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Qualified Small Business Stock: Quest for Quantum Exclusions, Part 3

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In this three-part report, the authors analyze the section 1202 qualified small business stock (QSBS) exclusion and planning with QSBS. This final installment closely examines and analyzes the most controversial issues surrounding QSBS planning, including defining transfers "by gift," multiplying the QSBS exclusion benefits, S corporation planning with QSBS, carried interest, the treatment of installment sales, and whether QSBS and qualified Opportunity Zone investments can be combined.

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A. How Are Various Transfers Defined?

1. Transfers by gift or at death.

Section 1202 provides that a transfer "by gift" or "at death" to a transferee will be treated as if the transferee had acquired the stock in the same manner as the transferor (continuing to satisfy the original issuance requirement) and as having a tacked holding period for the stock.[1] Transfers by gift and at death are not defined in section 1202, although the instructions to Schedule D refer to a transfer at death as an "inheritance."[2] The term "gift" is defined in chapter 12 of the code,[3] and chapter 11 broadly describes how specific transfers of property at the death of a decedent will be taxed for estate tax purposes.[4] Some commentators have asserted that transfers "by gift" and "at death" refer to whether the transfers would be considered taxable gifts for gift tax purposes or transfers subject to estate tax. We respectfully disagree. Section 1202 is an income tax section under chapter 1, and we believe the definition of gift should be determined under income tax principles, not transfer tax principles.

There is no definition of gift or a transfer at death in chapter 1. Rather, for income tax purposes, whether a gift has occurred is a question of fact.[5] The Supreme Court wrote, "The meaning of the term 'gift' as applied to particular transfers has always been a matter of contention. Specific and illuminating legislative history on the point does not appear to exist. Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious."[6] The courts have consistently held that a gift for income tax purposes should be defined and interpreted without reliance on how it is defined for transfer tax purposes. In one opinion the Second Circuit wrote:

> But we find nothing in this decision to show that a transfer, taxable as a gift under the gift tax, is ipso facto to be treated as a gift in construing the income tax law. . . . In our opinion the income tax provisions are not to be construed as though they were in pari materia with either the estate tax law or the gift tax statutes. . . . Because of this we think that a transfer which should be classed as a gift under the gift tax law is not necessarily to be treated as a gift income-tax-wise.[7]

In another opinion, the Ninth Circuit wrote:

> We are not here concerned with the interpretation of statutes defining gift tax obligations. Our problem involves section 102(a) of the Internal Revenue Code of 1954, pertaining to taxable income. We are not necessarily bound by the considerations which might result in the finding of a taxable gift under section 2512 of the Code.[8]

In most instances, the determination of whether someone has received a gift or a bequest/inheritance for income tax purposes is to resolve the question of who should be taxed on the income of the property, based on the facts and

[1] Section 1202(h)(1), (h)(2)(A), and (B).

[2] *See* 2017 Instructions for Schedule D, "Capital Gains and Losses."

[3] The regulations provide, for example, that a gift, for gift tax purposes, includes "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed." Reg. section 25.2511-1(c). Further, a gift, for gift tax purposes, is not limited to a gift under the common law, which is a voluntary transfer without consideration. Reg. section 25.2511-8.

[4] *See* sections 2031 through 2046.

[5] *See Commissioner v. Duberstein*, 363 U.S. 278 (1960).

[6] *Id.* at 284. *See also United States v. Davis*, 370 U.S. 65, 69 (1962) ("In interpreting the particular income tax provisions here involved, we find ourselves unfettered by the language and considerations ingrained in the gift and estate tax statutes.").

[7] *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812, 814-815 (2d Cir. 1947).

[8] *Hamberg v. Commissioner*, 400 F.2d 435, 438 (9th Cir. 1968).

circumstances and income tax section at issue. Under section 102, gross income of the transferee does not include the value of property acquired by gift, bequest, devise, or inheritance.[9] The issue is often whether a particular transfer is a gift or bequest, on one hand, or a sale of an asset or the payment of compensation, a dividend, interest, or other taxable income to the transferee, on the other hand. Importantly, when a transferor makes a gift or a bequest, the transferor is no longer the taxpayer for income tax purposes. After the gift or bequest, the transferee has responsibility for the payment of tax on any taxable income related to the property.

On the question of adjusted basis of the transferred property, under section 1015(a), if a transferor gifts property, the transferee's basis in the property will be the same as it would be in the hands of the donor (carryover basis).[10] If the fair market value of the gift is less than the donor's basis, the donee's basis on a subsequent sale of the property will depend on whether the sale creates a gain or a loss. If the donee recognizes a loss, the donee's basis for purposes of determining the recognizable amount of that loss is the FMV of the property at the time of the gift. If the donee recognizes a gain, the donee's basis for purposes of determining the recognizable amount of that gain is the donor's basis at the time of the gift.[11] Under section 1014, if a transferee acquires property "from a decedent or to whom the property passed from a decedent," the transferee's basis in the property will be the FMV of the property "at the date of the decedent's death."[12]

With the foregoing in mind, we believe a transfer "by gift" under section 1202(h)(2)(A) is properly interpreted to mean a transfer that has the following elements:

1. the transfer is recognized for income tax purposes but is not a taxable sale or exchange;
2. after the transfer, a different taxpayer becomes the owner of the stock for income tax purposes, and thereafter the taxpayer has responsibility for the payment of tax on any taxable income related to the stock; and
3. the transferee's basis in the stock will be the same as it would be in the hands of the transferor under section 1015.

Thus, any transfer to a grantor trust, regardless of whether it is considered a taxable gift for gift tax purposes, should simply be ignored, and clearly no transfer "by gift" has occurred. Further, an installment sale to an intentionally defective grantor trust (IDGT) would also be ignored. The IRS's position over the past few decades has consistently been that a grantor trust is not treated as a separate entity from the grantor for federal income tax purposes.[13] As such, these transfers are not recognized for income tax purposes, and none of them result in a different taxpayer-transferee.[14] The regulations acknowledge that the transfer of property to a grantor trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.[15] The IRS has also ruled that the termination of grantor trust status results in a transfer, for income tax purposes, of the underlying assets held by the grantor trust.[16] Consequently, the loss of grantor trust status, whether caused by the death of the grantor or some other reason (for example, the release of a power,[17] a change in trustees,[18] or a repayment of borrowed trust assets[19]) is considered a transfer that would qualify as a transfer by gift under section

[9] Section 102(a).

[10] Section 1015(a). The basis of the property is increased by any federal gift tax paid attributable to any appreciation in the property transferred. