph (4)(B) shall be applied by substituting one-half of the dollar amount in effect under such paragraph for the taxable year for the amount so in effect.
>
> (B) Allocation of exclusion
>
> In the case of any joint return, the amount of gain taken into account under subsection (a) shall be allocated equally between the spouses for purposes of applying this subsection to subsequent taxable years.

Thus, section 1202(b)3)(B) fails to directly address whether a married couple filing jointly is entitled to a single or double Gain Exclusion Fixed Cap.

Proponents of a double cap argue that each spouse is entitled to a separate Gain Exclusion Fixed Cap, under the principle that, absent explicit statutory language to the contrary, each individual taxpayer is treated as a separate taxpayer under the Code notwithstanding a joint filing. In other Code sections, each spouse is treated as a separate taxpayer, even when filing jointly.[16] The Tax Court has stated that "it is a long recognized legal maxim that a husband and wife are separate and distinct taxpayers notwithstanding the fact that they have filed joint Federal income tax returns."[17] The Service has stated likewise.[18]

Furthermore, where a pass-through entity holds QSBS, the Gain Exclusion Fixed Cap is applied at the partner or shareholder level and not at the pass-through level; each partner or shareholder is treated as a separate taxpayer. By analogy, some argue, each spouse is a separate individual taxpayer and is entitled to a separate cap, even when filing a joint return (particularly where each spouse independently acquired and held QSBS).

Proponents of a single Gain Exclusion Fixed Cap, however, argue that it is wholly illogical for a married couple to have a greater section 1202 exclusion benefit if they file jointly than if they file separately. The only explanation for why section 1202(b)(3) specifies "separate returns" is that it was poorly drafted; its intention is that *even* when the spouses file separate returns they

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Section 1202(b)(3)(B) then provides the following rule for a married couple that files a joint return and later files a separate return:

> Allocation of exclusion
>
> In the case of any joint return, the amount of gain taken into account under subsection (a) shall be allocated equally between the spouses for purposes of applying this subsection to subsequent taxable years.

[16] See, *e.g.*, Section 219(f)(2) (governing the section 401(a)(9) required IRA minimum distributions).

[17] *Nell v. Commissioner*, T.C. Memo 1982-228 (applying the maxim in the fraud context to hold that an addition to tax for section 6653(b) fraud attached only to the culpable husband, who had been criminally convicted, while the wife was treated as an innocent spouse, even though the couple had filed joint returns) (citing *Dolan v. Commissioner*, 44 T.C. 420, 428 (1965)). *But see Levy v. Comm'r*, 46 BTA 1145 (1942) (holding that a husband and wife who filed a joint return and each separately sustained losses on the sale of capital assets were limited to a single $2,000 capital-loss deduction rather than $2,000 each on the ground that income on a joint return is computed on an aggregate basis).

[18] TAM 9853002 (Jan. 4, 1999) (stating that a taxpayer and his spouse are not treated as a single taxpayer for purposes of the $5 million installment obligation limitation of Section 453A). In the TAM, the Service stated that:

> In particular, if Congress had intended that married individuals be treated as one taxpayer for purposes of applying the $5,000,000 limitation set out in section 453A, it could have easily provided for this attribution in express terms rather than resort to a strained and unlikely interpretation of sections 52 and 1563. In fact, in numerous other Code provisions, Congress has specifically provided for the allocation of various limitations among married individuals. See, e.g., section 38(c)(3) (limitation on the general business credit); section 163(h) (limitations on amounts treated as acquisition or home equity indebtedness); section 179(b)(4) (limitation on election to expense certain depreciable business assets); section 1211(b) (limitation on capital losses). Where Congress is silent on this point, as in section 453A, we do not believe that an allocation between married individuals can be implied.

Id.

nonetheless must split the Gain Exclusion Fixed Cap—and all the more so when they file a joint return.[19] A rule providing for a single cap for a married couple filing separately and a double cap for a married couple filing jointly appears nonsensical. Under principles of statutory interpretation, section 1202(b)(3)(A)'s failure to explicitly specify a joint return might be attributed to a scrivener's error or omission.[20]

Given the ambiguity and the significant tax consequences at stake, regulatory or administrative clarification is needed to ensure consistent and equitable application of the exclusion. We urge the Service to issue guidance addressing whether the Gain Exclusion Fixed Cap applies per return or per individual in the context of joint returns.

B. Ordering of the gain exclusion limitation and gain exclusion percentage

The interrelationship of the limitation and the exclusion percentage raises a question: What is the proper ordering of these rules? Which qualification should be applied first—the gain limitation or the exclusion percentage? The answer can make a difference when computing the amount of excluded gain on the sale of QSBS issued before September 27, 2010, or after July 4, 2025.

For example, suppose Shareholder X incorporated Corporation Y on July 30, 2025, following the effective date of the OBBBA. On August 30, 2028, X sold her Y stock, in which her basis is zero, for $18 million. The $18 million of gain is limited by both (1) the greater of $15 million and 10 times basis limitation (limiting X's exclusion amount to $15 million, because her basis in the Y stock was zero), and (2) the 50% exclusion percentage. Should X first apply the limitation (which reduces the eligible gain to $15 million) and then apply the exclusion percentage of 50%, yielding an exclusion amount of $7.5 million? Or should X instead first apply the exclusion percentage of 50% (which reduces the eligible gain to $9 million) and then apply the $15 million limitation, for a final exclusion amount of $9 million?

We request the Service and Treasury clarify the proper order of applying these two rules, as clarity would benefit taxpayers, practitioners, and the Service alike in consistently applying the rules of section 1202.

We recommend the Service and Treasury clarify that taxpayers should first apply the gain limitation and then apply the exclusion percentage. In the example above, this results in $7.5 million of excluded gain.[21] Our recommendation is based on a plain reading of the language of

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[19] Said differently, the drafters of section 1202 may have worked under the assumption that a married couple filing jointly is entitled to only a single Gain Exclusion Fixed Cap. Accordingly, section 1202(b)(3) only needed to address (i) whether a married couple filing separate returns is entitled to a single or double cap, and (ii) how the exclusion applies to a married couple filing jointly where the couple files separately in future years.

[20] *See*, *e.g.*, *Chickasaw Nation v. United States*, 208 F.3d 871 (10th Cir. 2000), *aff'd*, 534 U.S. 84 (2001) (Supreme Court ruled to disregard language of a tax statute because it "incorporates an error in drafting").

[21] A related question is whether the shareholder is thereafter precluded from excluding any further gain from sales of shares of the corporation. For example, in the above example, suppose X sold additional zero-basis Y stock in 2021 (after holding the stock for five years). In 2021, may X exclude from gain up to an additional $7.5 million? Or is X precluded from any gain exclusion in 2021 (as she has already utilized her full exclusion in connection with recognition of $15 million of gain in 2028)?

the Code. The gain limitation provision of section 1202(b)(1) states that the $10 million or 10 times basis limitation is the maximum amount that “may be taken into account under” section 1202(a).[22] That subsection lays out the exclusion percentages. The plain reading of these provisions indicates that taxpayers should apply the subsection (a) percentage to the figure that is obtained after they apply subsection (b)(1).[23]

C. Gain exclusion limitation and section 1045 interrelationship

Section 1202(a) provides that a taxpayer’s "gross income shall not include" a specified percentage of the gain from the sale of QSBS. This gain is permanently excluded and is never recognized for federal income tax purposes. In contrast, section 1045, enacted in 1997 and intended to complement section 1202, provides for a *deferral* of gain from the sale of QSBS. Section 1045(a) states that gain from a QSBS sale "shall be recognized only to the extent that the amount realized on such sale exceeds" the cost of replacement QSBS purchased within the 60-day period.[24] The Section 1045 deferral is accomplished through a downward basis adjustment to the shareholder’s basis of the replacement QSBS in the amount of the unrecognized gain on the sale of the initial QSBS.[25]

Uncertainty exists regarding the interaction between the gain exclusion rule of section 1202 and the gain deferral rule of section 1045 when a taxpayer sells QSBS and seeks to utilize both provisions for the same transaction. Specifically, guidance is needed to clarify the required reinvestment amount under section 1045 when a portion of the gain on the sale of QSBS has been excluded from gross income under section 1202.

Consider a taxpayer who holds QSBS (issued prior to the OBBBA) with zero basis and sells it for $22 million, realizing a $22 million gain. Assume the taxpayer is eligible to and does exclude $10 million of this gain from gross income under section 1202(a). The taxpayer then seeks to defer the remaining $12 million of gain under section 1045 by purchasing new QSBS within 60 days. The ambiguity lies in whether, to achieve full deferral of the remaining $12 million of gain, the taxpayer must reinvest the entire $22 million amount realized or only the $12 million of proceeds attributable to the non-excluded gain.

A literal interpretation of section 1045(a) could suggest that the entire "amount realized" ($22 million in the example) must be reinvested to defer all the gain. However, this reading might also conflict with the functions of the two Code provisions. Section 1045 operates to defer gain that

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[22] Section 1202(b)(1).

[23] Legislative history also supports this reading of the statute. The 1993 conference report states: “The House bill generally permits a noncorporate taxpayer . . . to exclude 50 percent of any gain on the sale or exchange of the stock. The amount of gain eligible for the 50 percent exclusion is limited to the greater of [$10 million and 10 times basis].” This explanation, by specifying “gain eligible for the 50 percent exclusion,” indicates that taxpayers should apply the gain limitation before applying the exclusion percentage. H.R. Conf. Rep. No. 103-213, 103rd Cong. 1st Sess. (1993), at 523.

[24] Section 1045(a).

[25] Section 1045(b)(3).

would *otherwise be recognized*.[26] Gain that is excluded under section 1202 is, by definition, not recognized. Therefore, this literal reading of section 1045 could create an effect whereby the taxpayer would defer gain that otherwise would have been excluded.

Another argument against this literal reading of section 1045 is that requiring a taxpayer to reinvest the tax-free proceeds excluded under section 1202 to defer a separate, taxable portion of the gain is illogical, as it requires reinvesting one set of cash proceeds to defer gain arising from *other* cash proceeds. Moreover, such an approach could undermine the incentive that section 1202 is intended to provide. It would effectively trap tax-free cash in a new investment to defer a different taxable gain, a result contrary to the policy of encouraging investment in small businesses.[27]

We request that the Service and Treasury issue guidance clarifying that when a taxpayer excludes a portion of gain from a QSBS sale under section 1202, the reinvestment requirement under section 1045 applies only to the portion of the amount realized that is attributable to the gain *not* excluded under section 1202.

D. Section 1202 holding period and section 1223 tacking

A tension exists between two provisions of section 1202 regarding the acquisition date of stock issued in exchange for contributed property. Where a taxpayer acquires stock in exchange for other property – such as via the incorporation of an LLC taxed as a partnership (treated from the shareholder's point of view as a section 351 exchange)[28] or via the conversion of convertible corporate debt into shares of the issuer corporation's stock – does the section 1202(a)(1) holding period begin on the date the taxpayer acquires the stock, or at an earlier date? Said differently, do the holding period rules of section 1223 (which provide for "tacking" in certain scenarios) apply for purposes of section 1202(a)(1)?

Section 1202(i)(1)(A) states that when a taxpayer transfers property other than money or stock to a corporation in exchange for stock, the stock is "treated as having been acquired by the taxpayer on the date of such exchange" for purposes of section 1202.[29] This provision makes no reference to section 1223 and clarifies that the holding period for section 1202 purposes begins on the actual date of stock issuance and not earlier. Prior to enactment of the OBBBA it was clear that the shareholder's holding period would begin on the date of the stock's issuance,

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[26] Service Treasury Decision, Final Rule, T.D. 9353, 72 F.R. 45346, *Section 1045 Application to Partnerships* (which added Reg. section 1.1045-1) ("Section 1045 permits a non-corporate taxpayer that holds QSB stock for more than six months and sells it after August 5, 1997, to elect to *defer recognizing gain* (other than gain treated as ordinary income) on the sale." (emphasis added)).

[27] While the preamble to the regulations under section 1045 (T.D. 9353) does not directly address this specific interaction, its language perhaps supports requiring only the non-excluded gain to be deferred under section 1045. Service Treasury Decision, Final Rule, T.D. 9353, 72 F.R. 45346, *Section 1045 Application to Partnerships* (which added Reg. section 1.1045-1). The preamble describes section 1045 as a provision to "defer recognizing gain." This focus on deferring *recognized* gain supports the view that gain already excluded from recognition under section 1202 is outside the scope of the section 1045 mechanics.

[28] See Rev. Rul. 84-111, 1984-2 C.B. 88; Rev. Rul. 2004-59, 2004-24 I.R.B. 1050.

[29] Section 1202(i)(1)(A).

and would not be lengthened by inclusion of the taxpayer's holding period with respect to the nonstock property exchanged for the newly issued stock.

However, new section 1202(a)(6)(B), enacted as part of the OBBBA, appears to contradict section 1202(i)(1)(A). Section 1202(a)(6) sets the "applicable date" as the date of its enactment.[30] Stock acquired after the applicable date can be eligible for capital gain exclusion under section 1202(a) after a three-year holding period, with a five-year holding period still required for the 100 percent exclusion to apply.[31] Section 1202(a)(6)(B) provides that "the acquisition date for purposes of this section shall be the first day on which such stock was held by the taxpayer determined after the application of Section 1223."[32]

Because section 1223 provides for tacked holding periods in numerous contexts including section 351 exchanges,[33] a literal reading of section 1202(a)(6)(B) could permit a taxpayer who incorporates a business (e.g., via a check-the-box election or partnership-to-corporation conversion[34]) to tack the holding period of the contributed assets onto the stock and satisfy the three-to-five-year holding period requirement immediately, even if the stock was issued only recently. It appears that section 1202(a)(6)(B) is primarily intended to clarify that the holding period rules added in OBBBA should apply to the new three- and four-year holding period provisions enacted as part of the OBBBA. Nonetheless, section 1202(a)(6)(B)'s broad language can be read to generally extend the holding period following a section 1223 event. Such a reading, however, runs counter to the express language of section 1202(i)(1)(A), and would render section 1202(i)(1)(A) surplusage—a statutory provision with no effect.

Such a result almost certainly was not intended by Congress. Consider section 1202(a)(3), which still remains in effect post-OBBBA but is essentially a predecessor of section 1202(a)(6)(B) with respect to stock issued between February 18, 2009, and September 28, 2010. Section 1202(a)(3) harmonizes the different levels of capital gain exclusion applicable to stock acquired at different dates using the phrase "for purposes of this subsection" rather than "this section," and the Joint Committee on Taxation stated at the time that the provision was "not intended to change the acquisition date determined under Section 1202(i)(1)(A) for certain stock exchanged for property."[35] Section 1202(a)(4) similarly harmonizes the different levels of capital gain exclusion applicable to stock acquired before and after September 28, 2010. The holding period for purposes of applying the 100 percent exclusion, rather than a lesser exclusion, is determined with application of the section 1223 holding period rules rather than the more limited

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[30] Section 1202(a)(6) was enacted as part of OBBBA on July 4, 2025.

[31] *See* Sections 1202(a)(1), 1202(a)(5), and 1202(a)(6)(A).

[32] Section 1202(a)(6)(B).

[33] Section 1223(1) (the holding period of property received in an exchange includes the holding period of the property exchanged, if the exchanged property had the same basis, in whole or in part, in the taxpayer's hands as the property received).

[34] *See* Rev. Rul. 84-111, 1984-2 C.B. 88 (describing three forms of partnership incorporation transactions, all treated as section 351 transactions); Reg. section 301.7701-3(g)(1)(i) (deemed assets-over transaction upon check-the-box election); Rev. Rul. 2004-59, 2004-1 C.B. 1050 (same treatment for formless state law conversions).

[35] JCT, "General Explanation of Tax Legislation Enacted in the 112th Congress," JCS-2-13, at 185, footnote 490 (Feb. 25, 2013) (explaining the amendment to section 1202 to provide for 100% exclusion of stock issued after September 27, 2010, and section 1045 rollover which results in a tacked holding period under section 1223).

section 1202(i)(1)(A) rule because of section 1202(a)(4). 36 Section 1202(a)(4)'s language, like that of section 1202(a)(3), provides that its rule applies "for purposes of this subsection." That language clearly delineates where its rule (invoking section 1223) applies, and where section 1202(i)(1)(A) (departing from section 1223) applies.

There is no indication that the OBBBA's addition of section 1202(a)(6)(B) was intended to create a result so dramatically different from the result created via sections 1202(a)(3) and 1202(a)(4). If that dramatically different result were to apply, section 1202(a)(6)(B) would negate section 1202(i)(1)(A)'s applicability in every situation even though Congress did not repeal, alter, or remove section 1202(i)(1)(A).

Statutes should not be interpreted in a manner that renders an entire subparagraph as surplusage or meaningless.[37] Treasury should apply that canon of statutory interpretation here, and not permit section 1202(i)(1)(A) to be considered surplusage. We respectfully request that the Service and Treasury clarify that the holding period for stock issued in exchange for contributed property generally begins on the date the stock is issued, as provided in section 1202(i)(1)(A), and that the reference to section 1223 in section 1202(a)(6)(B) does not override this rule except as to the specific provisions of section 1202 related to stock holding periods added in OBBBA.

IV. Original Issuance – Section 1202(c)(1)(B)

Stock of an issuing corporation generally may constitute QSBS in the hands of a taxpayer who acquired the stock after August 10, 1993, at its original issuance.[38] Corporate stock satisfies the original issuance requirement if the disposing shareholder acquired the stock directly from the issuing corporation in exchange for money, property other than stock, or services provided to the issuing corporation.[39]

Stock qualifies as acquired at original issuance if, after its original issuance, it is transferred to the taxpayer in a manner that meets one of the exceptions listed in section 1202(h). An exception is met if the shareholder (a) received the QSBS as a gift, (b) received the QSBS at death, (c) received the QSBS as a distribution from a partnership as a partner of such distributing partnership (if certain conditions are met), or (d) exchanged QSBS for other stock as part of certain nontaxable transactions.[40] Where a shareholder acquired its stock under one of the exceptions, the shareholder is treated as acquiring the stock in the same manner as the transferor, and its holding period includes any continuous period immediately preceding the transfer.[41]

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[36] Sections 1202(a)(1)(A) and (a)(4).

[37] *Duncan v. Walker*, 533 U.S. 167 (2001); *Pulsifer v. United States*, 601 U.S. 124 (2024); *Sharp v. United States*, 580 F.3d 1234 (Fed. Cir. 2009).

[38] Section 1202(a)(4). If held through a pass-through entity, the stock of the issuing corporation must qualify as QSBS in the hands of the pass-through entity. Section 1202(g)(2).

[39] Section 1202(c)(1)(B).

[40] Section 1202(h).

[41] Section 1202(h)(1).

A. Original issuance applied to holding company stock issued in exchange for services to subsidiary

A question that frequently arises due to a common corporate structure involves an employee of an operating company that is owned by a holding company eligible to issue QSBS. If the employee receives stock of the holding company as compensation, does the stock qualify as QSBS because it was issued for services?[42] Or does it fail because the services were not provided to the issuing corporation as apparently required under the statute,[43] but rather to the operating entity, which is a subsidiary of the issuing corporation?

In two other contexts within section 1202, it provides for a look-through rule applicable to a holding company that owns an operating company. For purposes of the Gross Assets Test, all corporations that are members of the same parent-subsidiary controlled group are treated as a single corporation.[44] For purposes of the active business requirement, stock and debt in any subsidiary corporation is disregarded and the parent corporation is deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities.[45] Like the above two rules, one might argue that a look-through rule should apply for purposes of the original issuance requirement. If so, an employee of a corporate operating company who provides services to the operating company and receives stock of the corporate holding company should be treated as having provided services to the issuing corporation. However, the Code does not explicitly provide for this rule.

Since section 1202(c)(1)(B)(ii) mentions only services provided to the issuing corporation, an argument may be made that its plain meaning precludes stock from meeting the 1202(c) initial issuance requirement if the stock is issued in exchange for services provided to a subsidiary of the issuing corporation.[46] However, the Supreme Court has characterized statutory construction as a “holistic endeavor.”[47] Consistent with this approach, the Court has further explained that a meaning that may appear correct when a term is viewed in isolation should not be followed if

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[42] Section 1202(c)(1)(B)(ii).

[43] *Id.*

[44] Section 1202(d)(3). Parent-subsidiary group in this context means a controlled group of corporations connected through stock ownership with a common parent corporation as defined in section 1563(a)(1), except that “more than 50 percent” is substituted for the “at least 80 percent” requirement in that section. Section 1202(d)(3)(B).

[45] Section 1202(e)(5)(A). Subsidiary in this context means a subsidiary corporation in which the parent owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock of the corporation.

[46] The Supreme Court has recognized that the plain meaning of a federal tax statute controls its interpretation if it is not ambiguous, applying the common meanings of the words used by Congress. *Gitlitz v. Commissioner*, 531 U.S. 206 (2001); *Old Colony R.R. Co. v. Commissioner*, 284 U.S. 552 (1932).

[47] *United Savings Association of Texas v. Timbers of Inwood Forest Associates Ltd*., 484 U.S. 365 (1988) (citations omitted). The Court added: “A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme — because the same terminology is used elsewhere in a context that makes its meaning clear, or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law.” *Id.*

applying that meaning would be untenable in light of the statute as a whole.[48] Parent stock received in exchange for services provided to a subsidiary arguably would meet the section 1202(c) initial issuance requirement based on a holistic approach.[49]

A corporate structure featuring a holding company that does not operate a business owning a subsidiary that does operate a business is common. We recommend that in such a structure where parent stock is issued for services provided to the subsidiary, the issuance should qualify as QSBS. If the subsidiary's activities enable the parent company to meet the section 1202(e) active business test, it would appear unfair and arbitrary to deny the ability of the subsidiary's employees who have received parent stock in exchange for services to claim benefits under section 1202 merely because their employer was the subsidiary and not the parent.

V. Redemptions – Section 1202(c)(3)

Certain redemption transactions disqualify stock from satisfying the QSBS requirements, specifically (i) redemptions from a taxpayer or a related person, and (ii) significant redemptions. Under the first of these rules, QSBS held by a particular taxpayer loses QSBS status if the issuing corporation purchases any of its own stock (directly or indirectly) from either that shareholder or persons related to the shareholder within a four-year period beginning two years before the date of the issuance.[50] Under the second rule, stock issued by a corporation is not treated as QSBS if, within a two-year period beginning on a date one year before the issuance of the stock, the corporation makes significant purchases of its own stock.[51]

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[48] *Oregon Department of Revenue v. ACF Industries Inc.*, 510 U.S. 332 (1994). Considering the statutory scheme as a whole may also be referred to as the principle of *noscitur a sociis*, ("it is known from its associates"), *Black's Law Dictionary*, 1209 (1968), under which interpretation of a statutory provision may be based on the nature of the provisions surrounding it. *See, e.g., National Muffler Dealers Association Inc. v. Commissioner*, 565 F.2d 845 (2d Cir. 1977), *aff'd on other grounds*, 440 U.S. 472 (1979) (applying the *noscitur a sociis* principle to determine the meaning of the term "business league" in section 501(c)(6)); *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303 (1961) ("the maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings."). *See also* Scalia and Garner, *Reading Law: The Interpretation of Legal Texts* (2012) at 195 (under *noscitur a sociis*, when words "are associated in a context suggesting that the words have something in common, they should be assigned a permissible meaning that makes them similar").

[49] However, it could also be argued that the stock should not meet the section 1202(c) initial issuance requirement based on the principle *expressio unius est exclusio alterius* or "expression of one is exclusion of the other." *See, e.g., National Muffler Dealers*, 565 F.2d 845. *See also Bingler v. Johnson*, 394 U.S. 741 (1969), *rev'g* 396 F.2d 258 (3d Cir. 1968) (addressing the section 117 qualified scholarship rules, reversing the Third Circuit's *expressio unius*-based holding in favor of the taxpayer, holding reg. section 1.117-4 valid, and resolving a conflict between circuits).

[50] Section 1202(c)(3)(A). A person is "related" if related as defined in either section 267(b) or 707(b). De minimis amounts are excluded. Stock acquired from the shareholder or a related person exceeds a de minimis amount only if (1) the aggregate amount paid for the stock exceeds $10,000, and (2) more than 2% of the stock held by the taxpayer and related persons is acquired. The following rules apply for purposes of determining whether the 2% limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

[51] Section 1202(c)(3)(B) and Reg. section 1.1202-2(b). More specifically, stock is not QSB stock if, in one or more purchases during the two-year period beginning on the date one year before the issuance of the stock, (1) the issuing corporation purchases more than a de minimis amount of its stock, and (2) the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of the issuing corporation's stock as of the beginning of such two-year period.

A. Definition of "purchase" and transactions constituting a redemption

We request guidance regarding the scope of transactions constituting a "purchase" or "redemption" for purposes of the redemption rules in section 1202(c)(3). While Reg. section 1.1202-2 provides some parameters, the application of these rules to many common corporate transactions remains uncertain.

The redemption rules in section 1202(c)(3) are intended to ensure that capital raised by a corporation is used for business growth rather than to "cash out" existing shareholders, and to prevent sham transactions relating to stock already outstanding undertaken to obtain the exclusion where it otherwise would not be available.[52] The statute and regulations therefore target certain corporate "purchases" of stock, alternatively described as "redemptions."[53] A "redemption" is defined in section 317(b) as a transaction where a corporation acquires its stock from a shareholder in exchange for property. However, the application of this framework to the following common scenarios is unclear:

1. **Dividends:** A distribution of property from a corporation to its shareholders, which is subject to section 301, does not involve the corporation's acquisition of corporate stock from its shareholder. Therefore, based on the plain language of section 317(b), such a distribution should not be considered a redemption or purchase for purposes of section 1202(c)(3).[54] However, without explicit confirmation, taxpayers are left with some uncertainty as to whether any distribution of corporate property could be viewed as a disqualifying transaction.[55]

2. **Dividend Equivalent Redemptions:** Under section 302(d), certain redemptions from shareholders (such as a pro rata redemption) are treated as a section 301 distribution. In such a case, the shareholder-level tax treatment is that of a dividend notwithstanding that the transaction constitutes an actual redemption of stock (and constitutes a section 317(b) redemption). It is unclear whether such a transaction, which is sometimes economically equivalent to a dividend and is treated as such, should be treated as a

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[52] *See* H.R. Conf. Rep. No. 103-213, 103rd Cong. 1st Sess. (1993) ("In order to prevent evasion of the requirement that the stock be newly issued, the exclusion does not apply if the issuing corporation (1) purchases any stock from the stockholder (or a related person) within 2 years of the issuance of the stock or (2) redeems more than 5 percent (by value) of its own stock within 1 year of the issuance. For purposes of this anti-evasion rule, purchases by persons related to the issuing corporation are treated as purchases by the issuing corporation.")

[53] Section 1202(c)(3)(B).

[54] Note that section 301 governs "a distribution of property … made by a corporation to a shareholder with respect to its stock" while a redemption is described in section 317(b) as a corporation's acquisition of "its stock from a shareholder in exchange for property" (emphasis added). Note further that this conclusion holds true notwithstanding that, pursuant to section 301(c)(3), a section 301 distributions can in some cases be treated akin to an exchange of property (where the distribution is not a dividend and exceeds the shareholder's adjusted basis of the stock).

[55] Treasury and the Service may, however, consider issuing an anti-avoidance rule to address a situation that in form constitutes a distribution but in substance resembles a redemption. In that situation, prior to a new issuance of stock, a corporation "declares" a dividend (for the benefit of the current but not future investors), then issues new stock, and later funds the previously declared dividend recipients (based upon the post distribution value of stock) with cash raised from the stock issuance.

disqualifying purchase under section 1202(c)(3) (which is concerned with the use of corporate assets, not shareholder-level tax consequences).

3. **Recapitalizations:** In a recapitalization, a shareholder exchanges stock of the corporation for other stock of the corporation. Under section 368(a)(1)(E), recapitalizations are treated as tax-free reorganizations and not as taxable purchases.[56] Nonetheless, it is not entirely clear that the exchange of stock in a recapitalization does not constitute a "redemption" of stock for purposes of section 1202(c)(3).

4. **Recapitalizations with Boot:** In a recapitalization (governed by section 368(a)(1)(E)), a shareholder might exchange (i) old stock for (ii) new stock plus cash (boot). The boot is taxed pursuant to specific gain recognition rules provided in section 356(a), and the character of the recognized gain is determined under section 356(a)(2) (the dividend equivalency test). It is uncertain whether the exchange of stock for boot in such a recapitalization constitutes a "purchase" for purposes of the section 1202(c)(3) test, or does not because it is ancillary to a tax-free recapitalization.

5. **Founder Redemptions:** It is common for a founder of a business to form a corporation, contribute cash for stock, and subsequently redeem a portion of that stock within the section 1202(c)(3)(B) prohibited two-year period. For example, consider a newly formed corporation requiring $4 million of cash to cover start-up operating expenses, upon which a shareholder provides the $4 million of funding in exchange for stock. The shareholders later determine that the business only requires $3 million for the operating expenses; the corporation therefore redeems one-quarter of that shareholder's shares for $1 million. While this transaction technically falls within the section 1202(c)(3) redemption rules, it does not represent the type of abuse the statute was designed to prevent (i.e., a bailout of corporate earnings). Instead, it is one component of a series of transactions that results in a net infusion of capital. The literal application of the rule in this context could disqualify all stock issued during the testing period, a result that appears contrary to the policy of section 1202.

We acknowledge the framework of what constitutes a significant or related party redemption established in Reg. section 1.1202-2 and do not propose fundamental changes. Nonetheless, we recommend the issuance of guidance to establish a clearer delineation of what constitutes a "purchase" of stock. We recommend that such guidance provide (i) explicit confirmation that a dividend and recapitalization do not constitute a "purchase" or "redemption" for purposes of section 1202(c)(3) and (ii) clarification regarding the other scenarios described above.

VI. Aggregate Gross Assets – Section 1202(d)

In order to qualify as a QSB, the corporation must meet the Gross Assets Test at the date of each issuance. To satisfy the Gross Assets Test, the adjusted tax basis of the aggregate gross assets of the corporation (and any of its predecessors) must not have exceeded $50 million (a) at any time on or after August 10, 1993, and (b) before or immediately after the issuance of the

[56] Section 1202 addresses the original issuance status of stock received in a section 368(a)(1)(E) recapitalization in section 1202(h)(3).

stock for which preferential treatment is sought.[57] As described above, under the OBBBA, the Gross Assets Test threshold increased to $75 million with respect to stock issued after July 4, 2025.[58]

When determining a corporation's aggregate gross assets, the adjusted basis of any property (other than cash or stock) contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) is determined as if the basis of the property contributed to the corporation was equal to its fair market value (FMV) as of the time of such contribution (the Contributed Assets Rule).[59]

An aggregation rule for affiliated corporations modifies the Gross Assets Test under section 1202 and treats all corporations that are members of the same parent-subsidiary controlled group as one corporation for purposes of the Gross Assets Test.[60]

A. Definition of "immediately after" as applied to the Gross Assets Test

Section 1202(d)(1) states that a corporation is a QSB if its aggregate gross assets do not exceed the applicable adjusted tax basis threshold up until and "immediately after the issuance (determined by taking into account amounts received in the issuance)." This raises a question regarding how the Gross Assets Test applies in a situation where several related issuances occur sequentially, or several components of a capital raise occur sequentially. How do the terms "the issuance" and "immediately after" apply in these cases?

As an example, suppose three investors, X, Y, and Z, purchase Series B stock of a corporation pursuant to a written agreement entered into by the corporation and X, Y, and Z on August 15, 2025. X's purchase closes on September 1, 2025, Y's purchase closes on September 15, 2025, and Z's purchase closes on December 1, 2025. When assessing the QSB qualification of X's stock, does the "immediately after" rule of section 1202(d)(1) encompass the cash raised in Z's purchase? For example, if the corporation's aggregate gross assets exceed $75 million for the first time on December 1, 2025, the date Z's Series B stock purchase closes, Z's stock clearly does not qualify as QSB stock under section 1202(d)—but does X's or Y's Series B stock qualify?

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[57] Section 1202(d)(1)(A) (as codified prior to the enactment of the OBBBA). For purposes of determining whether the corporation satisfied the Gross Assets Test immediately after an issuance, any amounts received by the corporation as part of that issuance are included. Section 1202(d)(1)(B).

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

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

[60] Section 1202(d)(3)(A). A parent-subsidiary controlled group for this purpose is one or more chains of corporations connected through stock ownership with a common parent corporation if: (a) stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote (total combined voting power) or more than 50% of the total value of shares of all classes of stock (total value) of each of the corporations, except the common parent corporation, is owned by one or more of the other corporations; and (b) the common parent corporation owns stock possessing more than 50% of the total combined voting power or more than 50% of the total value of at least one of the other corporations (excluding, in computing such voting power or value, stock owned directly by such other corporations). Sections 1202(d)(3)(B) and 1563(a)(1).

As another example, suppose a private equity fund (PE) forms a corporation to purchase the assets of a business (T) for $100 million. Under a preplanned sequence of events, (i) PE capitalizes the corporation with $70 million of equity funding on August 1, 2025, in exchange for stock of the corporation, (ii) the corporation borrows $30 million from a bank on August 4, 2025, and (iii) the corporation purchases T's business assets on August 4, 2025. Does the corporation's stock qualify as QSB stock (under the argument that its gross assets were no greater than $70 million as of immediately after its August 1, 2025, stock issuance)?

These questions raise a broader question: how the step transaction doctrine applies to stock issuances and related events for purposes of the Gross Assets Test, which applies "immediately after" an issuance of stock. Under the step transaction doctrine, steps in a transaction can be "stepped" together. Courts have developed several tests to determine whether to step transactions together. The most common of these tests are the (i) binding commitment test,[61] (ii) interdependence test,[62] and (iii) end result test.[63] Whether multiple transactions should be stepped together generally depends upon the application of one or several of these tests to the facts and circumstances of the transaction.[64]

We note that while many tax practitioners have considered step transaction principles when applying the Gross Assets Test, some have not. Those who have not would, for example, apply the test separately to multiple stock purchasers who each purchased stock at different times pursuant to one binding agreement. We respectfully request that the Service and Treasury provide guidance as to the appropriate standard for determining the extent to which several related issuances of stock or events constitute a single issuance or event for purposes of the Gross Assets Test.

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[61] Under the binding commitment test, a series of transactions will be stepped together if at the commencement of the first step there is a binding legal commitment to undertake the subsequent steps. *See*, *e.g.*, *Comm'r v. Gordon*, 391 U.S. 83 (1968); *see also* FSA 200126001 (Oct. 8, 1999) (applying the binding commitment test to disregard the existence of a transitory corporation in a leveraged buyout transaction).

[62] Under the interdependence test, a series of transactions will be stepped together if the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. *See*, *e.g.*, *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-26, 2001-1 CB 1297; FSA 200221046 (Feb. 19, 2002) (applying interdependence test to integrate a multi-step transfer of a domestic corporation's transfer of its foreign subsidiaries to its foreign parent corporation, thereby subjecting the transfer to section 367(a)). This test is somewhat similar to the end result test discussed below, in that it focuses on the subjective intent of the parties.

[63] Under the end result test, a series of transactions will be stepped together when the evidence shows that the parties' intent at the outset was to achieve a particular result and that the separate steps were all entered into as a means of achieving that result. *See*, *e.g.*, *Kuper v. Comm'r*, 533, F.2d 152 (5th Cir. 1976). This test would result in application of the step transaction doctrine in many transactions where the same result could have been achieved in a more direct manner. *See Del Commercial Properties, Inc. v. Comm'r*, 251 F.3d 210 (D.C. Cir. 2001) ("a particular step is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes"); FSA 200122007 (Feb. 13, 2001) (noting that courts are seldom rigid in applying the end result test and that courts will look at the intent of the parties and the time interval between steps).

[64] *See McDonald's Restaurants of Illinois, Inc. v. Comm'r*, 688 F.2d 520 (7th Cir. 1982). *See also True v. United States*, 190 F.3d 1165 (10th Cir. 1999) (noting that a transaction needs to satisfy only one of the tests to apply the step transaction doctrine); *Andantech, L.L.C. v. Comm'r*, T.C. Memo. 2002-97 (2002) (citing *True* and holding that certain sale-leaseback transactions should be disregarded under both the interdependence and end result tests); FSA 199929013 (Apr. 19, 1999) (applying all three tests in determining whether the section 355 continuity of interest requirement was satisfied).

We recommend applying traditional federal income tax step transaction principles to the section 1202 Gross Assets Test, which would be both reasonable and consistent with the statutory purpose of section 1202. The aggregate gross assets limitation is a central eligibility requirement designed to ensure that the benefits of section 1202 are targeted to genuinely small businesses. If related issuances or events that are contractually committed as part of a single plan are not aggregated, a corporation could structure a series of closings or events to avoid exceeding the statutory threshold, thereby undermining the policy objective of the statute. Where, for example, there is a binding commitment to multiple closings under a single plan, the economic reality is that the corporation is effectively raising the full amount of capital contemplated by the plan, even if the closings are staged over time. Measuring aggregate gross assets only after each individual closing would allow the corporation to temporarily remain under the threshold at each step, even though the total capital raised under the plan would cause the corporation to exceed the limit. This would frustrate the statutory intent and create an arbitrary disparity between corporations that close all sales simultaneously and those that close in stages pursuant to a binding agreement. A similar argument applies with regard to several components of a capital raise.[65]

Moreover, guidance should clarify that the test is not limited to a purely mechanical, moment-by-moment balance sheet snapshot. Rather, rules similar to those applied under the section 351 regulations should apply. Those regulations provide that "immediately after the exchange"[66] does not require simultaneous exchanges, but includes transactions where the parties' rights were previously defined and the agreement is executed expeditiously.[67] A similar approach is reflected in the section 338 regulations, which test relationships after the last acquisition in a series constituting a qualified stock purchase, or after the last transaction in a series effected pursuant to an integrated plan.[68]

Accordingly, we recommend that guidance follow in the footsteps of well-developed corporate step transaction principles such as those applied under sections 351 and 338 in determining whether a corporation satisfies the section 1202 aggregate Gross Assets Test "immediately after" requirement, and whether related contributions, financings, redemptions, acquisitions, or other steps should be integrated, disregarded, or respected. We further recommend that any such guidance include examples of common fact patterns, such as staged capital contributions,

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[65] In applying step transaction principles to the fact patterns described above, relevant considerations would include, among others, the legal rights of the parties, the value of the shares, whether the economics underlying all the relevant transactions were dependent on or set prior to or after a subsequent transaction step, whether any follow-on transactions were legally required, and what the capital was used for (e.g., the current business needs versus a future acquisition).

[66] Section 351(a).

[67] Reg. section 1.351-1(a)(1) ("[t]he phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure").

[68] Reg. section 1.338-3(b)(3)(ii) ("a purchasing corporation is treated as related to another person if the relationship specified in section 338(h)(3)(A)(iii) exists…in the case of a series of acquisitions …, immediately after the last acquisition in such series; and…in the case of a series of transactions effected pursuant to an integrated plan to dispose of target stock, immediately after the last transaction in such series").

delayed closings, rollover transactions, same-day or near-same-day financings, and prearranged post-issuance asset transfers, to enable taxpayers to more easily determine when the relevant measurement point is the isolated issuance and when it is the completion of the integrated transaction.

B. Definition of "contribution" for the Contributed Assets Rule – section 1202(d)(2)(B)

Section 1202(d)(2)(B) provides that for purposes of the Gross Assets Test the basis of any property "contributed to the corporation" is deemed to be its FMV at the time of the contribution, rather than its carryover basis (the Contributed Assets Rule). This Contributed Assets Rule is a critical component of the Gross Assets Test. We request clarification on the scope of the term "contribution" within the meaning of the Contributed Assets Rule.

The statute does not define the term "contributed" for purposes of section 1202. This creates uncertainty as to whether the term should be interpreted narrowly to encompass only transactions formally designated as "contributions" under other Code sections or legal definitions (e.g., a transfer to a corporation qualifying under section 351) or broadly to include any transaction that results in property being transferred to a corporation, such as a corporate merger or other reorganization.

Under the narrow interpretation, the term "contribution" is treated as a term of art, limited to transactions explicitly characterized as contributions to a corporation's capital. This would primarily include tax-free incorporations under section 351[69] and contributions to capital governed by section 118.[70] However, this reading is not compelled by the statutory text and would exclude many economically similar transactions.

Under an alternative, broad interpretation, "contribution" is interpreted according to its plain and ordinary meaning: any transaction in which property is transferred to a corporation (and is not dependent on the particular tax characterization of the transaction). It would encompass not only section 351 exchanges but also corporate reorganizations under section 368, such as a statutory merger, where the assets of a target corporation are deemed to be transferred to the acquiring corporation in exchange for stock.

We respectfully recommend that the Service and Treasury issue guidance adopting the broad interpretation of "contribution" for purposes of section 1202(d)(2)(B). It should be clarified that

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[69] *See* section 362(a)(2), (c)(1), and (c)(2) (describing various section 351 transfers as "contributions") and Reg. section 1.362-2 (same). Note that a partnership-to-corporation conversion, which is a common application of the Contributed Assets Rule, typically constitute section 351 transactions. *See* Rev. Rul. 84-111, 1984-2 C.B. 88. Under that rule, the incorporation of a partnership can take one of three forms, depending on how the taxpayer structures it: assets over, assets up, or interests over. The assets-over form refers to when the partnership contributes all its assets and liabilities to the newly formed corporation in exchange for stock in the corporation and the partnership immediately thereafter liquidates, distributing the stock of the corporation to its partners. If an entity classified as a partnership elects to be classified as a corporation for federal tax purposes, an assets-over transaction is deemed to occur. Reg. section 301.7701-3(g)(1)(i). Similarly, if a partnership converts into a corporation under a state law conversion statute (also known as a formless conversion), an assets-over transaction is deemed to occur. Rev. Rul. 2004-59.

[70] *See* section 118(a).

the term includes any transaction that results in the transfer of property to a corporation, regardless of the specific Code section governing the transaction's tax consequences. This approach is more consistent with the statutory text, the underlying policy of the Gross Assets Test, and the economic substance of the transactions.

A narrow interpretation creates arbitrary distinctions based on transactional form over substance. For example, consider a scenario where two corporations, each with nominal tax basis and $100 million of fair market value, merge. In a statutory merger, the assets of the target corporation are transferred to the acquiring corporation, which is economically indistinguishable from a direct contribution of those same assets to the acquirer. Application of the Contributed Assets Rule to a section 351 transaction but not to such a merger would elevate form over substance and create an unwarranted loophole in the Gross Assets Test, thereby undermining the legislative intent to restrict section 1202 benefits to small businesses.

We therefore request guidance clarifying that for purposes of section 1202(d)(2)(B), a "contribution" of property to a corporation occurs whenever property is transferred to that corporation, including (but not limited to) transfers governed by sections 351 and 368.

C. Basis adjustments and the application of the Contributed Assets Rule

Application of the Contributed Assets Rule of section 1202(d)(2)(B) is clear in a scenario in which a stock issuance takes place on the same day that property is contributed to a corporation. The statute does not, however, explain how the rule affects the Gross Assets Test with respect to later stock issuances. Based on a plain reading of the statute,[71] it appears that the FMV of the assets contributed generally must be carried over to subsequent periods as an adjustment to the property's adjusted tax basis (a FMV Carryforward). Accordingly, the Gross Assets Test basis is measured as: (i) the FMV of the property initially contributed; plus (ii) the company's asset basis as of the subsequent issuance date; less (iii) the asset basis as of the contribution date.

