SPECIAL REPORT

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Travels Through 1202

by Stefan Gottschalk and Joseph A. Wiener

Stefan Gottschalk is a senior director and Joseph Wiener is a manager in RSM US LLP's Washington National Tax office. The authors thank Nick Gruidl for his assistance with the preparation of this article.

In this article, Gottschalk and Wiener highlight some questions surrounding the application of code section 1202 and offer some answers, including examples showing how taxpayers can maximize its tax benefit, an exclusion of capital gain from gross income.

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Section 1202[1] provides an excellent tax benefit to those who qualify — an exclusion of capital gain from gross income. The exclusion can apply to as much as 100 percent of the gain on the sale of qualified small business stock (QSBS).[2] Section 1202 was enacted in 1993.[3] In recent years — since the exclusion became permanent in 2015, and when the corporate tax rate was lowered to 21 percent in 2017 legislation — section 1202 has caught the eye of more investors, including many in the private equity and venture capital sectors.

Many practical questions about the application of section 1202 remain unanswered, in

[1] Unless otherwise stated, all references to sections in this article are to the Code of 1986, as amended.

[2] Section 1202(a)(1) and (a)(4)(a).

[3] P.L. 103-66, section 13113(a).

part because of a dearth of precedential case law, regulations, or other guidance. Similarly, published tax literature on this topic is relatively sparse, addressing only some of the unanswered questions.[4] This article highlights some of these questions and suggests some answers.

I. Basics of Section 1202

A detailed review of the section 1202 rules can be found elsewhere.[5] We confine ourselves here to a summary of its main provisions.

Section 1202's capital gain exclusion is available only on the sale of QSBS that was held by a noncorporate taxpayer for more than five years.[6] The capital gain exclusion generally applies to 100 percent of the gain on sale of QSBS acquired after September 27, 2010.[7] For stock acquired on or before that date, 75 percent or 50 percent of the gain generally is excluded, depending on the date of acquisition.[8]

The taxpayer must have acquired the stock directly (or through an underwriter) from the issuing corporation for money, property other than stock, or services provided to the issuing corporation, known as the original issuance requirement.[9] The corporation issuing QSBS must be a qualified small business (QSB). It must be a C corporation with aggregate gross assets, including assets transferred to it in the relevant stock issuance transaction, that have not exceeded $50 million at any time before the time immediately after the stock's issuance.[10]

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 providing services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, and other specified businesses.[11]

The amount of gain a taxpayer is eligible to exclude for a tax year is limited. 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 regarding stock of the corporation, or (2) 10 times the aggregate adjusted basis of QSBS issued by the corporation and disposed of by the taxpayer during the tax year.[12]

Section 1202's capital gain exclusion is available to noncorporate taxpayers only.[13] Taxpayers who own an interest in a passthrough entity may exclude gain regarding QSBS sold by the passthrough entity,[14] subject to additional rules. These rules limit section 1202's applicability to situations in which the passthrough entity

[4] In 2020, *Tax Notes* published a three-part series on section 1202. *See* Paul S. Lee et al., "Qualified Small Business Stock: Quest for Quantum Exclusions," *Tax Notes State*, July 6, 2020, p. 25 ("Quest," part 1); Lee et al., "Qualified Small Business Stock: Quest for Quantum Exclusions Part 2," *Tax Notes State*, July 13, 2020, p. 133; and Lee et al., "Qualified Small Business Stock: Quest for Quantum Exclusions Part 3," *Tax Notes State*, July 20, 2020, p. 255. *See also* Janet Andolina and Kelsey Lemaster, "Candy Land or Sorry: Thoughts on Qualified Small Business Stock," *Tax Notes*, Jan. 8, 2018, p. 205; David F. Levy and Nickolas P. Gianou, "2011: A Boom Year for the Qualified Small Business?" *Corporate Business Taxation Monthly*, Apr. 2011. At least one treatise addresses section 1202 in some detail. Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions, and Buyouts* (Dec. 2020).

[5] *See* Ginsburg, Levin, and Rocap, *supra* note 4, at para. 215; "Quest," part 1, *supra* note 4. *See also* Nick Gruidl, Joseph Wiener, and Sarah Lieberman, "Understanding the Qualified Small Business Stock Gain Exclusion," RSM Tax Insights (2020) (discussing the requirements more briefly).

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

[7] *See* section 1202(a)(1) and (a)(4)(a).

[8] *See* section 1202(a)(1) and (a)(3).

[9] 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 is precluded from qualifying for capital gain exclusion under section 1202 regarding the stock. *See generally* section 1202(c), (f), (g), and (h).

[10] Section 1202(d)(1). This aggregate gross assets test is generally applied to the corporation's tax basis in assets. Section 1202(d)(2)(A). In the case of assets contributed to the corporation, however, the assets' fair market value at the time of the contribution (rather than the assets' tax basis) is included in aggregate gross assets. Section 1202(d)(2)(B). Under this special rule for contributed assets, a question may arise as to whether a transaction entails a contribution of assets within the rule's meaning. This article does not address that question further.

[11] Section 1202(c)(2)(A) and (e)(3). In this regard, an active trade or business requirement generally must be met. Section 1202(c)(2). The corporation generally must use at least 80 percent of its assets, measured by value, in the active conduct of one or more qualified trades or businesses for substantially all the shareholder's holding period. Section 1202(e)(1). There is a favorable rule 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).

[12] 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).

[13] Section 1202(a).

[14] Section 1202(g)(1). Section 1202(g)(4) defines passthrough entity (spelled pass-thru in the statute) to include partnerships, S corporations, regulated investment companies, and common trust funds.

meets the five-year holding period requirement, and the taxpayer has owned the relevant interest in the passthrough entity throughout the same five-year holding period.[15] The exclusion's application to passthrough owners is limited by a rule that precludes an increase in the exclusion available to an owner as a result of the owner's acquisition of an additional interest in the passthrough entity after the entity has acquired to QSBS. More specifically, this rule provides that the gain exclusion applies only to the extent that the taxpayer's share of the gain recognized by the passthrough entity does not exceed the share that the taxpayer would report if it had held the same interest in the passthrough entity on the date the QSBS was disposed of as it held on the date the stock was acquired.[16]

In 2021 legislative proposals have be made that would, if enacted, limit taxpayers' ability to claim benefits under section 1202 in one manner or another.[17] This article does not discuss those proposals.

To illustrate some of the questions addressed in this article, we refer to a fictitious corporation, Soup Nuts Inc., whose shareholders seek the benefit of section 1202 on their sale of Soup Nuts stock.

II. Questions Involving the Aggregate Gross Assets Test

A. Discrepancies Between Aggregate Gross Asset Basis of Holding Company and Operating Company

As noted, the aggregate gross assets of the corporation must not have exceeded $50 million before the time immediately after the issuance of the stock for which the exclusion is sought.[18] A question can arise in applying the aggregate gross assets test when a shareholder contributes cash to a QSB that is a holding company, which in turn purchases an operating company. Is the test applied at the holding company level or at the operating company level?

For example, suppose Soup Nuts has an asset basis of $60 million and debt of $25 million. A private equity firm decides to buy Soup Nuts, so it forms a corporation, SN HoldCo, to which it contributes $35 million. SN HoldCo then purchases Soup Nuts for $35 million. Is the stock of SN HoldCo valid QSBS, or is it disqualified under the aggregate gross assets test? Does the rule focus on the gross assets of the holding company (whose assets are less than $50 million), which is the QSB, or on the operating company (whose assets are more than $50 million), which is the entity whose operations are enabling the holding company to qualify as a QSB?

This question can also arise in the reverse scenario. Suppose that on date 1, the private equity firm contributes $30 million to SN HoldCo, which purchases 100 percent of Soup Nuts for $30 million. SN HoldCo and Soup Nuts file annual consolidated federal income tax returns. SN HoldCo's basis in its Soup Nuts stock subsequently increases by $20 million because of adjustments required under the consolidated return regulations.[19] SN HoldCo issues additional stock on date 2, at which time SN HoldCo has a $50 million basis in its Soup Nuts stock, and Soup Nuts has $30 million of federal tax basis in its assets. At the end of date 2, SN HoldCo issues additional stock in exchange for $10 million of cash and contributes that cash to Soup Nuts. Is SN HoldCo a QSB on date 2? Once again, does the rule focus on the gross assets of the holding company (whose assets in this case have an aggregate basis of over $50 million) or of the operating company (whose assets have an aggregate basis of less than $50 million)?

Although section 1202 does not expressly answer this question, it does address members of a parent-subsidiary controlled group. Section 1202(d)(3) states that all corporations that are members of the same parent-subsidiary controlled group are treated as a single

[15] Section 1202(g)(2).

[16] Section 1202(g)(3).

[17] *See, e.g.*, Joint Committee on Taxation, "Description of the Chairman's Amendment in the Nature of a Substitute to the Committee Print relating to the Infrastructure Financing (Subtitle F), Green Energy (Subtitle G), the Social Safety Net (Subtitle H), and Prescription Drug Pricing (Subtitle J)," JCX-43-21, at 56 (Sep. 13, 2021) (describing a House Ways and Means Committee legislative proposal that includes amendments to section 1202).

[18] The corporation's liabilities do not affect the aggregate gross assets test under section 1202(d).

[19] *See generally* reg. section 1.1502-32 (providing investment adjustment rules requiring adjustments to the tax basis in stock of subsidiary corporations in a group filing consolidated returns).

corporation for purposes of the aggregate gross assets test.[20] Under this single corporation fiction, which corporation's assets should be tested for purposes of the gross assets test — the holding company's or the operating company's? Does the test ignore the holding company's basis in the operating company's stock and only focus on the operating company's basis in its assets? Or does the test ignore the operating company's basis in its assets and focus only on the holding company's basis in the operating company stock?

The most common-sense view of the phrase "treated as 1 corporation"[21] may be to ignore the holding company's basis in operating company stock, because applying the fiction under this view results in a single corporation that both (1) has issued stock held by the holding company's shareholders, and (2) holds the business assets held by the operating company. For section 1202 generally, the holding company's stock is the more relevant stock (the holding company stock may be QSBS), and the operating company's assets are the more relevant assets (the operating company assets are typically the assets that will be tested under the active business requirement).[22]

A logical approach would be to perform a dual inquiry that does not completely disregard the holding company's beginning basis in the operating company stock. This dual-inquiry approach could apply differently on the date of the holding company's acquisition of the operating company than it would after. As of the original issuance of the holding company stock, the holding company's cash and property would be subject to the gross assets test and may not exceed $50 million.[23] For periods after the original issuance, the gross assets test would focus on the operating company's asset basis.

B. The FMV-Adjusted Basis Rule

The aggregate gross assets test requires that the corporation's aggregate gross assets must not have exceeded $50 million before and immediately after the issuance of the stock for which the exclusion is sought.[24] In general, the aggregate gross assets test is applied regarding asset tax basis.[25] However, a special rule applies to the tax basis measurement when property other than cash or stock is contributed to the corporation. When determining a corporation's aggregate gross assets, section 1202(d)(2)(B) states, "The adjusted basis of any property 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) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution."[26] We refer to this as the FMV-adjusted basis rule.

Under this rule, a corporation's tax basis in its assets for purposes of the active business test may exceed its tax basis applicable for other purposes. It is not the equivalent of asset basis used elsewhere, and the corporation may need to track it separately.

This special rule typically applies to the incorporation of a partnership, which, for tax purposes, generally constitutes a section 351 contribution of assets to a newly formed (or deemed newly formed) corporation in exchange for its stock.[27] When the incorporation is achieved via an entity conversion under state law or a check-the-box entity classification election under regulation section 301.7701-3, the following is deemed to occur: (1) the partnership contributes all its assets and liabilities to the corporation in exchange for stock in the corporation, and (2)

[20] Section 1202(d)(3). The Code defines a parent-subsidiary controlled group to include corporate ownership chains consisting of more than 50 percent ownership. Section 1202(d)(3)(B).

[21] Section 1202(d)(3).

[22] *See* section 1202(e)(5)(A) (providing for a look-through rule when applying the active business requirement).

[23] This approach would subject to aggregate gross asset testing the cash and other property provided by (or on behalf of) the holding company as consideration for its purchase of the operating company's stock.

[24] Section 1202(c)(1).

[25] Section 1202(d)(2)(A).

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

[27] *See* Rev. Rul. 84-111, 1984-2 C.B. 88. Under the 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.

immediately thereafter, the partnership liquidates, distributing the stock of the corporation to its partners.[28]

As a general matter, neither the incorporated partnership nor its successor, the newly formed corporation, will recognize gain or loss regarding the incorporation transaction, and the corporation's tax basis in its assets would be the same as the partnership's immediately before the transaction.[29] However, under the FMV-adjusted basis rule, the aggregate gross assets test will focus on the FMV of the newly converted corporation's assets and not its carryover asset basis.[30]

C. Conversion of Partnership With Asset Tax Basis Exceeding $50 Million

If a partnership with more than $50 million in assets intends to convert to a corporation, can it dispose of some of its assets so that immediately after the conversion it has less than $50 million in assets, and thus satisfy the gross assets test?

For example, suppose Soup Nuts is taxed as a partnership and has assets with a FMV of $60 million. Included in those assets are cash and accounts receivable of $15 million. Before converting into a corporation, Soup Nuts distributes the cash and accounts receivable to its partners to reduce the FMV of the assets transferred via the incorporation to $45 million. Does Soup Nuts satisfy the $50 million gross assets test?

This situation requires consideration of substance-over-form principles and detailed consideration of the facts. Relevant considerations include whether the business can operate without the assets; whether the assets are pledged against the business's debts and, if so, whether negotiations took place with creditors; the restrictions on the distributee's rights to use or dispose of the assets; how the distribution was documented and effected; and whether the assets (or proceeds thereof) were later transferred back to the corporation.

D. The FMV-Adjusted Basis Rule and an F Reorganization

Suppose Soup Nuts was formed in 2010 as a Florida corporation, but in 2012 changed its state of incorporation to Delaware. This change would be treated under section 368(a)(1)(F) as an F reorganization.[31] Does the F reorganization trigger the FMV-adjusted basis rule?

In the F reorganization, the Florida corporation would be deemed to transfer its assets to the Delaware corporation.[32] Read literally, such a transfer implicates the FMV-adjusted basis rule, because the property held by the company after the F reorganization is "property contributed to the corporation." If Soup Nuts issued stock as part of the reincorporation plan, must the company's FMV — and not asset basis — not exceed $50 million for the stock to constitute QSBS?

A closer look reveals that an F reorganization should not trigger the FMV-adjusted basis rule. Section 1202(h) provides that some transfers of QSBS will not affect the stock's status and provides that "rules similar to the rules of section 1244(d)(2) shall apply for purposes of this section."[33] In turn, section 1244(d)(2) provides that a successor corporation in an F reorganization is treated as the same corporation as its predecessor.[34] The F reorganization therefore should not trigger the FMV-adjusted basis rule.[35]

[28] 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, 2004-1 C.B. 1050.