The statute is silent as to whether the FMV Carryforward is static or if it is reduced in subsequent periods by depreciation or amortization that would be allowable had the contributed property's tax basis actually been its FMV. If the assets contributed to the corporation include depreciable or amortizable property, may the FMV Carryforward be decreased annually to reflect depreciation and amortization (to which these assets would be eligible if their tax basis equaled their FMV on the contribution date)?

If one reads the Contributed Assets Rule as mandating an unchanging FMV Carryforward, the basis would be determined "as of the time of such contribution" and remain static, regardless of the economic depreciation or amortization of the underlying asset and regardless of whether the corporation has disposed of that asset. We do not believe that reading would be appropriate.

The better view is that a wasting basis approach should apply, treating the contribution's FMV in excess of tax basis for aggregate Gross Assets Test purposes as basis that is subject to all other applicable basis adjustment rules under the Code, such as section 1016(a)(2), which

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[71] *See* section 1202(d)(2)(B).

requires that basis be reduced by the amount of depreciation or amortization “allowable.” Under this view, the property’s basis immediately after the contribution is determined as if it were equal to its FMV, and—in line with general principles of tax depreciation and amortization—the property’s deemed tax basis decreases over time.[72] Additionally, if the corporation has disposed of the contributed property (other than in a transaction not permitting recognition of gain or loss), the corporation should not be treated as retaining any of the contributed property’s tax basis for purposes of the Gross Asset Test.

We respectfully recommend that Treasury and the Internal Revenue Service issue guidance adopting the wasting basis interpretation. Specifically, guidance should clarify that for purposes of applying the Gross Assets Test, the tax basis in property contributed must be reduced by the amount of depreciation or amortization that would have been allowable had the property's basis been its FMV on the date of contribution. Additionally, that tax basis should be reduced if the contributed property is disposed of (other than in a transaction that does not permit recognition of gain or loss). The concept of a wasting basis for depreciable or amortizable property is a fundamental tenet of the Code.[73] A static basis approach would create an anomaly unique to section 1202.

Assets used in a trade or business are consumed over time. A wasting basis approach properly reflects this economic reality by reducing the asset's value for purposes of the Gross Assets Test as it is utilized. A static basis, in contrast, would artificially inflate a corporation's gross assets, potentially causing it to fail the $75 million test on a future stock issuance even as the economic value of its asset base has declined. This would penalize growing businesses, contrary to the purpose of section 1202.

Our recommended approach is analogous to the well-established framework for tracking "book" and "tax" basis for contributed property under section 704(c). For purposes of maintaining partners' capital accounts, the regulations provide that the book value of contributed property (its FMV) is reduced by book depreciation or amortization.[74] This dual-tracking system demonstrates that treating an asset's FMV as a wasting basis is both administrable and a recognized solution for addressing book-tax disparities.[75]

This established treatment of a deemed FMV basis as a wasting asset provides a strong precedent for applying the same principle to the “as if” FMV basis under section 1202(d)(2)(B).

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[72] *See generally* sections 167, 168, and 197.

[73] As an example, the regulations under section 704 provide that a partner’s capital accounts are decreased to reflect amortization and depreciation adjustments of assets contributed by the partner to the partnership. Reg. section 1.704-1(b)(2)(iv)(g)(3).

[74] Reg. section 1.704-1(b)(2)(iv)(g)(3).

[75] The wasting basis approach is also consistent with the treatment of assets following an election under section 338. When a qualified stock purchase is treated as an asset acquisition, the target corporation's assets receive a new adjusted basis derived from the stock's purchase price, which generally reflects their FMV. Sections 338(a) and (b). This new basis is not static; it serves as the basis for future cost recovery via depreciation and amortization. *See also* Notice 2003-65 (applying the rules of section 338 in interpreting the net unrealized built-in gain rules of section 382(h)).

When applying this principle, Treasury and the Service may consider whether the "bonus depreciation" (immediate expensing) rules of section 168(k) should apply. Those rules were intended to encourage capital investment by reducing the cost of capital and simplify recordkeeping.[76] Treasury and the Service determined in Notice 2018-30 that those section 168(k) rules do not apply to calculations of recognized built-in gain and recognized built-in loss items under section 382(h).[77]

D. Corporate reporting – section 1202(d)(1)(C)

Section 1202(d)(1)(C) provides that a corporation qualifies as a "qualified small business" only if it agrees "to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section." To date, neither the Treasury Department nor the Service has mandated that corporations submit such reports. In practice, corporations often do not provide shareholders with documentation or indications regarding QSB status until prompted by a shareholder inquiry. This lack of standardized reporting often creates challenges for shareholders seeking to substantiate QSBS eligibility when filing their tax returns.

For this reason, we recommend that the Service and Treasury issue regulations requiring a corporation to indicate that its stock qualifies as QSBS by including a statement on its corporate tax return and/or by providing notice to its shareholders.

We further recommend that such a notice include clauses addressing each of the key requirements of section 1202.[78] Each shareholder would then utilize the information provided to form a shareholder-specific determination as to whether their particular shares qualify based on their unique circumstances.

We do not provide here specific recommendations regarding some additional aspects of this proposed requirement, such as (i) whether the reporting may take place via the corporation's tax return, a notice to shareholders, or both; (ii) the year(s) in which the reporting would need to occur; (iii) whether the corporation must retain documentation supporting its assertion of qualification; and (iv) the ramifications of a corporation's failure to comply with this reporting requirement.

E. Subsidiary aggregation and the Gross Assets Test – section 1202(d)(3)

We request that Treasury and the Service clarify the treatment of subsidiary corporations within the meaning of section 1202(d)(3)—whether the Gross Assets Test focuses on the assets of the subsidiary corporation, the holding corporation, or both. This question frequently arises in holding company structures in which an issuing corporation raises capital and uses the

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[76] H.R. Rep. No. 115-409 (2018).

[77] Notice 2018-30, I.R.B. 2018-21, *modifying* Notice 2003-65, 2003-2 C.B. 747. Notice 2018-30 concluded that section 168(k) represented a departure from the wasting asset approach applied in depreciation and amortization rules under the Code. *See id*.

[78] This would include the Active Business Requirement of section 1202(e) (which an early-stage corporation could in many cases satisfy via the start-up activities or research activities exceptions of section 1202(e)(2), or the working capital exception of section 1202(e)(6)).

proceeds to acquire stock of an operating subsidiary. While section 1202(d)(3) provides that corporations within a parent-subsidiary controlled group are treated as a single corporation for purposes of the aggregate Gross Assets Test, the statute does not specify how that rule applies in this common holding company structure.

For example, suppose a target corporation (Target) has gross assets with an aggregate basis of $90 million and debt of $20 million. Investors form HoldCo after the OBBBA effective date and fund it with $70 million, after which HoldCo purchases all of Target's stock for $70 million. The threshold question is whether the Gross Assets Test is applied at the HoldCo level by reference to HoldCo's basis in the Target stock, or whether the analysis looks through HoldCo and measures the gross assets of Target at the subsidiary level. If the test is applied only at the HoldCo level, the HoldCo stock may qualify as QSBS because HoldCo held $70 million in cash before the acquisition and its basis in the Target stock immediately after the acquisition is $70 million. If the test looks through to Target's underlying assets, however, the HoldCo stock may not qualify because Target's asset basis immediately following the transaction is $90 million. In this scenario, should asset basis be measured by reference to the gross assets of the holding company whose stock is intended to qualify as QSBS, or by reference to the operating subsidiary whose business activities enable the holding company stock to satisfy the active business requirement?

This question can also arise in the reverse scenario. Suppose the investors contribute $90 million to HoldCo to purchase Target, and Target's asset basis is $70 million. Once again, does the gross asset rule focus on the gross assets (stock basis) of the holding company (in which case HoldCo's stock would not qualify as QSBS); or of the operating company (in which case HoldCo's stock would qualify as QSBS)?

We recommend that guidance clarify that, at the time of the holding company's initial issuance, the aggregate Gross Assets Test would only be satisfied if the assets of each corporation—the holding company and operating company—are below the statutory threshold. (A contrary approach—that the gross asset basis of the holding company may be disregarded—would potentially enable QSBS qualification in the case of a billion-dollar purchase of a target company that has an asset basis of less than $75 million; this result would appear to run counter to the intent of section 1202.)

We further recommend that, for periods following the corporation's initial issuance, the relevant measure of assets would hinge on the assets of the operating subsidiary only and ignore the holding company's basis in the operating company stock. This follows a common-sense view of the section 1202(d)(3) phrase "treated as 1 corporation," because applying the fiction under this view results in a single corporation that both (i) has issued stock held by the holding company's shareholders, and (ii) holds the business assets held by the operating company.

A related issue arises in leveraged acquisition structures involving a pre-closing distribution or redemption by the target corporation. For example, suppose Target has a fair market value of $100 million and an aggregate adjusted tax basis in its assets of $50 million. As part of the acquisition, Target borrows and makes a debt-financed distribution to its existing shareholders before closing. The distribution may be characterized either as a dividend or as a redemption under the principles commonly associated with Zenz-type transactions.[79] Purchaser Corporation then pays $70 million to acquire all of the Target stock. Purchaser's basis in the Target stock is $70 million, while Target's inside asset basis remains $50 million. Although Target may have temporarily held the debt proceeds before the distribution, Purchaser did not own Target at that time, and the stock intended to qualify as QSBS is stock of Purchaser Corporation, not Target. Accordingly, if the Gross Assets Test is applied at either the Purchaser or Target level immediately post-transaction, the structure appears to satisfy the statutory requirements, while total consideration to the target shareholders is $100 million. We request guidance confirming whether temporary pre-acquisition leverage and cash proceeds at Target should be disregarded for purposes of testing the issuing corporation's gross assets where the redemption or distribution occurred at Target before Purchaser acquired the Target stock.

F. Partnership interests and the Gross Assets Test

We request that Treasury and the Service clarify the treatment of partnership interests for purposes of the aggregate Gross Assets Test of section 1202(d). In particular, guidance is needed to determine whether (i) a corporation holding an interest in a partnership should measure its assets by reference to the tax basis of its partnership interest or by reference to the underlying assets of the partnership, and (ii) whether any such measurement should be taken into account on a proportionate or full-value basis.

We recommend that, for this purpose, the tax basis of a partnership interest be disregarded. Instead, the corporation should be treated as holding the underlying assets of the partnership. We further recommend that the corporation be treated as taking into account the full amount of the partnership's assets for purposes of section 1202(d), adjusted upwards (or downwards) for partner level adjustments such as section 743 adjustments with respect to the corporation's interest in the partnership's assets.[80] Measuring assets on a proportionate basis could permit multiple investors to obtain section 1202 treatment with respect to interests in a business whose total assets substantially exceed the statutory threshold, thereby undermining the purpose of section 1202(d).[81]

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[79] *See Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 54-458, 1954-2 C.B. 167.

[80] Partner level adjustments should be defined so as to encompass the partner-level items that provide the effect of partnership asset tax basis only with respect to a specific partner rather than with respect to the entire partnership. Adjustments to consider in this regard may include section 743(b) adjustments to the basis of partnership property upon the transfer of a partnership interest, and built-in loss amounts with respect to partnership property under section 704(c)(1)(C), potentially adjusted for remedial allocations of income, gain, loss or deduction to a partner pursuant to section 704(c) and Reg. section 1.704-3(d). *See*, *e.g.*, Reg. Section 1.163(j)-6(b)(2) and -6(b)(3) (defining "partner-basis items" and "remedial Items" for purposes of Reg. Section 1.163(j)-6).

[81] For example, under a proportionate-share approach, if ten newly formed corporations each purchase a 10% interest in a partnership that holds $700 million of assets, each corporation would be viewed as holding only $70 million of assets. Such a result would be difficult to reconcile with Congress's clear intent that section 1202 benefits be limited to investments in businesses whose aggregate asset base does not exceed the statutory threshold. The issue becomes even more pronounced in private equity, joint venture, and tiered partnership structures.

This approach is supported by the structure and purposes of section 1202. First, disregarding the partnership's outside tax basis reflects an aggregate approach to partnerships. Second, it is consistent with sections 1202(d)(3(A) and 1202(e)(5), which attribute assets of a corporate subsidiary to the parent corporation. Third, viewing the corporation as owning the full amount of the partnership's assets for purposes of section 1202(d) is consistent with section 1202(d)(3(A), which, for gross assets testing purposes, treats a corporate parent as owning 100% (and not a ratable portion) of the assets of its corporate majority-owned subsidiary.[82] Fourth, measuring the full asset base of the partnership is consistent with the policy underlying the aggregate Gross Assets Test, which is intended to limit section 1202 benefits to relatively small businesses. Accordingly, guidance should confirm that, for purposes of section 1202(d), the relevant asset base includes the assets of the partnership (adjusted upward or downward for partner-level adjustments such as section 743 adjustments pertaining to the corporation) rather than a proportionate or investment-based measure.[83]

VII. Active Business Requirement and qualifying business – section 1202(e)

In order for the stock of an issuing corporation to qualify as QSB stock under section 1202, the corporation must be an eligible corporation that actively conducts a QTOB for "substantially all" of the taxpayer's holding period of such stock (the Active Business Requirement).[84] Under the Active Business Requirement, an eligible corporation actively conducts a QTOB for any period of time if during that period the corporation uses at least 80% of its assets, measured by value, in the active conduct of one or more QTOBs.[85] The term QTOB means any trade or business other than certain businesses specifically enumerated in the Code, including health, engineering, consulting, financial services, and brokerage services, among others.[86]

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[82] *Compare* H.R. 2264, § 14113 (as passed by the House) ("the parent corporation is deemed to own its ratable share of the subsidiary's assets for purposes of the 'qualified corporation,' 'active business,' and 'gross assets' tests"), *with* H.R. Rep. No. 103-213 (1993) (Conf. Rep.) (conference agreement modified the House bill so that a "parent-subsidiary controlled group (using a more than 50% ownership test) are treated as a single corporation for purposes of the gross assets test," while retaining ratable-share treatment for the active-business test). The Conference Report approach was enacted into law. *See* IRC sections 1202(d)(3) and 1202(e)(5)(A).

[83] If Treasury and the Service determine that partnership assets should be taken into account for purposes of section 1202(d) on a ratable basis, guidance would be required to clarify how the rule applies to tiered partnerships, preferred and carried interests, differing capital and profits percentages, and other arrangements where a taxpayer's economic rights do not neatly correspond to a single ownership percentage.

[84] Section 1202(c)(2). For purposes of the Active Business Requirement, the term "eligible corporation" means any domestic corporation except (a) a current or former domestic international sales corporation (DISC), (b) a RIC, real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC), and (c) a cooperative. Section 1202(e)(4).

[85] Section 1202(e)(1). In determining whether at least 80% of an eligible corporation's assets are used in an active QTOB, no more than 10% of the value of that issuing corporation's assets (in excess of liabilities) may consist of stock or securities in other corporations in which it does not own more than 50% of the stock by voting power or value. The assets of the corporation's subsidiaries are taken into account. Under section 1202(e), the stock and debt in any subsidiary corporation is disregarded, and the parent corporation is deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities if the parent corporation owns more than 50% of either the total combined voting power or total value of the subsidiary's stock. Section 1202(e)(5).

[86] Section 1202(e)(3). More specifically, the definition includes:

If an eligible corporation uses assets in certain activities relating to a future QTOB, such as start-up activities, those assets may qualify as assets used in the active conduct of a QTOB without regard to whether that corporation has any gross income from such activities at the time of the determination.[87] The Active Business Requirement includes an exception for working capital assets, which qualify as used in the active conduct of a trade or business (the Working Capital Allowance).[88]

A. Active Business Requirement and original issuance intersection

The Active Business Requirement of section 1202(c)(2)(A) provides that, for stock to qualify as QSBS, the issuing corporation must meet the requirements of section 1202(e) during substantially all of the taxpayer's holding period. By its terms, this requirement is keyed to the holding period generally and does not expressly apply at the issuance date. In contrast, Section 1202(c)(1)(A), which requires that the issuing corporation be a "qualified small business" as of the date of issuance, only requires (per section 1202(d)(1)'s definition of "qualified small business") that the corporation be a domestic C corporation that satisfies the Gross Assets Test. Section 1202(c)(1)(A) does not, on its face, incorporate the Active Business Requirement.

A literal reading of the statute therefore appears to permit stock to qualify as QSBS even where the issuing corporation, as of the date of issuance, is neither actively conducting a QTOB nor engaged in start-up activities described in section 1202(e)(2),[89] so long as the corporation ultimately satisfies the Active Business Requirement for substantially all of the shareholder's holding period. Section 1202's legislative history, however, can be read to suggest a contrary view, as the Conference Report states that "[t]he issuing corporation must be a qualified small business as of the date of issuance and during substantially all of the period that the taxpayer holds the stock"; thus using the term "qualified small business" in a manner that appears

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1. 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,
2. Any banking, insurance, financing, leasing, investing or similar business,
3. Any farming business (including the business of raising or harvesting trees),
4. Any business involving the production or extraction of products of a character with respect to which a depletion deduction is allowable under section 613 or section 613A, and
5. Any business of operating a hotel, motel, restaurant or similar business.

[87] Section 1202(e)(2).

[88] Section 1202(e)(6). Assets that (a) are "held as part of the reasonably required working capital needs of a qualified trade or business" of a corporation or (b) are "held for investment and are reasonably expected within 2 years to finance research and experimentation… or increases in the working capital needs" of a QTOB are considered working capital assets. For periods after the corporation has been in existence for at least two years, the Working Capital Allowance may not exceed more than 50% of the assets of the corporation.

[89] Section 1202(e)(2) (treating assets used in certain start-up activities, activities resulting in the payment or incurring of research and experimentation expenditures, and activities with respect to in-house research expenses as used in the active conduct of a QTOB, irrespective of whether the corporation has gross income from such activities).

broader than the statutory definition under section 1202(d).[90] This tension remains unresolved by published guidance.

The interpretive question presents itself in several common scenarios: (i) a corporation funded with cash that has not yet identified or commenced any business activity (whether a QTOB or otherwise) at the time of the stock issuance; (ii) a corporation that, as of the date of issuance, is actively conducting a non-qualifying business under section 1202(e)(3) and subsequently transitions into a QTOB; and (iii) a corporation whose start-up activities at the date of issuance are de minimis relative to its total capital. In each such case, even assuming the Active Business Requirement is ultimately satisfied for substantially all of the holding period, a question remains as to whether the stock can ever qualify as QSBS in the absence of qualifying activities at the date of issuance.

If the answer is yes, a further question arises as to whether tax doctrines and rules such as *Moline Properties*,[91] the shell corporation doctrine,[92] section 269,[93] economic substance principles,[94] or some other administrable safeguard applies to prevent the use of shelf companies to artificially commence the section 1202 holding period prior to the identification or commencement of a QTOB.[95] We respectfully request that the Service and Treasury issue guidance clarifying whether the Active Business Requirement must be satisfied as of the date of issuance, and what particular parameters (if any) apply to determining whether a corporation with no qualifying or start-up activities at issuance may issue QSBS.

B. One corporation conducting qualifying and non-qualifying businesses

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[90] H.R. Conf. Rep. No. 103-213, 103d Cong., 1st Sess. (1993), at 523.

[91] *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943) (holding that a corporation formed for a business purpose, or that in fact engages in business activity, is a separate taxable entity from its shareholders, but suggesting that a corporation that is a mere sham or engages in no business activity may be disregarded for federal income tax purposes)

[92] *See, e.g.*, *Aldon Homes, Inc. v. Commissioner*, 33 T.C. 582 (1959) (disregarding multiple corporations formed without a sufficient business purpose and treating them as a single entity for federal income tax purposes); *Bass v. Commissioner*, 50 T.C. 595 (1968) (a corporation that lacks independent business activity can be disregarded).

[93] Section 269 permits the Service to disallow a deduction, credit, or other tax allowance when a person acquires control of a corporation and the principal purpose of the acquisition is to secure a tax benefit the acquirer would not otherwise enjoy.

[94] Section 7701(o).

[95] If Treasury and the Service choose to provide with respect to these (or other) principles as a safeguard against the use of shelf companies to artificially increase holding periods, we recommend that the guidance expressly state that it applies solely with respect to section 1202 and not to other corporate tax issues. We would not recommend, for example, turning the section 1202 regulation project into a project that provides broad-based guidance regarding economic substance rules. Another issue on which we recommend guidance specifically with regard to section 1202 relates to meaningless gesture contributions. Meaningless gesture contributions involve a sole shareholder who contributes additional capital to the corporation without receiving additional shares in return. If Treasury and the Service decide to issue guidance regarding the effect of meaningless gesture contributions on section 1202, we recommend that guidance expressly state that it applies only for purposes of section 1202. For more details on section 1202 issues arising from meaningless gesture contributions, see Gottschalk and Wiener, "Travels Through 1202," 172 *Tax Notes Federal* 2083, 2091-2094 (Sept. 27, 2021).

Section 1202(c)(2)(A) requires that, during substantially all the taxpayer's holding period, the issuing corporation meet the Active Business Requirement of section 1202(e), under which at least 80% of the value of the corporation's assets must be used in the active conduct of one or more QTOBs.[96] The statute and existing guidance do not, however, address how this 80% test applies with regard to a corporation that (a) simultaneously conducts two or more separable trades or businesses, one of which is a QTOB and one of which is not, or (b) conducts a single integrated business that provides goods or services bearing characteristics of both a QTOB and a non-QTOB.

Two distinct fact patterns illustrate the ambiguity. First, a corporation may operate two clearly separable lines with distinct customers, revenue streams, and assets—for example, a software development business (a QTOB) and a financial advisory business (a non-QTOB under section 1202(e)(3)(A)).[97] Second, a corporation may operate a single integrated business in which qualifying and non-qualifying elements are functionally inseparable and have a single undivided revenue source, earning revenue from a single payor source.[98] A permutation that has become increasingly common involves a business whose principal value derives from proprietary technology that the business utilizes to facilitate its delivery of (non-qualifying) services. In that case, the question is whether such a business is properly characterized by the nature of the technology or by the nature of the service provided to the customer. We request that the Service and Treasury issue guidance addressing these questions.

We recommend a bifurcated approach that distinguishes between separable trades or businesses, on the one hand, and a single integrated business, on the other. Where a corporation operates two or more separable trades or businesses, the 80% test should be applied by allocating asset value between qualifying and non-qualifying activities and determining whether at least 80% of the corporation's asset value (including its self-created intangible value and measured by FMV, consistent with section 1202(e)(1)) is used in the active conduct of a QTOB.[99]

In contrast, where a corporation operates a single integrated business whose components cannot be meaningfully bifurcated by revenue or asset use, the qualifying or non-qualifying character of the business should be determined holistically by reference to objective indicia of the business's overall character, including the source and nature of the corporation's revenue or profitability and the principal goods or services for which customers are paying. Under this holistic approach, the incidental presence of licensed professionals should not, by itself, recharacterize a business whose principal value lies elsewhere. Conversely, a business whose

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

[97] Section 1202(e)(3)(A) (excluding from the definition of QTOB 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").

[98] *See* Wiener, et. al., "Section 1202: What Exactly Are 'Health' Services?," *Tax Notes Federal*, June 2, 2025 (discusses in section V fact patterns in which qualifying and non-qualifying activities are functionally intertwined).

[99] Such an approach can draw from rules developed under section 1060 to identify a discrete trade or business as a set of assets to which goodwill could attach. *See* Section 1060(c) (defining "applicable asset acquisition" by reference to a transfer of assets which constitute a trade or business); Reg. section 1.1060-1(b)(2) (defining "trade or business" by reference to whether goodwill or going concern value could attach).

principal value derives from delivering services in a non-qualifying field should not become a QTOB merely because those services are facilitated, in whole or in part, by proprietary technology or performed by employees or contractors whose individual labor is not the primary value driver.[100] This approach is consistent with the statutory focus on the nature of the trade or business in which assets are used, rather than on the particular means by which that business is conducted.[101]

C. The meaning of "substantially all"

Section 1202(c)(2)(A) requires that the issuing corporation satisfy the Active Business Requirement of section 1202(e) during "substantially all" of the taxpayer's holding period for the stock. The term "substantially all," as used in this provision, has not been defined by the Code, the regulations, or the courts.[102] In various contexts in the Code outside of section 1202, the term "substantially all" has been interpreted to mean (or be satisfied by) 70%,[103] 80%,[104]

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[100] For examples of this proposed approach, *see, e.g.*, Reg. section 1.199A-5(b)(2)(vii) (providing that the "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 a[sic] [specified service trades or businesses] . . . if there is no separate payment for the consulting services"); PLR 202342013 (concluding that a corporation providing data migration and management services was engaged in a QTOB notwithstanding that its employees provided advice and counsel to customer personnel in the course of implementing the corporation's services, where such advice was not separately invoiced). *See also* PLR 202319013 (enterprise cloud application services corporation was engaged in QTOB despite reliance on technical employees, where principal asset was the corporation's intellectual property); Reg. section 1.199A-5(b)(3)(ix), Ex. 10 (software licensor that discusses customer's needs, advises on appropriate software, and assists with implementation for a flat license fee is not engaged in consulting). Although Reg. section 1.199A-5(b)(2)(i)(A) provides that those rules apply solely for purposes of section 199A, the section 199A regulations interpret a statutory list of excluded fields substantially identical to that of section 1202(e)(3)(A), and the Service has applied analogous reasoning under section 1202.

[101] Section 1202(e)(1) ("the active conduct of 1 or more qualified trades or businesses"). *See also* Reg. section 1.41-2(a)(3) and (e)(2) (the research credit rules focus on the party that bears the economic risk and retains rights, regardless of whether work is performed by employees or contractors); Reg. section 1.174-2(a)(10) and (b)(3) (similar approach under section 174).

[102] *See, e.g.*, *Owens v. Comm'r*, T.C. Memo. 2012-21 (2012) (court concluded that the company's stock was QSBS without analyzing the substantially all requirement of section 1202(c)).

[103] *See* Rev. Rul. 57-518 ("substantially all" within the context of a section 368(a)(1)(C) reorganization referred to the transfers of 70 percent of the corporation's assets to another corporation in exchange solely for voting stock, but also depended on the facts and circumstances); Rev. Proc. 77-37, 1977-2 CB 568, *as amplified by* Rev. Proc. 86-42, 1986-2 CB 722 (in the reorganization context and for safe harbor purposes, "substantially all" is met where assets represent at least 90 percent of the fair market value of net assets and at least 70 percent of the fair market value of gross assets held by the target corporation immediately before the transaction).

[104] *See* Reg. section 1.41-4(a)(6) (the substantially all requirement of section 41(d)(1)(C) and (a)(2)(iii) is satisfied if 80 percent or more of a taxpayer's research activities constitute elements of a process of experimentation. *See also* Rev. Proc. 92-33, 1992-1 C.B. 28 (in determining whether an organization has the corporate characteristics of free transferability of interests, under the Reg. section 301.7701-2(e)(1) requirement that members owning "substantially all" the interests in the organization are free to assign all their interests in the organization without the consent of other members, a partnership lacks free transferability of interests where the partnership agreement restricts the transferability of partnership interests representing more than 20 percent of all interests).

85%,[105] 86%,[106] and 90%.[107] Given the multi-year holding period over which the Active Business Requirement must be tested, taxpayers and their advisors often face uncertainty as to what constitutes "substantially all" of a holding period, absent any definitive guidance.

We respectfully request that the Service and Treasury issue guidance providing that the "substantially all" requirement of section 1202(c)(2)(A) is satisfied if the issuing corporation meets the Active Business Requirement of section 1202(e) for at least 80% of the taxpayer's holding period for the stock.[108] This standard is consistent with the 80% threshold used elsewhere in the Code in analogous contexts and is administrable for both taxpayers and the Service. We further recommend that the guidance permit the 80% "substantially all" test to be measured by reference to the aggregate number of days during the holding period on which the Active Business Requirement was satisfied.

D. Definition of certain excluded businesses – section 1202(e)(3)

Numerous service fields are excluded from the definition of a "qualified trade or business" (QTOB) under section 1202(e)(3)(A). For example, the fields of "consulting," "financial services," "health," and "engineering" are listed as non-qualifying businesses. The Code and existing precedential guidance provide no clear definitions for these terms in the context of section 1202(e). While categorizing whether a particular business falls within one of these excluded fields may appear straightforward in the abstract, the application of these terms to the wide variety of businesses operated in the modern economy is often murky and unclear, creating significant uncertainty for taxpayers and practitioners in determining whether a corporation's stock can qualify as QSBS.[109] The uncertainty in turn impedes the effective administration of section 1202.