[29] *See generally* sections 351, 358, and 362. Note that there are exceptions to these general rules. For example, section 357(c) requires gain recognition if the partnership's liabilities exceed its asset tax basis, and section 362(e) requires reductions to basis in the case of some transactions involving built-in loss property (that is, property with a tax basis over its FMV).

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

[31] *See Berghash v. Commissioner*, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966). *See also* reg. section 1.368-2(m).

[32] *See generally* reg. section 1.368-2(m). *See also* section 1244(d)(2).

[33] Section 1202(h)(3).

[34] *Id.*

[35] *See also* LTR 201603010 (Jan. 15, 2016) (status of a corporation's QSBS is unaffected if the corporation undergoes an F reorganization); LTR 201603011 (Jan. 15, 2016) (same); LTR 201603012 (Jan. 15, 2016) (same); LTR 201603013 (Jan. 15, 2016) (same); LTR 201603014 (Jan. 15, 2016) (same). *See also* H.R. Rep. No. 103-111 (P.L. 103-66) p. 603 (stating that in the case of a conversion of preferred stock into common stock, which generally is treated as a reorganization under section 368(a)(1)(E) (*see* reg. section 1.368-2(e)(4)), the gross assets determination is made at the time the convertible stock is issued and not at the time it is converted).

E. The FMV Carryforward

How the FMV-adjusted basis rule applies is clear in a scenario in which a stock issuance takes place on the same day that property is contributed to a corporation. However, the Code and regulations do not fully explain how the application of the FMV-adjusted basis rule affects the aggregate gross assets test at the time of later stock issuances.

For example, suppose that in 2010, two partners formed Soup Nuts LLC, initially taxed as a partnership. The owners of Soup Nuts later decide to convert the LLC to a corporation, Soup Nuts Inc. The conversion occurs on August 1, 2014, when the Soup Nuts asset tax basis is $10 million and its assets' FMV is $40 million. At conversion one August 1, 2014, Soup Nuts Inc. issues stock, which may be an original issuance of QSBS. The incorporation of Soup Nuts LLC generally would be treated as a section 351 transaction,[36] and thereby implicate the FMV-adjusted basis rule regarding the business assets contributed (or deemed contributed) in the conversion.[37] Thus, the FMV of the company's assets will determine whether the company meets the aggregate gross assets test on the stock issuance date of August 1, 2014.

Suppose further that the Soup Nuts asset basis increases in two years, from $10 million on August 1, 2014, to $25 million on August 1, 2016. If Soup Nuts were to issue stock on August 1, 2016, how should the aggregate gross assets test be applied?

Based on a plain reading of the statute,[38] it appears that the FMV of the assets contributed on August 1, 2014, generally must be carried over to subsequent periods as an adjustment to the property's adjusted tax basis (which we refer to as a FMV carryforward). Accordingly, the section 1202 gross assets basis would be measured as:

- the FMV of the property initially contributed; plus
- the company's asset basis as of the subsequent issuance date; less
- the asset basis as of the contribution date.

Absent further adjustments, the Soup Nuts aggregate gross assets on August 1, 2016, would be $55 million, computed as the $40 million FMV carryforward, plus $25 million (asset tax basis on August 1, 2016), less $10 million (asset tax basis on August 1, 2014). The August 1, 2016, issuance would fail the section 1202 aggregate gross assets test, because the company's aggregate gross assets would exceed $50 million at or before the time immediately after the stock issuance on August 1, 2016.[39]

F. Adjustments to the FMV Carryforward Amount

Suppose the Soup Nuts shareholders contribute a new business line to Soup Nuts Inc. Under the FMV carryforward rule, the FMV of the new business line generally must be carried over to subsequent periods for purposes of the gross assets test.[40] Several questions can be raised regarding potential adjustments to this FMV carryforward.

1. Subsequent Changes to the Contributed Property's Value

If the contributed property undergoes a reduction in value, may the corporation reduce the FMV carryforward? It appears clear that a change to the contributed property's FMV should not give rise to any adjustment to the FMV carryforward. Section 1202(d)(2)(B) states that the adjusted basis of property contributed to the corporation is determined as if the basis of the contributed property were equal to its FMV as of the time of the contribution. No further FMV-based adjustments are authorized. Under the Code's general realization requirement, a taxpayer may not mark property to market absent a realization event,[41] and section 1202(d)(2)(B) does not indicate any departure from that general

[36] *See* Rev. Rul. 84-111, 1984-2 C.B. 88; and Rev. Rul. 2004-59, 2004-1 C.B. 1050.

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

[38] *See id.*

[39] *See generally* section 1202(d).

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

[41] *See, e.g.*, *Helvering v. Horst*, 311 U.S. 112 (1940) (discussing the policy behind the realization principle); *United States v. S. S. White Dental Manufacturing Co.*, 274 U.S. 398 (1927). The Code provides for mark-to-market accounting, eliminating the realization requirement under some circumstances. *See, e.g.*, section 475(a) (mark-to-market accounting for securities dealers and for commodities dealers, securities traders, and commodities traders) and section 1256 (mark-to-market accounting for some section 1256 contracts).

rule. Accordingly, a taxpayer likely may not reduce the FMV carryforward to reflect a later decrease or increase to the contributed property's FMV.

2. Subsequent Sale of Contributed Property

If the company sells some of the property it received in the contribution, should it adjust the FMV carryforward to reflect the amount of cash received in return? The answer to this question appears straightforward. The aggregate gross assets test applies on a continuous basis to the corporation from the August 10, 1993 — date of section 1202's enactment — to the time immediately after the stock issuance being tested for section 1202 eligibility.[42] The test only applies to assets of the corporation, and should not apply to assets the corporation has sold and no longer owns.[43] The company should adjust the FMV carryforward to remove the amount attributable to the property the company has sold. The tax basis of the property received in exchange for the property sold would of course be included in the corporation's aggregate gross assets.[44]

3. Subsequent Amortization or Depreciation of Contributed Assets

If the contributed assets include depreciable or amortizable property, can the FMV carryforward be decreased annually to reflect the depreciation and amortization to which these assets would be eligible if their tax basis equaled their FMV on the contribution date? Although we are unaware of authority addressing this question, there is a straightforward rationale for permitting depreciation or amortization adjustments. Section 1202(d)(2)(B) states: "The adjusted basis of any property contributed to the corporation . . . shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution."

Under this rule, 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[45] — the rule may be interpreted to permit the property's deemed tax basis to decrease over time because of depreciation and amortization.[46]

III. Questions Involving the Original Issuance and Holding Period Requirements

A. Stock Issued Upon the Exercise of Options

In general, stock acquired by a taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue as of the date of the exercise or conversion.[47]

Options (or warrants, which are another name for options granted by a corporation to purchase that corporation's stock) may in some circumstances be treated for federal income tax purposes as stock on the date the options are granted. One factor is whether the options are deep in the money (that is, their whether their strike price is significantly below the market price of the underlying stock, with the result that the options will almost certainly be exercised).[48] The factors listed in the Tax Court's opinion in *Alumax*,[49] which discussed characteristics of stock ownership, would generally be relevant in this context. If a stock option or warrant granted by a corporation to purchase stock of that corporation is treated for federal income tax purposes as a stock of the corporation when granted, the option's grant date would be the stock's original issuance date for purposes of section 1202.

[42] Section 1202(d)(1).

[43] *See id.*

[44] *See generally* section 1202(d).

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

[46] 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). Amortization and depreciation-based adjustments to the FMV carryforward amount in the case of contributed assets may be viewed as analogous.

[47] Conference Report to Omnibus Budget Reconciliation Act of 1993, H.R. Conf. Rep. No. 103-213, p. 526 (Aug. 4, 1993).

[48] *See, e.g.*, Rev. Rul. 82-150, 1982-2 C.B. 110 (nominal holder of stock subject to deep in the money option treated as nominee; option holder treated as stockholder); LTR 201230008 (Apr. 25, 2012) (holding warrants of distributing corporation should be treated as stock for federal income tax purposes so that distributions of controlled corporation stock to holders of distributing corporation warrants are treated as distributions regarding stock for purposes of section 355).

[49] *Alumax Inc. v. Commissioner*, 109 T.C. 133 (1997), *aff'd*, 165 F.3d 822 (11th Cir. 1999).

B. Stock Issued Under an Employee Compensation Plan

If a company issues stock under an employee compensation program, a question can arise as to the stock's issue date for purposes of the five-year holding period. Section 1202's 1993 legislative history states that the issue date of stock for performance of services for purposes of the five-year holding period is determined in accordance with the rules of section 83.[50] Thus, if the taxpayer receives unrestricted stock in exchange for services, the issue date is the date of receipt.[51] If the stock is nontransferable and subject to a substantial risk of forfeiture, and the taxpayer does not make a section 83(b) election, the issue date is the first date on which the stock becomes either transferable or no longer subject to a substantial risk of forfeiture.[52] If the taxpayer makes a section 83(b) election to accelerate the inclusion of income from the stock, the stock's issue date is the date the stock was transferred to the service provider.[53]

An interesting question can be raised regarding an employee of an operating company that is owned by a holding company otherwise eligible to issue section 1202-qualifying stock. If the employee receives stock of the holding company as compensation, does the stock qualify as QSBS because it was issued for services?[54] Or does it not qualify because the services were not provided to the issuing corporation as apparently required under the statute,[55] 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 lookthrough rule applicable to a holding company that owns an operating company. For purposes of the aggregate gross assets test, all corporations that are members of the same parent-subsidiary controlled group are treated as a single corporation.[56] 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.[57] Like the above two rules, one might argue that a lookthrough 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. The Supreme Court has recognized that the plain meaning of a federal tax statute controls its interpretation if it is not ambiguous but is clear on its face, applying the common meanings of the words used by Congress.[58]

However, the Supreme Court also has characterized statutory construction as a "holistic endeavor," explaining:

> 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

[50] Conference Report, *supra* note 47, at 526.

[51] *See* section 83(a).

[52] *See* section 83(a); reg. section 1.83-1(a) and -3(b).

[53] *See* section 83(b)(1); reg. section 1.83-1(a) and -2(a).

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

[55] *Id.*

[56] 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).

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

[58] *Gitlitz v. Commissioner*, 531 U.S. 206 (2001); *Old Colony R.R. Co. v. Commissioner*, 284 U.S. 552 (1932).

substantive effect that is compatible with the rest of the law.[59]

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 applying that meaning would be untenable in light of the statute as a whole.[60] 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"[61]), under which interpretation of a statutory provision may be based on the nature of the provisions surrounding it.[62]

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 or *noscitur a sociis* approach. 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."[63]

There are tax authorities outside section 1202 that may be relevant to considering whether employees of a subsidiary corporation should be treated as receiving stock in exchange for providing services to the parent. Employees of the subsidiary may be officers or common law employees of the parent. Section 3121(d) defines employees for purposes of chapter 21 of the code as including officers and common law employees. The IRS in Rev. Rul. 87-41[64] set out 20 factors underlying whether common law employee status applies for purposes of FICA, FUTA, and the collection of income tax at source on wages (withholding of income tax on wages).

A corporate structure featuring a holding company that does not operate a business and one or more subsidiaries that do operate businesses is common. If the subsidiary's activities enable the parent company to meet the section 1202(e) active business test, it would seem 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. Given the lack of clarity regarding whether these employees' parent stock may meet the section 1202(c) original issuance requirement, government guidance on this point would be welcome.

C. The Impact of Contributions to Capital When Stock Issuance Is a Meaningless Gesture

Frequently a shareholder makes an initial capital contribution to a wholly owned corporation in exchange for all the corporation's stock and later contributes additional capital to the corporation without receiving additional shares in return. In such a case, does the second capital contribution result in the deemed issuance of stock for purposes of section 1202, thus requiring a new five-year holding period?[65] Does the taxpayer need to bifurcate his shares for section 1202 purposes, testing each portion for QSB eligibility separately?

For example, suppose Susan Nuts incorporated Soup Nuts in 2013 and contributed $10 million in exchange for 100 percent of its shares. In 2017, Susan contributed an additional $10 million to Soup Nuts but did not take back shares in return. Susan then sells all her shares in 2020. May Susan exclude 100 percent of the gain on the sale, subject to the per-issuer limitation? Or must Susan treat a portion of the gain as allocable to stock she has held for only three years — since the 2017 capital contribution date — which would

[59] *United Savings Association of Texas v. Timbers of Inwood Forest Associates Ltd.*, 484 U.S. 365 (1988) (citations omitted).

[60] *Oregon Department of Revenue v. ACF Industries Inc.*, 510 U.S. 332 (1994).

[61] *Black's Law Dictionary*, 1209 (1968).

[62] *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* Antonin Scalia and Bryan A. 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").

[63] *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).

[64] 1987-1 C.B. 296.

[65] Correspondingly, does the corporation need to satisfy the $50 million aggregate gross assets test immediately after the second capital contribution for the shareholder to be eligible for the section 1202 exclusion regarding all the shares held?

leave her partially unable to satisfy section 1202's five-year holding period requirement?

This fact pattern invokes the meaningless gesture principle — the principle dictating that an issuance of additional shares is not required to satisfy the exchange requirement of section 351 when the issuance would be a meaningless gesture. In the context of a contribution by a single shareholder to a wholly owned corporation, the issuance of shares generally is viewed as a meaningless gesture. Accordingly, both the courts and the IRS have held that an actual stock issuance is not required to qualify the contribution for tax-free treatment under section 351.[66] It is not entirely clear, however, whether a meaningless gesture contribution situation involves a deemed stock issuance by the corporation receiving the contributed property. In Rev. Rul. 64-155, the IRS addressed a domestic parent corporation's transfer of property to its wholly owned foreign subsidiary. Although the parent did not receive additional shares of the subsidiary's stock, the ruling states that section 351 would apply to the parent's contribution. It did not expressly state whether the subsidiary generally would be treated as issuing stock to its parent.[67]

The ruling expressly concluded that section 367 would apply to the transfer, generally requiring the transferor to recognize gain notwithstanding the transaction's qualification under section 351. Section 367 applies to some transfers of property to a foreign corporation in exchange for stock of the foreign corporation, including transfers of property in exchange for stock in a section 351 transaction.[68]

The government sought to enforce Rev. Rul. 64-155 in *Abegg*.[69] Instead, the taxpayer prevailed. The foreign corporation receiving property from its domestic shareholder was not deemed to issue stock to the domestic shareholder, and section 367 could not apply to the shareholder without any receipt of stock.[70]

In the wake of the government's loss in *Abegg*, Congress amended section 367 in 1970 to create a constructive property-for-stock exchange when one or more controlling shareholders transfer property to a foreign corporation as a contribution to capital.[71] While section 367(c)(2) expressly provides for a deemed issuance of stock by a foreign corporation if the issuance would be a meaningless gesture, it does not address transfers of property to domestic corporations.