We respectfully recommend that the Service and Treasury issue guidance adopting the detailed guidance provided in the section 199A regulations for purposes of section 1202.[110] Although

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[105] *See* Rev. Rul. 73-248 (the "substantially all" ownership test of section 521(b)(2), relating to farmers' cooperatives, is satisfied if at least 85 percent of the shares of capital stock of a farmers' cooperative is held by producers).

[106] *Comm'r v. First National Bank of Altoona*, 104 F.2d 865 (3d Cir. 1939), *cert. dismissed*, 309 U.S. 691 (1940) (frequently cited as establishing that 86 percent of the total net worth satisfies the "substantially all" requirement for a section 368(a)(1)(C) reorganization, in contrast to *Arctic Ice Machine Co. v. Comm'r*, 23 BTA 1223 (1931), which established that 68 percent is insufficient).

[107] *See* PLR 8104064 (October 29, 1980) (for purposes of satisfying the "substantially all" test of section 103, a series of bonds will qualify under section 103(b)(4)(A) if at least 90 percent of the net proceeds of the bonds are used to provide loans for rehabilitating properties).

[108] Several Commentators have suggested that 80% is a reasonable benchmark for purposes of section 1202.S*ee* Ginsburg, Levin, Rocap, *Mergers, Acquisitions, and Buyouts*, ¶ 215.1, n.26 ("although the phrase 'substantially all' is not defined, these words certainly mean well more than 50 percent, and perhaps as much as 75 percent or 80 percent"); Andolina and Lemaster, "Candy Land or Sorry: Thoughts on Qualified Small Business Stock," *Tax Notes Federal,* Jan. 8, 2018 ("general rule of thumb of 80 percent ... may be a reasonable guideline"); Gottschalk and Wiener, "Travels Through 1202," *Tax Notes Federal,* Sept. 27, 2021 ("it might be reasonable to assume that 80 percent suffices").

[109] *See, e.g.,* Wiener, Tekbali, Gruidl, "Section 1202: What Exactly Are 'Health' Services?," *Tax Notes Federal*, June 2, 2025 (provides numerous examples of health-related businesses whose qualification as QTOBs is uncertain).

[110] Reg. sections 1.199A-5(b)(1)(vi), (b)(1)(viii), (b)(2)(vii), and (b)(2)(ix).

the section 199A regulations state that they apply solely for purposes of that section,[111] the lists of business types referenced in section 199A are those listed in section 1202(e)(3)(A) (with several exceptions),[112] and adopting that guidance would promote consistency, administrability, and certainty. It is detrimental to consistent tax policy for identical statutory phrases to have different meanings in closely related Code sections. Adopting the section 199A definitions would provide a common-sense and consistent interpretive framework that taxpayers can rely on.

With regard to many of the service types listed in section 1202(e)(3)(A), the regulations under section 199A provide clear and administrable definitions. (With regard to "brokerage services," however, see our comments below.) Adopting these definitions for section 1202 purposes would resolve much of the current uncertainty.

In contrast, while "engineering" is specified in section 1202(e)(3)(A), Congress deliberately removed it from the list of the section 199A specified service trades or businesses (SSTBs).[113] Consequently, the section 199A regulations provide no definition for engineering. This statutory divergence leaves taxpayers without any analogous regulatory framework for interpreting the term under section 1202 and highlights the pressing need for specific guidance. We request guidance as to which types of engineering businesses cannot qualify to issue QSB stock. The need for guidance in this area is heightened by the current prevalence of technology, software, and artificial intelligence in modern engineering businesses and in businesses that perform software engineering and programming.

E. Definition of "brokerage"

The business of "brokerage services" is likewise an excluded field under section 1202(e)(3)(A) that is undefined in the Code and regulations. The lack of a definition for the term leaves its application subject to wide interpretive latitude in the evolving modern business landscape in which new business models have emerged that may no longer fit into historic categorizations. This ambiguity is exacerbated by conflicting non-precedential guidance, creating uncertainty for taxpayers.

The Service's non-precedential rulings addressing section 1202 have offered divergent interpretations of "brokerage services." PLR 202114002 concluded that an insurance agency business performing significant administrative services in addition to connecting customers with insurance companies was not a "mere intermediary" and thus was not engaged in brokerage

[111] Reg. section 1.199A-5(b)(2)(i)(A).

[112] Section 199A(d)(2)(A) makes direct reference to section 1202(e)(3(A) in identifying specified service trades or businesses (SSTBs) but explicitly removes engineering and architecture for purposes of the section. Reg. section 1.199A-5(b)(1) lists and defines all businesses included under section 1202(e)(3)(A) except those carved out in section 199A(d)(2)(A).

[113] Section 199A(d)(2)(A) ("applied without regarding to the words 'engineering, architecture'").

services.[114] In contrast, CCA 202204007 applied a much broader standard in stating that a website facilitating real property leases was engaged in brokerage services.[115]

Further complicating matters, the regulations under section 199A define "brokerage services" very narrowly, limiting the term to services arranging transactions in securities.[116] While these regulations expressly do not apply to section 1202, they represent the most recent precedential guidance on a nearly identical statutory list (although their narrow focus on securities brokers is inconsistent with the broader dictionary definition and the approach taken in CCA 202204007). Additionally, the historic view of what constitutes brokerage has been challenged by the evolution of the digital economy and the increased use of artificial intelligence, which have spawned new iterations of online businesses.

We respectfully recommend that the Service and Treasury issue guidance adopting a clear, common-sense definition of "brokerage services" for purposes of section 1202(e)(3)(A). We propose that "brokerage services" be defined as a trade or business whose principal activity involves acting as an intermediary to facilitate transactions between buyers and sellers of property. This definition would extend far beyond the brokerage of securities, but would not extend to the brokerage of service businesses. This approach provides a clear and administrable line that aligns with the common understanding of a broker (e.g., a stockbroker or real estate broker, both of whom deal in property transactions).

F. Qualification of a contractor-based business as a QTOB

A question that arises often is whether a business that contracts with third-party service providers and uses technology to connect those providers with customers can qualify as a QTOB for purposes of section 1202. Where the business of those service providers does not itself constitute a QTOB under section 1202(e)(3)—such as health, actuarial, or legal services—does the contracting business qualify as a QTOB?

Consider a company that operates a technology platform to match patients with licensed medical professionals. The company contracts with doctors who provide medical services to patients. The company bills the patients (or their insurers) directly, collects payment, and pays the doctors a fixed fee per service. The company's revenue is derived from patient services, and its principal business activity is facilitating the provision of medical care, albeit through independent contractors rather than through employees. The company may argue that it is a

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[114] PLR 202114002 ("With respect to business performed pursuant to the first model described above, Business's role is not that of a mere intermediary. Contracts with insurance companies require Business to perform a number of administrative services beyond those that would be performed by a mere intermediary facilitating a transaction between two parties.").

[115] CCA 202204007 (borrowing from the definition of "broker" in section 6045(c)(1)). A summary and discussion of these two rulings can be found in Wiener, "Business connecting lease parties not qualified under section 1202," RSM Insights, Feb. 9, 2022.

[116] Reg. section 1.199A-5(b)(2)(x). That regulation states: "For purposes of section 199A(d)(2) and paragraph (b)(1)(ix) of this section only, the performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers."

technology business, not a health services business, because it uses proprietary software to identify and route providers to customers.

However, the statutory language of section 1202(e)(3) excludes from QTOB status any trade or business involving the performance of services in the fields of health. Does this exclusion extend to companies that provide services via contractors as well? Does the use of technology to deliver or facilitate such services alter the fundamental character of the business if the business's revenue and value are tied to the provision of disqualified services?

We recommend that guidance be issued clarifying that whether a company is engaged in a field of business is generally based on the source of its revenue, regardless of whether its services are performed by employees or contractors, and regardless of whether technology is used to facilitate the service. This approach is consistent with the treatment of contractors and employees under the research (R&D) credit of section 41 as well as the research and experimentation rule of section 174. For the R&D credit, the party entitled to the credit is the one that bears the economic risk of the research and retains substantial rights to the results, not the party that performs the work.[117] Similarly, under section 174, the party that must capitalize or deduct research costs is the one that bears the economic risk and retains rights to the research, not the contractor.[118] The classification of workers as employees or contractors does not change who is entitled to the benefit or who must capitalize the costs; the focus is on who bears the risk and retains rights.

We recommend that Treasury and the Service clarify that a business does not qualify as a QTOB under section 1202 if its revenue and value are fundamentally tied to the provision of services that would be excluded if performed directly by the business or its employees—even if those services are performed by contractors and even if technology is used to facilitate the service. The substance of the business activity and the source of revenue should be determinative, not the form of the service relationship or the use of technology. Allowing businesses to qualify as QTOBs merely by outsourcing disqualified services to contractors or by using technology to intermediate those services would undermine the integrity of the QTOB exclusion and create opportunities for circumvention inconsistent with congressional intent.

Note that the business model described here superficially resembles but actually differs from a business model that involves a company that does not itself contract with customers to perform a non-QTOB service, but instead merely identifies customers looking for such services and arranges for those customers to be serviced by the appropriate service providers. In this latter model, the service provider enters into a separate contractual arrangement with the customer and bills the customer directly; the initial company is not responsible (legally or otherwise) for the services and does not bill for the services.[119]

G. Partnership interests and the Active Business Requirement

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[117] Reg. sections 1.41-2(a)(3) and (e)(2).

[118] Reg. sections 1.174-2(a)(10) and (b)(3).

[119] In this latter model, however, the company may potentially be disqualified from QTOB status due to providing "brokerage services." *See* section 1202(e)(3)(A). See a discussion on the meaning of "brokerage services" in the section immediately above.

We request that Treasury and the Service issue guidance addressing whether and under what circumstances a corporation that owns an interest in a partnership may treat its proportionate share of the partnership's assets and activities as assets and activities of the corporation for purposes of satisfying the section 1202(e) Active Business Requirement. Section 1202(e)(1)(A) requires that at least 80 percent (by value) of a corporation's assets be used in the active conduct of one or more QTOBs, while section 1202(e)(5) provides an express look-through rule for certain corporate subsidiaries. However, section 1202 does not contain a comparable rule for partnerships, creating uncertainty for corporations that conduct operating businesses through partnership structures.[120]

The absence of guidance is particularly problematic because authorities outside of section 1202 do not provide a uniform answer regarding when partnership activities should be attributed to a partner. Courts and the Service have in some cases ruled that a partner of a partnership is treated as engaged in the partnership's trade or business, while in other cases they have emphasized the partnership's separate entity status and rejected attribution.[121] As a result, taxpayers seeking to apply the section 1202 Active Business Requirement to common business structures involving partnerships are left without a clear framework.

We recommend that Treasury and the Service adopt a limited attribution rule under which a corporate partner may take into account its proportionate share of partnership activities where it has a sufficient ownership interest in, and connection to, the partnership's business. Such a rule could be modeled on the principles reflected in existing guidance under sections 355 and 368, which permit look-through treatment where the corporate owner holds a significant partnership interest or, alternatively, holds a meaningful interest and performs active and substantial management functions with respect to the partnership's business.[122] A similar approach under section 1202 would appropriately distinguish active business arrangements from passive investment holdings.

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[120] More specifically, section 1202(e)(5) expressly provides a look-through rule for corporations owning more than 50 percent of a subsidiary corporation and treats the parent as owning its ratable share of the subsidiary's assets and conducting its ratable share of the subsidiary's activities. The omission of a comparable rule for partnerships has created significant uncertainty regarding common operating structures that utilize partnerships or limited liability companies taxed as partnerships.

[121] *See, e.g., Arens v. Commissione*r, 48 T.C. 640, 649 (1967) ("cases too numerous to cite have held that the business of a partnership is the business of its partners"); *Ward v. Commissioner*, 20 B.T.A. 352 (1930) ("by reason of being a partner in a business petitioner was individually engaged in business"); *but see Goodwin v. Commissioner,* 75 T.C. 424 (1980) (emphasizing the separate status of the partnership in the section 162 context). *See also* TAM 9728002 (stating that a partner is not always considered engaged in the trade or business of the partnership and indicating that the result may hinge on a limited partner versus general partner distinction, as well as the degree of the partner's involvement in the partnership's activities). These authorities demonstrate that partnership attribution questions relating to an active business are highly context specific and often turn on the purpose of the statute at issue.

[122] *See* Prop. Reg. section 1.355-3(b)(4)(iii), which generally attributes partnership assets and activities to a corporate partner where the corporation owns a significant partnership interest or owns a meaningful interest and performs active and substantial management functions with respect to the partnership business. *See also* Reg. section 1.368-1(d)(4)(iii), which recognizes partnership-owned business assets for purposes of the continuity of business enterprise requirement under specified circumstances. Although these provisions arise in different statutory contexts, they involve corporate-partnership structures and reflect established administrative principles for distinguishing active business ownership from passive investment activity.

This approach would further the purpose of section 1202 while avoiding arbitrary distinctions among economically similar business structures. A complete prohibition on partnership attribution could deny QTOB treatment to corporations actively conducting business through partnership joint ventures, while an unrestricted attribution rule could allow passive investments to satisfy the Active Business Requirement. Guidance should also clarify that any attribution applies only to the corporate partner's proportionate share of partnership assets and activities. We further recommend clarification regarding related issues, including tiered partnership structures, differing economic rights, and the interaction of any attribution rule with the section 1202(d) gross-assets limitation and other section 1202 requirements. [123]

VIII. Pass-through entity equityholders – section 1202(g)(2)

A taxpayer may qualify for the exclusion under section 1202 if gain includible in gross income is attributable to the taxpayer's interest in a pass-through entity, and such pass-through entity realizes that gain upon the sale or exchange of QSB stock. [124] In order for the gain to be eligible for exclusion at the taxpayer level, the pass-through entity must hold the stock for more than five years, and such stock must constitute QSB stock in the hands of that pass-through entity as determined by treating such entity as if it were an individual. [125] Further, the taxpayer must own its interest in the pass-through entity at the time the pass-through entity acquires the QSB stock and at all times thereafter until the pass-through entity disposes of such stock. [126] The taxpayer's eligible gain is limited to its interest in the pass-through entity at the time the pass-through entity acquired the QSB stock. [127]

A. Gain exclusion eligibility for stock held through tiered partnerships

The pass-through entity rule raises a question regarding eligibility for gain exclusion where QSBS is held through a tiered-partnership structure. While section 1202(g) provides that the exclusion is available to non-corporate partners of a pass-through entity that sells QSBS, the statute does not explicitly address whether this benefit flows through multiple tiers of partnerships to the ultimate non-corporate taxpayer. In a tiered investment structure (common in venture capital and private equity industries) an upper-tier partnership (UTP) holds an interest in a lower-tier partnership (LTP) and the LTP in turn holds the QSBS. The ultimate taxpayer is a partner in the UTP (or further up the "chain" of partnerships), not the LTP.

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[123] For example, if attribution is permitted, questions arise regarding measurement of the section 1202(d) gross-assets limitation (discussed in the gross assets section above), the treatment of capital interests versus profits interests, the application of the 80-percent active business test where multiple partnerships are involved, and the treatment of tiered partnership structures. These issues become increasingly significant as growth-stage businesses and private equity-backed enterprises grow and conduct operations through multiple partnership arrangements, a frequent occurrence.

[124] Section 1202(g) (addressing pass-through entities (called "pass-thru" therein).

[125] Section 1202(g)(1)(A).

[126] Section 1202(g)(2)(B).

[127] Section 1202(g)(3). If the taxpayer acquires an additional interest in the pass-through entity after such entity acquired the QSB stock, the exclusion only applies to the share of the gain attributable to the taxpayer's share in the pass-through entity at the time the pass-through entity acquired such stock.

A narrow reading of the statute could suggest that the taxpayer does not meet the holding requirement of section 1202(g)(2)(B) because the taxpayer does not hold a direct interest in the "pass-thru entity" that owns the QSBS. However, this interpretation would be inconsistent with principles of partnership taxation under Subchapter K, particularly the character flow-through rule of section 702(b).[128] Moreover, there is no indication that Congress intended to distinguish between the treatment of QSBS held via a single partnership structure and that held via a tiered partnership structure. While no regulations have been issued under section 1202(g), in the closely related QSBS rollover rules of section 1045, Treasury has explicitly adopted a look-through approach for tiered partnerships.[129] For these reasons, tax advisors routinely advise taxpayers that a tiered partnership structure qualifies as a pass-through for purposes of section 1202(g).

We respectfully recommend that the Service and Treasury issue guidance confirming that the section 1202 exclusion is available to non-corporate partners of a UTP with respect to QSBS held and sold by an LTP. Such guidance should clarify that for purposes of section 1202(g), a partner in a UTP is treated as holding a proportionate interest in the stock held by an LTP, and that the character of the gain from the sale of QSBS is preserved as it flows through the tiers to the ultimate taxpayer. Aside from the rationales noted above, this approach is consistent with the policy of section 1202 to encourage investment in small businesses regardless of the specific form of the investment vehicle.

B. Qualification via profits interest in a partnership holding QSBS

A question arises under section 1202(g) as to whether a holder of a profits interest in a partnership that holds QSBS is eligible for the section 1202 gain exclusion with respect to gain allocated to such partner upon the partnership's sale of QSBS.[130] A profits interest is a form of equity interest (in an LLC taxed as a partnership) that entitles the holder to a share of the LLC's future (but not the existing) profits and appreciation in value. This differs from a capital interest ("ordinary" LLC equity interests), which gives the holder a right to existing value in the LLC if it liquidates immediately after the grant.

General tax principles support treating a profits interest holder as eligible for the section 1202 gain exclusion. Section 1202(g) refers without qualification to an "interest" in the pass-thru entity

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[128] A partnership is not subject to income tax; rather the persons carrying on the business as partners are liable for income tax in their individual capacities. Section 701. Each partner takes into account their distributive share of capital gains and other items such as deductions and credits. Section 702(a). The character of each item is determined at the partnership level and retains that character in the hands of the partner. Reg. section 1.702-1(b).

[129] Reg. section 1.1045-1(g)(3)(iii) explicitly adopts a look-through approach, providing that for purposes of determining an "eligible partner," a UTP's ownership of an LTP is disregarded, and each partner of the UTP is treated as owning an interest in the LTP directly. The existence of this rule demonstrates that Treasury has previously determined a look-through approach to be the correct and administrable policy for QSBS held in tiered-partnership structures.

[130] Section 1202(g) provides that gain from the sale of QSBS by a "pass-thru entity" (which includes a partnership) may be excluded by a partner of such entity to the extent the gain is "includible in the gross income of the taxpayer by reason of the holding of an interest in [the pass-thru] entity which was held by the taxpayer on the date on which such pass-thru entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-thru entity." Section 1202(g)(1) and (2).

and does not distinguish between a capital interest and a profits interest. The regulations under section 704, which govern general federal tax determinations of a partner's interest in a partnership, provide that a partner's interest in a partnership includes both the partner's interest in partnership profits and the partner's interest in partnership capital, not just one or the other.[131] The Service has likewise treated the holder of a profits interest as a partner for federal income tax purposes from the date of grant.[132] Importantly, many provisions of the Code and regulations expressly refer to a partner's interest in *either* "partnership profits" or "partnership capital" as potentially determinative of a tax issue, an approach that clearly treats a profits interest as a partner's partnership interest.[133] The Code, regulations, and Service guidance repeatedly and correctly characterize profits interests as partnership interests.

Notwithstanding the foregoing, the regulations under section 1045 define an "eligible partner" for purposes of the section 1045 QSBS rollover rules by reference to the partner's "smallest percentage interest in partnership capital," effectively excluding profits-interest holders from the benefit of section 1045 rollover treatment.[134] Some suggest that profits-interest holders are therefore likewise ineligible for the section 1202 gain exclusion. This view is inconsistent with the plain language of section 1202(g), which is keyed to a partnership "interest" rather than to a "capital interest."[135]

We request that the Service and Treasury issue guidance confirming that a partnership profits interest holder is eligible for the section 1202 gain exclusion with respect to gain allocated to such holder upon the partnership's sale of QSBS, provided the requirements of section 1202(g)(2) are otherwise met. We recommend this result because the plain language of section

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[131] Reg. sections 1.704-1(b)(3)(ii). Under these regulations, a partner's interest in a partnership is determined by reference to all facts and circumstances, including the partner's interest in both partnership profits and capital. Reg. sections 1.704-1(b)(3)(i) and (ii) (identifying, among other factors, "[t]he interests of the partners in economic profits and losses" and "[t]he interests of the partners in cash flow and other non-liquidating distributions" as relevant to determining a partner's interest in a partnership).

[132] Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191 (treating a service provider as the owner of the partnership interest from the date of grant, even if the interest is substantially nonvested at that time).

133 *See* Banoff, *Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps*, Taxes 197 (Mar. 2007). This article provides in its appendices lists of (I) 102 items that represents a partial listing of Code and regulatory provisions that may have significant tax consequences depending upon the measurement of partners' interest in partnership profits and/or partners' interest in partnership capital, and (II) 163 items representing a partial listing of Code and regulatory provisions that derivatively incorporate partners' interest in partnership profits and/or partners' interest in partnership capital by their references to the section 267(b) and/or section 707(b) relationships between parties. *Id*.

[134] Reg. section 1.1045-1(d)(2) (defining an eligible partner's "smallest percentage interest in partnership capital" by reference to capital, as adjusted for capital contributions, distributions, and transfers, but excluding allocations of income and loss). *See also* T.D. 9353, 72 F.R. 45346 (Aug. 14, 2007) (preamble explaining that the capital-interest standard was selected as being "easier to administer" and "consistent with each partner's economic interest in the partnership").

[135] The Ginsburg, Levin, Rocap treatise states in this regard: "Section 1202 explicitly establishes an 'interest' test, not a 'capital' interest test, i.e., the plain language of §1202 encompasses any 'interest' (including both a capital and a profits interest) … we believe no such 'capital' limitation applies in the absence of such regulations, and, even if issued, we believe such a §1202 regulation would be of questionable validity…because…Code §1202 explicitly establishes an 'interest' test, not a 'capital' interest test, i.e., the plain language of section 1202 encompasses any 'interest' (including both a capital and a profits interest)..." Ginsburg, Levin, Rocap, *Mergers, Acquisitions, and Buyouts*, ¶215.1.

1202(g) expressly establishes an “interest” test rather than a “capital interest” test. The fact that the profits interest may not have entitled the holder to any allocation of partnership income in earlier years (because, for example, the partnership had not yet generated sufficient profits to reach the holder's tier in the distribution waterfall) does not alter the fact that the holder's partnership interest existed as of the relevant acquisition date and was held continuously thereafter.

The limitation under section 1202(g)(3), which caps the excludable gain by reference to the partner's interest in the partnership at the time the partnership acquired the QSBS, can be administered with respect to profits interests by reference to the holder's share of gain on the sale of QSBS as determined under the partnership agreement (subject to any applicable ceiling, such as a carried interest cap). Thus, if an amendment to the partnership agreement after the partnership has acquired the QSBS augments or increases a partner’s partnership interest, the portion of that partner’s allocable share of the partnership’s gain on sale of the QSBS attributable to the augmentation or increase would not be eligible for exclusion under section 1202, but the remainder of that partner’s allocable share of the gain would be eligible.

C. Contribution of interests of a partnership holding QSBS to a different partnership

Section 1202(h) states that certain transfers of QSBS do not disqualify the QSBS.[136] It appears clear from section 1202(h)(2) that a shareholder’s transfer of QSBS stock to a partnership (or entity taxed as a partnership) and subsequent sale of the QSBS by the partnership is not eligible for the section 1202 exclusion.[137]

However, where a partnership holds QSBS from the stock’s initial issuance, and one or more holders of partnership interest transfers those interests to a new (or different) legal entity taxed as a partnership, it is unclear whether those holders continue to be eligible for the section 1202 gain exclusion with regard to gain from a future sale of the QSBS. These partnership interest transfers may occur, for example, in transactions such as a partnership continuation, a partnership merger, or implementation of a tiered partnership structure.

Consider whether section 1202 eligibility may be maintained when implementing a tiered partnership structure—i.e., interests in a partnership that holds QSBS are transferred to a new upper tier partnership in exchange for interests in that upper tier partnership. One reading of section 1202(g)(2)(B) would dictate that such future gain does not qualify for the exclusion,

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[136] Section 1202(h)(2) (preserving QSBS status for stock transferred by gift, at death, or by a partnership to a partner of such partnership).

[137] *See* section 1202(h)(2) (which provides specific exceptions to the original issuance requirement of section 1202(c)(1), including distributions *from a partnership*—but which omits contributions *to a partnership*). *See also* H.R. Conf. Rep. No. 103-213, 103rd Cong. 1st Sess. (1993) (“[t]ransferees in other cases are not eligible for the exclusion. Thus, for example, if qualified small business stock is transferred to a partnership and the partnership disposes of the stock, any gain from the disposition will not be eligible for the exclusion.”); Reg. section 1.1045-1(f) (“[s]tock that is contributed to a partnership is not QSB stock in the hands of the partnership”).

under the theory that the partner no longer "holds" the original pass-thru entity.[138] However, such a literal reading ignores that the Code does not address tiered partnership structures, as discussed above.[139] Accordingly, the shift from a single partnership structure to a tiered partnership structure can be viewed as an innocuous structural modification that should permit continued eligibility of QSBS under the principles of section 1202(g).

A transaction involving transfers of partnership interest may occur in connection with a transaction treated as a continuation of the partnership, even if the legal entity treated as the continuing partnership is a different entity from the legal entity previously treated as that partnership for federal income tax purposes. If any part of a partnership's business or operations continues to be conducted by any of the partners in the partnership, section 708(b)(1)'s general rule indicates that the partnership does not terminate (i.e., the partnership continues). Continued QSBS eligibility under the principles of section 1202(g) should apply where partnership interests in a QSBS-holding partnership are transferred in a transaction resulting in a continuation of the same partnership in a different legal entity.

Transactions involving multiple partnerships are governed by section 708(b)(2)'s specific rules addressing where a partnership continuation will result from a partnership merger or division transaction.[140] In those cases too, there is a strong argument for continued QSBS eligibility.

We request that the Service and Treasury issue guidance addressing partnership continuations and section 1202 eligibility. We recommend that, in a transaction in which an original partnership is treated as continuing within a resulting partnership pursuant to section 708, such as in a merger of partnerships, the partners of the continuing partnership (both the partners who previously held interests of the partnership deemed to continue, as well as the partners who previously held interests of the entity deemed to not continue) should continue to be eligible for the section 1202 gain exclusion, subject to the principles of section 1202(g). This result is consistent with the underlying policy of section 1202 to preserve QSBS treatment through nonrecognition transactions that do not involve a meaningful change in the taxpayer's economic investment.[141]

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[138] Section 1202(g)(2)(B) provides that the gain exclusion is available to a partner of a pass-through entity only with respect to gain that is "includible in the gross income of [the] taxpayer by reason of the holding of an interest in [the] entity which was held by the taxpayer on the date on which [the] pass-thru entity acquired such stock and at all times thereafter before the disposition of [the] stock by [the] pass-thru entity."

[139] As noted above, Treasury has expressly sanctioned QSBS held through tiered partnership structures in the closely analogous context of section 1045. Reg. section 1.1045-1(g)(3)(iii) (treating each partner of a UTP as owning an interest in stock held by an LTP for purposes of identifying eligible partners for QSBS rollover treatment under section 1045).

[140] An original partnership is treated as continuing in a resulting partnership under section 708(b)(2) in (A) a merger or consolidation of two or more partnerships in which the members of one of the original partnerships own an interest of 50% or more in the capital and profits of the resulting partnership under section 708(b)(2)(A), and (B) a division of a partnership into two or more partnerships in which the members of the original partnership own a 50% or more interest in the capital and profits of one or more of the resulting partnerships under section 708(b)(2)(B).

[141] *See* section 1202(h)(4)(A) (preserving QSBS status for stock received in certain tax-free exchanges); sections 708 (b)(2)(A) and (B); Reg. sections 1.708-1(c) and (d) (discussing further mergers and divisions of partnerships). Note that, in any event, a partner would not be permitted to exclude gain resulting from an increase in their overall indirect interest in the QSBS stemming from the partnership transaction, pursuant to section 1202(g)(3).