[66] *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989), *aff'g on this point and rev'ing on another*, 85 T.C. 824 (1985); Rev. Rul. 64-155, 1964-1 C.B. 138. *But see Abegg v. Commissioner*, 50 T.C. 145 (1968), *aff'd on other grounds*, 429 F.2d 1209 (2d Cir. 1970), *cert. denied*, 400 U.S. 1008 (1971). The meaningless gesture doctrine is also relevant to determining whether an acquisition qualifies as a corporate reorganization under section 368(a)(1)(D) (a D reorganization). Stock need not actually be issued for an acquisition to qualify as a D reorganization if issuance of the stock would be a meaningless gesture. *See* reg. section 1.368-2(l); *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961); *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966); and Rev. Rul. 70-240, 1970-1 C.B. 81.

[67] Rev. Rul. 64-155, 1964-1 C.B. 138, states in its entirety:

> X, a domestic corporation, proposes to contribute appreciated property to Y, an existing wholly-owned foreign subsidiary. Although X will not receive any additional Y shares, the transaction will be considered an exchange of property for stock described in section 351 of the IRC of 1954. *Compare King v. United States*, 10 Fed. Supp. 206 (1935), *affirmed*, 79 Fed. (2d) 453 (1935); *Commissioner v. Walter L. Morgan, et ux.*, 288 Fed. (2d) 676 (1961), *certiorari denied*, 368 U.S. 836 (1962). Consequently, section 367 of the code will be applicable and gain recognized to X corporation to the extent of the appreciation in value of the contributed property unless it is previously established that the proposed transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. [Citations in original.]

[68] *See generally* section 367(a). The rules of section 367 have undergone significant augmentation and revision since Rev. Rul. 64-155 was issued. This article does not discuss these changes other than the 1970 amendment providing the language codified in section 367(c)(2).

[69] *Abegg*, 429 F.2d 1209 (2d Cir. 1970), *aff'g* 50 T.C. 145 (1968), *cert. denied*, 400 U.S. 1008 (1971). While the Tax Court held that the capital contribution did not qualify under section 351 because no stock was received, the Second Circuit confined its analysis to section 367, holding that it is inapplicable absent an actual issuance of stock. One reason the court viewed the IRS's position as untenable is that it would reduce to a dead-letter redundancy or an unintended double tax the section 1491 excise tax then applicable to some contributions to the capital of foreign corporations and some transfers to foreign partnerships or trusts. The Tax Court subsequently allowed section 351 qualification based on the meaningless gesture principle in *Lessinger*, 85 T.C. 824. On appeal in *Lessinger*, the Second Circuit noted the Tax Court's change of heart:

> The first question is whether section 351 applies when no new shares are issued to the shareholder, having in mind the statutory language that a transfer must be made "solely in exchange for stock or securities." *See* section 351(a). The Tax Court strained somewhat to analyze this case under, and perhaps to overrule, the case of *Abegg v. Commissioner*, 50 T.C. 145 (1968), *aff'd on other grounds*, 429 F.2d 1209 (2d Cir. 1970), *cert. denied*, 400 U.S. 1008, 91 S. Ct. 566, 27 L. Ed. 2d 621 (1971), involving transfer under section 367 by a nonresident alien to a wholly-owned corporation. We agree, however, with the Tax Court's ultimate conclusion that the exchange requirements of section 351 are met where a sole stockholder transfers property to a wholly-owned corporation even though no stock or securities are issued therefor. Issuance of new stock in this situation would be a meaningless gesture.

Lessinger, 872 F.2d at 522 (citations in original).

[70] *Abegg*, 429 F.2d 1209.

[71] P.L. 91-681, section 1(a). The amendment added section 367(d), which contained the language now codified in section 367(c)(2). If the transferors of property to a foreign corporation own stock possessing a total of 80 percent or more of the total combined voting power of the corporation's stock, section 367(c)(2) will deem an exchange for stock to have occurred in connection with the transfer if no exchange occurred.

Because only domestic corporations can issue section 1202-eligible stock, this 1970 legislative fix does not supply an answer to our section 1202 question.[72]

There are authorities that address whether a shareholder's contribution of a corporation's own debt to capital results in a deemed issuance of stock.[73] These authorities take differing approaches. Their story starts with a loophole. Before 1980,[74] some taxpayers took the position that neither the corporation nor the shareholder realized taxable income when a corporation had previously deducted an amount payable to a shareholder and the shareholder thereafter contributed the amount receivable to the corporation's capital. The government did not like the asserted result — a tax deduction with no corresponding income inclusion — and argued for a deemed stock issuance to counter it.

The corporation's previously deducted liability was compensation to the shareholders in *Fender Sales*.[75] Fender Sales Inc. actually issued stock in pro rata to its two 50 percent shareholders in exchange for their contribution of the compensation liability back to the corporation. The Ninth Circuit, reversing the Tax Court, held that the shareholders were taxable on receipt of the stock as compensation even though the stock did not change their 50-50 ownership.

In *Putoma*,[76] the previously accrued deduction was interest expense. Putoma Corp. received the accrued interest obligation contributed by its shareholder but did not issue stock to the shareholder in exchange. The Fifth Circuit and the Tax Court in *Putoma* did not follow *Fender Sales*; the debt contribution resulted in no income for either the corporation or the shareholder. There was no deemed transfer of stock in exchange for the shareholder's contribution of the accrued interest receivable. The Bankruptcy Tax Act of 1980 added section 108(e)(4) and (e)(6) to prevent avoidance of cancellation of debt income in these types of contribution to capital situations.[77] These provisions do not dictate any deemed stock issuance.[78]

About 20 years ago, the IRS issued multiple field service advice memoranda citing *Fender Sales* and recommending assessment of withholding tax based on treatment of deemed issued stock as a payment of interest when actual issuance of stock would be a meaningless gesture.[79] The Service acknowledged that its position in these FSAs conflicted with the holding in *Putoma*.[80]

For corporate reorganizations lacking an actual issuance of stock that would be a meaningless gesture, regulations finalized in 2009 apply a deemed stock issuance and redemption construct.[81] Because those regulations apply only to transactions qualifying as corporate reorganizations, they do not apply to a typical type of contribution — one akin to Susan Nuts's second capital contribution to Soup Nuts Inc. That type of contribution transaction does not qualify as a corporate reorganization under section 368 but does qualify as a section 351 transaction thanks to the meaningless gesture principle. Regulations proposed in 2009 would have prospectively applied a deemed stock issuance and redemption approach to these section 351 transactions, like the approach taken by regulations regarding section 368 transactions.[82]

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[72] Section 1202(e)(4).

[73] These debt contribution authorities generally do not involve analysis of issues regarding operation of section 351 or the tax basis results under section 358 of a transaction qualifying under section 351.

[74] Before the enactment of section 108(e)(4) and (e)(6) in the Bankruptcy Tax Act of 1980.

[75] *Commissioner v. Fender Sales Inc.*, 338 F.2d 924 (9th Cir. 1964), *rev'ing* T.C. Memo. 1963-119.

[76] *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1979), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

[77] Bankruptcy Tax Act of 1980, P.L. 96-589, section ?2(a), 94 Stat. 3389 (Dec. 24, 1980). Subsequently, the rules governing taxpayers' accrual of interest income also were changed significantly because of the enactment in 1982 and 1984 of the code's original issue discount provisions, and the issuance of final regulations implementing the provisions. *See generally* sections 1271-1275; T.D. 8517, 61 F.R. 30133 (Jan. 27, 1994); T.D. 8674, 61 F.R. 30133 (June 14, 1996).

[78] Section 108(e)(4) and (e)(6). *See generally* section 108.

[79] FSA 200006003 (Feb. 11, 2000); FSA 199922034 (June 4, 1999). The IRS concluded in each of these two field service advice memoranda that the rationale of *Fender Sales*, *supra* note 75, rather than that of *Putoma*, *supra* note 76, should apply, stating that the Tax Court should apply *Fender Sales* to the taxpayers in each FSA under the rule of *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), given that appeal from the Tax Court for these taxpayers would be heard by the Ninth Circuit. *See also* FSA 199926018 (Mar. 30, 1999), re-released Apr. 29, 2005, with additional information.

[80] FSA 200006003; FSA 199922034.

[81] Reg. sections 1.358-2(a)(2)(iii) and 1.368-2(l), promulgated in T.D. 9475; 74 F.R. 67053 (Dec. 18, 2009).

[82] Prop. reg. section 1.358-2(g)(3), issued in Notice of Proposed Rulemaking, REG-143686-07, 74 F.R. 35-9 (Jan. 21, 2009).

However, those proposed regulations were not finalized and were withdrawn in 2019.[83]

The IRS's most recent take on this deemed stock issuance question is contained in a generic legal advice memorandum (GLAM) involving two relatively abusive situations in which taxpayers looked to extend their holding periods in corporate stock beyond the true duration of their economic investments.[84] The GLAM concludes that a stock issuance by the transferee corporation is deemed to occur in connection with a meaningless gesture contribution.[85] Because no precedential authority provides this conclusion, the GLAM instead cites the tax policy, exemplified in section 1223(1), that a holding period should track the sources of basis. The GLAM also cites Rev. Rul. 85-164,[86] which addressed actual exchanges of stock qualifying under section 351 but did not involve or mention any deemed stock issuances.[87]

Consistent with this discussion, there are arguments for and against applying deemed stock issuance treatment in connection with a shareholder's contribution of property to a corporation in exchange for no additional stock when issuance of additional stock would be a meaningless gesture. A deemed issuance of stock would result in the shareholder's having a split holding period, with a longer-duration component and a shorter-duration component. After a contribution to capital in a meaningless gesture situation, the shorter-duration component would obtain under a deemed stock issuance approach and would not obtain if the contribution is not treated as resulting in any deemed stock issuance. A split holding period result could be unfavorable or favorable to the shareholder, depending on the shareholder's situation.

A split holding period would tend to result in negative consequences because the shorter duration holding period component would make it more difficult for the shareholder to meet holding period requirements.[88] However, in some cases a deemed issuance could have a taxpayer-favorable result. For example, a deemed issuance of qualifying section 1202 stock after September 27, 2010, could provide a favorable 100 percent exclusion even if the shareholder's stock was actually issued at an earlier date, when the exclusion was lower (that is, 50 percent or 75 percent).[89]

Another potential shareholder benefit in the event of a split holding period may arise under the section 1202(b) limitation on the maximum amount of gain eligible for exclusion. This limitation, as noted above, is equal to the greater of: (1) $10 million, reduced by the aggregate amount of gain previously taken into account for section 1202 regarding stock of the corporation, or (2) 10 times the aggregate adjusted basis of QSBS issued by the corporation and disposed of by the taxpayer during the tax year.[90] The adjusted basis of stock is determined for this purpose regardless of any addition to basis after the date on which such stock was issued.[91] As a result, basis in cash or other property contributed in a meaningless gesture situation would increase the 10 times basis component of the section 1202(b) gain exclusion limitation when compared with the limitation that would apply if no stock were deemed issued to the shareholder.

[83] 84 F.R. 11686 (Mar. 28, 2019).

[84] AM 2020-005 (May 22, 2020).

[85] *Id.*

[86] Rev. Rul. 85-164, 1985-2 C.B. 117 (shares of stock received in exchange for property with different bases and holding periods in an exchange to which section 351 applies have split bases and split holding periods for purposes of determining long-term or short-term capital gain or loss). In this regard, the GLAM cited to Rev. Rul. 85-164 with a "*cf.*" symbol, denoting "compare," which appeared to reflect the IRS's awareness that Rev. Rul. 85-164 did not provide any holding regarding deemed issuance of stock. AM 2020-005. Arguments contrary to the GLAM's conclusion regarding deemed stock issuance may be made based on authorities including those discussed in this article and on others such as section 108(e)(6). *See, e.g.*, Ginsburg, Levin, and Rocap, *supra* note 4, at para. 1505.2.2.

[87] AM 2020-005.

[88] *See, e.g.*, section 1222(3) and 1(h) (defining long-term capital gain and providing a favorable tax rate for individuals' long-term capital gain, respectively); section 1061(a) (extending to "over three years" the requisite holding period for long-term capital gain treatment for applicable partnership interests); and section 1202(a) (five-year holding period required to benefit from exclusion of some capital gain under section 1202).

[89] *See* section 1202(a)(1), (a)(3), and (a)(4)(a).

[90] 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 issued. Section 1202(b)(1)(B).

[91] Section 1202(b)(1)(B).

IV. Questions Involving the Active Business Requirement

A taxpayer is only eligible for gain exclusion on the sale of QSBS if the corporation meets the active business requirement for substantially all the taxpayer's holding period of the stock (the active business requirement).[92] This rule requires, among other things, that the corporation use at least 80 percent of its assets, measured by value, in the active conduct of a QTOB.[93]

The active business requirement includes a working capital exception as an important corollary: Assets that are "held as part of the reasonably required working capital needs of a qualified trade or business" of a corporation, or that 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 treated as used in the active conduct of a trade or business.[94] The statute adds, however, that after the corporation has been in existence for at least two years, no more than 50 percent of the assets of the corporation may qualify as used in the active conduct of a QTOB by reason of this provision.[95]

A. The Meaning of 'Substantially All'

The code, regulations, and courts do not discuss the meaning of the term "substantially all" as used in this provision.[96] In IRC contexts outside section 1202, substantially all has been interpreted to mean (or be satisfied by) 70 percent,[97] 80 percent,[98] 85 percent,[99] 86 percent,[100] or 90 percent[101] of the items in question. For purposes of section 1202's substantially all requirement, it might be reasonable to assume that 80 percent suffices.[102]

B. Addressing the Active Business Requirement Generally

It is clear from the active business requirement's statutory language that the 80 percent-of-assets test is based on the FMV of the company's assets, which may include off-balance-sheet assets such as goodwill and other self-generated intangible assets.[103] This is an important and taxpayer-friendly rule some might overlook. A significant portion of a successful company's value may consist of its intangible assets such as goodwill that are not shown on the company's balance sheet. Accordingly, by requiring focus on FMV, the active business requirement generally permits holding a greater amount of assets not used in an active business than it would if it applied to tax basis or balance sheet amounts.

More stringent asset-value-based tests apply to portfolio stock or securities held by the corporation, and real property that is not used in

[92] Section 1202(c)(2).

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

[94] Section 1202(e)(6).

[95] *Id.*

[96] *See, e.g.*, *Owens v. Commissioner*, T.C. Memo. 2012-21 (court concluded that the company was a QSB without analyzing the substantially all requirement of section 1202(c)).