For other scenarios involving the contribution of partnership interests to a new partnership (such as transactions in which the original partnership remains in existence following the contribution), we do not propose a specific recommendation but request guidance addressing the application of section 1202(g)(2)(B) to such transactions, including the treatment of gain measured before and after the contribution and the application of section 704(c) principles to gain attributable to QSBS appreciation through the contribution date.[142]

IX. Tax-Free Transactions – Section 1202(h)

If QSBS is exchanged for other stock in a nontaxable exchange described under section 351 or section 368, that other stock (Other Stock) qualifies as QSBS even if it would not otherwise qualify as QSBS.[143] Where a shareholder acquired QSBS in a tax-free exchange for other QSBS, the shareholder is treated as acquiring the stock in the same manner as the exchanged stock, and the shareholder's holding period includes any continuous period immediately preceding the exchange.[144]

Section 1202(h)(4)(B) distinguishes between a scenario in which the corporation issuing the Other Stock independently qualifies as a qualified small business at the time of the exchange (Qualifying Other Stock) versus where it does not (Nonqualifying Other Stock). In the latter scenario, the QSBS status of the Nonqualifying Other Stock only applies to exclude gain to the extent of the gain that would have been recognized at the time of the transfer (that is, the built-in gain of the transferor stock is "frozen" as excludable gain within the Other Stock (Frozen Gain)).[145]

A. Gain exclusion limitation following a taxable sale with rollover of new QSBS

When a shareholder disposes of QSBS in a transaction governed by section 351 or 368 and receives in return Other Stock, a question arises as to whether the shareholder's Gain Exclusion Fixed Cap resets with respect to the Other Stock. Because the Gain Exclusion Fixed Cap applies with respect to each issuing corporation,[146] a literal reading of section 1202(b)(1) supports a conclusion that the shareholder is entitled to a new, full Gain Exclusion Fixed Cap with respect to the Other Stock, even if the shareholder has previously fully utilized the cap

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[142] Section 704(c)(1)(A) (allocating built-in gain or loss with respect to contributed property to the contributing partner).

[143] Section 1202(h)(4).

[144] Section 1202(h)(1).

[145] Section 1202(h)(4)(B) states: "This section shall apply to gain from the sale or exchange of stock treated as qualified small business stock by reason of subparagraph (A) only to the extent of the gain which would have been recognized at the time of the transfer described in subparagraph (A) if section 351 or 368 had not applied at such time."

[146] Section 1202(b)(1)(A) (limiting the amount of gain eligible for exclusion to the greater of $10 million (or $15 million, for post-OBBBA stock) or 10 times basis, with respect to stock "issued by such corporation").

attributable to the original issuing corporation. On the other hand, such a conclusion perhaps runs counter to the intent of section 1202's Gain Exclusion Fixed Cap provision.

Where the Other Stock is Nonqualifying Other Stock and qualifies solely by preserving QSBS status for stock that would not otherwise qualify, a fresh cap may perhaps be inconsistent with the nature of that provision, which is to preserve, not expand, the section 1202 benefit through a nonrecognition exchange. Where, however, the Other Stock is Qualifying Other Stock, a new cap tied to a genuinely different qualifying issuer may perhaps be appropriate.

We request that the Service and Treasury issue guidance addressing both the Qualifying Other Stock scenario and the Nonqualifying Other Stock scenario. We recommend that in the case of Nonqualifying Other Stock, the Gain Exclusion Fixed Cap is not reset; rather, the cap applicable to the new stock should carry over from the exchanged stock, reduced by any gain previously excluded.

B. Eligibility of stock received in recapitalizations and F reorganizations

Questions arise as to whether the section 1202(h)(4) Frozen Gain rule described above applies in the case of an F-reorganization or E-reorganization. An F-reorganization is a reorganization described in section 368(a)(1)(F) ("a mere change in identity, form, or place of organization of one corporation, however effected") and an E-reorganization is a reorganization described in section 368(a)(1)(E) (a recapitalization).

Section 1202(h)(3) provides that "rules similar to the rules of section 1244(d)(2) shall apply for purposes of this section." Section 1244(d)(2) provides, in part, that a successor corporation in a reorganization described in section 368(a)(1)(F) will be treated as the same corporation as its predecessor. Section 1244(d)(2)'s title indicates that the same treatment applies in the case of a recapitalization.

We request that Treasury and the Service clarify that where both section 1202(h)(3) and section 1202(h)(4) could apply to the same transaction, section 1202(h)(3) governs. Such guidance should clarify that stock received in a recapitalization or an F-reorganization retains section 1202 eligibility without limitation. By contrast, applying section 1202(h)(4) in this context could introduce limitations, such as the Frozen Gain Rule, that are not consistent with the nature of recapitalizations and F reorganizations.

This result is supported by statutory interpretation principles. Section 1202(h)(3) addresses these transaction forms directly and is therefore the more specific provision relative to section 1202(h)(4).[147] In addition, tax rules relating to recapitalizations and F reorganizations consistently treat these transactions as representing mere changes in form, identity, or capital structure that do not alter the underlying corporate enterprise or the shareholder's investment.[148]

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[147] *See*, *e.g.*, *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 645 (2012) (citing numerous cases in support of the proposition that "it is a commonplace of statutory construction that the specific governs the general").

[148] For example, unlike regarding other section 368 reorganizations, the continuity of interest (COI) and continuity of business enterprise (COBE) requirements need not be met for a transaction to qualify as a E-reorganization or F-reorganization. *See* Reg. section 1.368-1(b); T.D. 9182. The rationale is that COI and COBE are designed to

The section 358 regulations similarly trace basis to the particular stock received in a reorganization and, where the exchange terms identify which stock or class of stock is received for particular surrendered shares, generally respect that identification if economically reasonable.

With regard to recapitalizations specifically, questions sometimes arise when both QSBS and non-QSBS stock of a corporation are recapitalized as part of one transaction, into either two new classes of stock or into a single new class of stock. In such scenarios, to what extent do the shares received in the recapitalization qualify as QSBS?

We recommend that guidance confirm that properly identified shares received in respect of QSBS retain their qualified status, while shares received in respect of non-QSBS stock do not become QSBS merely because they are exchanged in the same recapitalization.[149] Moreover, guidance should clarify that the principles of Reg. section 1.358-2(a) generally govern the allocation of basis and QSBS treatment of stock received in exchanges to which section 354 or 356 applies (which would include such recapitalizations).[150]

In this regard, we note that a shareholder's allocation of basis under Reg. section 1.358-2(a) to stock received in any of these transactions could affect the maximum section 1202 capital gain exclusion available to the shareholder under the section 1202(b)(1) per-issuer limitation on a taxpayer's excludable gain. We therefore recommend that Treasury and the Service consider promulgating guidance (via operative rules and/or examples) regarding application of the basis allocation rules of Reg. section 1.358-2(a) to an exchange of QSBS.[151]

C. Applicability to section 355 transactions – sections 1202(h)(3) and (4)

By its terms, section 1202(h)(4)(A) treats stock received in a tax-free reorganization as QSBS only where the transaction (i) qualifies as a section 351 or section 368 transaction and (ii) the QSBS is "exchanged" for other stock.[152] A section 355 tax-free spinoff is not delineated in section 1202(h)(4)(A). This creates uncertainty as to whether stock of a controlled corporation

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distinguish a true reorganization from a disguised taxable transfer between two corporate enterprises, a concern that is absent in an E-reorganization (which "involves only a single corporation") and an F-reorganization (a "mere change… of one corporation"). *See* Rev. Rul. 82-34, 1982-1 C.B. 59 (obsoleted by T.D. 9182, but illustrative of the underlying policy).

[149] *See* Reg. section 1.358-2(a)(2) (providing rules regarding identification of stock prior to stock recapitalizations and other transactions).

[150] As discussed below, we recommend considering whether Treasury and the Service will provide guidance that distributions to which section 355 applies would permit application of section 1202(h)(3) or 1202(h)(4). See the discussion below titled "Applicability to section 355 transactions – sections 1202(h)(3) and (4)." If so, a reference to section 355 should be added alongside the references to sections 354 and 356.

[151] Alternatively, the guidance would address an exchange of QSBS or a section 355 distribution with respect to QSBS in the event that guidance will provide that distributions to which section 355 applies would permit application of section 1202(h)(3) or 1202(h)(4).

[152] Section 1202(h)(4)(A) provides that stock received in a transaction described in section 351 or section 368 in exchange for QSBS is treated as QSBS, even if such stock would not otherwise qualify as QSBS in the hands of the recipient. Section 1202(h)(4)(B) imposes a frozen-appreciation rule limiting the excludable gain to the gain that would have been recognized at the time of the exchange had section 351 or section 368 not applied, unless the issuing corporation independently constitutes a QSB as of the date of the exchange.

received in certain tax-free section 355 distributions qualifies as QSBS under section 1202(h)(4)(A), because (i) not all section 355 distributions occur in connection with a section 368 reorganization, and (ii) not all section 355 distributions involve an "exchange" of distributing corporation stock. Although a divisive D reorganization (under section 368(a)(1)(D)) followed by a non-pro rata split-off necessarily involves an exchange of stock by the distributing corporation's shareholders, a pro rata spin-off typically does not involve any actual surrender of distributing corporation stock at the shareholder level.[153]

There is no apparent policy basis for distinguishing among these forms of section 355 distributions for purposes of section 1202(h)(4).[154] Pro rata and non-pro rata distributions are treated identically under the basis rules of sections 358(a)(1) and (c) by deeming an exchange in the case of a pro rata spin-off, and the holding period rules of section 1223(1) likewise apply uniformly regardless of whether an actual exchange occurs.

We request that the Service and Treasury exercise their authority under section 1202(k) to issue guidance providing that stock received with respect to QSBS in a section 355 distribution qualifies as QSBS under section 1202(h)(4)(A), subject to the frozen-appreciation rule of section 1202(h)(4)(B), regardless of whether the distribution was effected as part of a divisive reorganization under section 368(a)(1)(D) or as a stand-alone section 355 distribution, and regardless of whether the distribution is structured as a pro rata spin-off or a non-pro rata split-off or split-up.[155] We recommend that this result apply by deeming an exchange to have occurred at the shareholder level (in the case of a pro rata distribution).[156] Such guidance would be helpful given the lack of clarity with regard to QSBS treatment following section 355 transactions.[157]

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[153] A divisive reorganization under section 368(a)(1)(D) is comprised of (i) a contribution by the distributing corporation of assets to the controlled corporation and (ii) a distribution of the controlled corporation's stock under section 355. A section 355 distribution may, however, be effected outside of a divisive D reorganization where the distributing corporation does not contribute property to a pre-existing controlled corporation in connection with the distribution.

[154] The Service itself has, in non-precedential guidance, applied section 1202(h)(4) to controlled corporation stock received in a section 355 distribution effected as part of a divisive D reorganization. PLR 9810010 (Dec. 3, 1997) (treating controlled corporation stock received in a divisive D reorganization and section 355 distribution as QSBS under section 1202(h)(4) in the hands of shareholders who held distributing corporation QSBS prior to the transaction and tacking the holding period of the distributing corporation QSBS for purposes of section 1202).

[155] We would expect, however, that if the pre-spin corporation’s gross assets exceeded $75 million at any point in time prior to the spinoff, any stock newly issued post-spin by either the distributing corporation or the controlled corporation would not qualify as QSBS.

[156] This approach would be analogous to the "meaningless gesture" doctrine, under which a pro rata stock distribution may be treated as satisfying the distribution requirement of a divisive D reorganization without an actual surrender of distributing corporation stock. Reg. section 1.368-2(l) (deeming a distribution of stock in a divisive D reorganization where the transaction otherwise satisfies the requirements of section 368(a)(1)(D) and the issuance of additional stock by the controlled corporation would be a meaningless gesture).

[157] We further recommend that the per-issuer Gain Exclusion Fixed Cap of section 1202(b)(1) be allocated between the distributing corporation and the controlled corporation in proportion to the relative basis allocated under section 358 following the distribution, consistent with the principle that a divisive reorganization should not duplicate the section 1202(b)(1) cap among the two resulting corporations. *See* sections 358(a)(1) and (c) (allocating the shareholder's basis in distributing corporation stock between the distributing corporation stock retained and the controlled corporation stock received based on relative fair market values). A further question arises with regard to

D. Interaction of the increased exclusion limitation rules and tax-free exchanges

The OBBBA's increased Gain Exclusion Fixed Cap ($15 million instead of $10 million) and Gross Assets Test threshold ($75 million instead of $50 million) generally apply to stock "acquired" after July 4, 2025 (the enactment date).[158] A tax-free exchange under section 351 or section 368 (which covers certain types of mergers, a recapitalization, and an “F reorganization”) involves an actual or deemed exchange of old stock for new stock. If such a transaction occurs after the OBBBA's effective date, is the new stock that was “acquired” in that transaction subject to the enhanced thresholds?

Section 1202(h)(4)(A) treats stock received in such an exchange as QSBS "acquired on the date on which the exchanged stock was acquired." Prior to the OBBBA enactment, that provision served to permit “tacking” of the holding period of the exchanged stock onto the holding period of the stock received in the exchange. Post-enactment, however, that provision might also serve to dictate that the original, pre-enactment acquisition date is preserved and the pre-enactment limitations (the Gain Exclusion Fixed Cap and the Gross Assets Test threshold) remain in effect. Arguments can be made in support of each position.[159]

We request that the Service and Treasury provide guidance clarifying whether stock received in a post-enactment tax-free exchange in exchange for pre-enactment QSBS retains the original acquisition date for all purposes of section 1202—thereby remaining subject to the pre-OBBBA limitations—or is treated as newly acquired stock eligible for the enhanced benefits.

X. CONCLUSION

Section 1202 plays a significant role in encouraging investment in qualified small businesses, but the statute’s practical operation is burdened by numerous areas of uncertainty. The issues identified in this letter arise frequently in ordinary commercial settings and often affect taxpayers’ ability to determine, report, and substantiate QSBS eligibility with confidence. We therefore urge Treasury and the Service to prioritize guidance that provides clear and administrable rules while preserving the statutory purpose of section 1202. Such guidance

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measuring the aggregate gross assets of the controlled corporation for purposes of section 1202(d) as of the date of the distribution; whether the Contributed Assets Rule of section 1202(d)(2)(B) (applying fair market value in place of asset basis) applies. We suggest that where the divisive transaction is structured outside of a consolidated group, the controlled corporation be tested at the fair market value of its assets, and that where the controlled corporation was a member of the distributing corporation's consolidated group prior to the distribution, intra-group transfers (including mergers and section 351 contributions effected in connection with the section 355 distribution) not give rise to a fair market value step-up for purposes of section 1202(d).

[158] Sections 1202(a)(1)(B) and (a)(6).

[159] On the one hand, a shareholder who receives stock of an issuing corporation in a legitimate, non-tax motivated post-enactment business combination arguably should be eligible for the enhanced benefits, because the shareholder holds stock of a genuinely different (and potentially larger) enterprise after the transaction. At the same time, if a mere recapitalization or F reorganization were sufficient to "refresh" the acquisition date, taxpayers could undertake transactions solely to access the higher $15 million cap, a result that would invite abuse. Additionally, the plain language of section 1202(h)(4)(A) can be read as requiring both a tacked holding period and application of the Gain Exclusion Fixed Cap and Gross Assets Test older (lesser) dollar amounts.

would benefit taxpayers, advisors, and the Service alike by promoting certainty, consistency, and administrability. We appreciate your consideration of these recommendations and would be pleased to discuss any of the matters addressed in this letter.