[97] *See* Rev. Rul. 57-518, 1957-2 C.B. 233 (substantially all in the context of a section 368(a)(1)(C) reorganization referred to the transfers of 70 percent of the corporation's assets, but also depended on the facts and circumstances); Rev. Proc. 77-37, 1977-2 C.B. 568, *as amplified by* Rev. Proc. 86-42, 1986-2 C.B. 722 (in the reorganization context, substantially all means assets representing at least 90 percent of the FMV of net assets and at least 70 percent of the FMV of gross assets).

[98] *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.

[99] *See* Rev. Rul. 73-248, 1973-1 C.B. 295 (the substantially all ownership test of section 521(b)(2), relating to farmers' cooperatives, is satisfied by 85 percent).

[100] *See Commissioner 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 satisfies the substantially all requirement for a section 368(a)(1)(C) reorganization, in contrast to *Arctic Ice Machine Co. v. Commissioner*, 23 B.T.A. 1223 (1931), which established that 68 percent is insufficient).

[101] *See* LTR 8104064 (Oct. 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 is used to provide loans for rehabilitating properties).

[102] *See, e.g.*, Ginsburg, Levin, and Rocap, *supra* note 4, at para. 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.").

[103] Section 1202(e)(1) ("at least 80 percent (by value)").

the active conduct of a QTOB. These rules are potential traps for the unwary. A corporation fails to meet the active business requirement for any period during which more than 10 percent of the value of its assets (over liabilities) consists of stock or securities in other corporations whose stock it does not own 50 percent or more of by voting power or value.[104] A corporation fails to meet the active business requirement for any period during which more than 10 percent of the value of its assets consists of real property that is not used in the active conduct of a QTOB.[105]

C. Application of the Working Capital Exception

As noted, the working capital exception includes two categories: (1) assets "held as a part of the reasonably required working capital needs" of the business (category A), and (2) assets held for investment that are reasonably expected to be used by the business within two years to finance research or increases in working capital (category B). There is little authority interpreting category A's term "reasonably required working capital needs."

"Working capital" has differing meanings based on the context in which it is used. For example, working capital might include the sum of some or all the following: cash, accounts receivable, inventory, or accounts payable (the latter as a reduction to working capital). One interpretation of working capital, in a context outside section 1202, is the *Bardahl* formula. That formula determines a company's working capital needs based on its operating cycle for purposes of the accumulated earnings tax.[106]

Section 1202's working capital exception provision and other relevant authorities do not provide direction on how the exception should be applied. Examining each corporation's working capital needs holistically based on its facts and circumstances appears an appropriate approach. The many factors that may affect a corporation's reasonable working capital needs may include expected periodic cash flows, volatility of cash flows, seasonality of business, expected capital expenditures, regulatory requirements, and risk profile.

V. Questions Involving the QTOB Definition

In general, the code defines the term "qualified trade or business" by negation. It is any trade or business other than various businesses listed in the statute, which include "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 of business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees."[107]

A. The Meaning of Consulting

What is the meaning of consulting for purposes of this provision? Section 1202 does not define the term and authorities under section 1202 do not address its meaning. The meaning of the word is inherently somewhat vague.[108] To illustrate, consider whether the following activities constitute consulting:

- special education advice and advocacy;
- due diligence services on behalf of prospective buyers of target companies;
- real property appraisals for property tax purposes;
- risk management assessment services; or
- business expansion advice and proposal writing.

Do these activities constitute consulting? Based merely on the colloquial use of the term, there is no clearly correct answer. However, regulations under other code provisions provide clarification on the meaning of the term.

[104] Section 1202(e)(5). Which definition of securities applies in this context is not specified in the code or regulations, and this article does not address the question.

[105] Section 1202(e)(7).

[106] *See Bardahl Manufacturing Corp. v. Commissioner*, T.C. Memo. 1965-200. Although testimony by Sens. Joe Lieberman and Dale Bumpers included recommendations that Treasury issue regulations under section 1202 providing guidelines like those used in *Bardahl* to determine the meaning of "reasonably required working capital," (139 *Cong. Rec.* S10680) these regulations have not been issued.

[107] Section 1202(e)(3).

[108] The dictionary definition does not clarify the matter much. *See, e.g., Merriam Webster Dictionary* ("consulting" is defined as "providing professional or expert advice").

Temporary regulations under section 448 state that "consulting means the provision of advice and counsel."[109] The temporary regulations provide that consulting "does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services," and "the determination . . . shall be based on all the facts and circumstances of that person's business" including "the manner in which the taxpayer is compensated for the services provided (e.g., whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect)."[110]

The temporary regulations provide 10 examples that illustrate which services constitute "the provision of advice and counsel." A close analysis of these examples reveals that those engaged in consulting merely provide advice, while those not engaged in consulting provide non-advisory services or goods, sometimes together with the provision of advice. Those non-advisory services include, for example, transaction execution, personnel and hiring assistance, and advertising.

The section 448 temporary regulations are an appropriate source of guidance.[111] For decades, the only authoritative interpretation given to the term "consulting" as used in the code was the interpretation that appeared in these temporary regulations.[112] Accordingly, "consulting," as used in section 1202(e)(3), likely refers to the provision of advice and counsel that does not complement other services provided.[113]

B. The Meaning of Accounting

As noted, accounting is one of the businesses disqualified from QTOB status. Here, too, section 1202 and its regulations do not elaborate on the meaning of this term, leading to some ambiguity. For example, do bookkeeping, audit services, payroll processing services, and accounts receivable and collection services constitute accounting?

In interpreting section 1202(e)(3), it is appropriate to look to authorities under section 448 for guidance, and some limited guidance can be found in the section 448 regulations. In explaining the scope of accounting, the regulations state that a taxpayer who provides audit and financial statement preparation and tax return preparation is providing services in the field of accounting.[114] The Tax Court discussed the meaning of accounting under these regulations, and held that tax return preparation and bookkeeping services provided to clients are accounting services even when the services do not constitute public accounting and do not require a state CPA license.[115] The court added that accounting includes determining in which annual accounting period revenues and expenditures are to be recognized, and bookkeeping, which is a branch of accounting.[116]

However, payroll processing services and accounts receivable collection services likely extend too far beyond these limited categories to be considered accounting. A payroll processor

[109]Section 448 states that a C corporation may not use the cash method of accounting unless it falls under one of several exceptions, one of which is qualification as a personal service corporation. A personal service corporation is defined in part as a corporation that performs substantially all its activities as services "in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting." Section 448(d)(2)(A).

[110]Temp. reg. section 1.448-1T(e)(4)(iv)(A).

[111]It's unclear whether it is appropriate to rely on the section 199A regulations as a source of guidance for the meaning of consulting as used in section 1202. Section 199A permits a 20 percent deduction for a "specified service trade or business," which is defined in section 199A(d) to exclude the services listed in section 1202(e)(3)(A), one of which is consulting. Section 199A(d)(2)(A). In defining the term "consulting," the section 199A regulations adopt the same language as used in the section 448 proposed regulations — "advice and counsel," and provide a detailed explanation of its scope. However, the preamble to the section 199A final regulations states that "the rules for determining whether a business is a specified service trade or business within the meaning of section 199A(d)(2) apply solely for purposes of section 199A and therefore, may not be taken into account for purposes of applying any other provision of law, except to the extent that another provision expressly refers to section 199A(d)." T.D. 9847; *see also* reg. section 1.199A-5(a)(1). The breadth of these "solely for purposes of section 199A" statements is striking, given that section 199A(d)(2)(a) expressly refers to services listed in section 1202(e)(3)(A).

[112]The preamble to the section 199A proposed regulations states that "the text of section 1202(e)(3)(A) substantially tracks the definition of 'qualified personal service corporation' under section 448." Notice of Proposed Rulemaking, REG-107892-18, 83 F.R. 40884 (Aug. 16, 2018).

[113]An article we wrote includes additional discussion of this issue. *See* Wiener and Gottschalk, "What Does 'Consulting' Mean for Purposes of Sec. 1202?" *The Tax Adviser*, Apr. 2020.

[114]Reg. section 1.448-1T(e)(5)(vi), example 1. *See also* TAM 8927006 (Jan. 1, 1989) (a business that filed insurance claims, billed patients, and provided bookkeeping services only to the extent necessary to process the billings, was not involved in "accounting").

[115]*Rainbow Tax Service Inc v. Commissioner*, 128 T.C. 42 (2007).

[116]*Id.*

typically is responsible for processing payroll for a company's employees. Its duties include validating employee work hours, calculating wages, and issuing checks to the employees.[117] An accounts receivable collection service is responsible for collecting debts owed to its customers. Neither of these services is akin to conventional accounting services, which typically involve documenting, reporting, or testing regarding revenues, expenditures, or financial results of entities or persons on a daily or periodic basis. Accordingly, payroll processing services and accounts receivable collection services do not appear to constitute accounting under section 1202(e)(3)(A).

C. The Meaning of a Business Whose Principal Asset Is the Skill of Its Employees

Section 1202(e)(3)(A) provides that aside from the enumerated disqualified trades or businesses, a business in which "the principal asset of the trade or business is the reputation or skill of one or more of its employees" is not a QTOB. This language could be read broadly to draw into the ambit of section 1202(e)(3) almost every skill-based business. Here, too, the code and regulations do not provide a definition or explanation.

The section 199A regulations, however, construe this principal asset provision to refer to a narrow range of services such as endorsing products, licensing one's name, and appearing at an event.[118] Although these regulations only control regarding section 199A,[119] their reasoning may also apply to section 1202.[120] It is reasonable to interpret the section 1202(e)(3) principal asset clause narrowly, as it would be inconsistent with the "text, structure, and purpose"[121] of section 1202 to exclude sales of stock in all service businesses, most of which involve employee reputation or skill, from qualifying for the section 1202 deduction. A strictly literal (that is, broad) interpretation of the phrase "any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees" would create a substantial redundancy because the inclusion of "health, law, engineering, architecture, accounting, actuarial science" would be superfluous.[122]

Accordingly, it is reasonable to conclude that the provision refers to the narrow range of services listed in the section 199A regulations and similar services.[123]

VI. Question Involving the Dollar Limitation

As noted, the amount of gain a taxpayer is eligible to exclude is limited to the greater of (1) \$10 million for all the taxpayer's QSBS; and (2) 10 times the aggregate adjusted basis of the

[117] *See, e.g.*, ZipRecruiter, What Is a Payroll Processor?

[118] Reg. section 1.199A-5(b)(2)(xiv)(B). The preamble explains that "a broad interpretation of the reputation and skill clause would result in substantial uncertainty for both taxpayers and the IRS." Further, "it would be inconsistent with the text, structure, and purpose of section 199A to potentially exclude income from all service businesses from qualifying for the section 199A deduction" and "if Congressional intent was to exclude all service businesses, Congress clearly could have drafted such a rule." T.D. 9847 (Feb. 4, 2019).

[119] See the language for the regulation preamble, *supra* note 111.

[120] Section 199A's categories of excluded services are defined by reference to the excluded services of section 1202(e)(3). Section 199A permits some taxpayers to take a deduction for up to 20 percent of income from a "qualified trade or business." Section 199A(b). A trade or business is qualified if it does not consist of "performing services as an employee" and is not a "specified service trade or business." Section 199A(d)(1). Section 199A defines the term "specified service trade or business" to mean any trade or business (i) that is described in section 1202(e)(3)(A), with minor exceptions, or (ii) that involves the performance of investing, trading, or other related services (as specified therein). Section 199A(d)(2)(A). Since section 199A determines the QTOB excluded services by explicit reference to section 1202(e)(3)(A), it stands to reason that the rationale provided to interpret the section 199A excluded services can be instructive for purposes of interpreting the section 1202(e)(3) excluded services.

[121] *See* reg. section 1.199A-5(b)(2)(xiv)(B).

[122] Under the surplusage canon of statutory construction, an interpretation of a statute that creates redundancy is to be avoided if possible. *See, e.g.*, *Corley v. United States*, 556 U.S. 303 (2009) (quoting *Hibbs v. Winn*, 542 U.S. 88 (2004) ("A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant."). *See also* Scalia and Garner, *supra* note 62, at 440 ("If possible, every word and every provision is to be given effect.").

[123] *See also* LTR 201717010 (Apr. 28, 2017) (diagnostic testing business was not disqualified under the principal asset provision, even though the diagnostic testing services were required to be performed by highly trained employees); LTR 201436001 (May 22, 2014) (pharmaceutical company was a QTOB); *Owen v. Commissioner*, T.C. Memo 2012-21 (an insurance sales company's "training and organizational structure" — rather than its business owner's expertise — were its principal assets).

corporation's QSBS disposed of by the taxpayer in the tax year.[124] As enacted, the gain exclusion applied to a maximum of 50 percent of a taxpayer's recognized gain on sale or disposition of QSBS. The exclusion was later increased to 75 percent for QSBS acquired after February 17, 2009, and then to 100 percent for QSBS acquired after September 27, 2010.

The interrelationship of these two rules — 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?[125] The answer can make a difference when computing the amount of excluded gain regarding QSBS issued before September 27, 2010.

For example, suppose Susan Nuts incorporated Soup Nuts Inc. before February 17, 2009, at a time when the exclusion percentage was 50 percent. In 2020 she sold her Soup Nuts stock, in which her basis is zero, for $18 million. The $18 million of gain is limited by both (1) the greater of $10 million or 10 times basis limitation (limiting Susan's exclusion amount to $10 million, because her basis in the Soup Nuts stock was zero) and (2) the 50 percent exclusion percentage. Should Susan first apply the limitation (which reduces the eligible gain to $10 million) and then apply the exclusion percentage of 50 percent, yielding an exclusion amount of $5 million? Or should Susan instead first apply the exclusion percentage of 50 percent (which reduces the eligible gain to $9 million) and then apply the $10 million limitation, for a final exclusion amount of $9 million?

The better answer is to first apply the gain limitation and then apply the exclusion percentage, resulting in $5 million of excluded gain. 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).[126] 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).

Moreover, legislative history 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]."[127] This explanation, by specifying "gain eligible for the 50 percent exclusion," clearly indicates that taxpayers should apply the gain limitation before applying the exclusion percentage.

VII. Conclusion

The capital gain exclusion benefit provided by section 1202 can provide a tax benefit worth many millions of dollars to a taxpayer selling corporate stock. The section 1202 rules contain significant ambiguity and raise numerous questions, including those discussed in this article. Taxpayers' increased consideration and use of section 1202's benefit over the years has required practitioners to consider these questions more frequently. We hope this article will assist tax practitioners in addressing some of these questions. ■

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

[125] Several commentators discuss this question. *See* Ward et al., "The Fact and the Fantasy of I.R.C. Section 1202: An Illustrative Overview and Analysis," 8 *Entrepreneurial Exec.* 39, 42 (2003); "Quest," part 1, *supra* note 4, at 25.

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

[127] Conference Report, *supra* note 47, at 523.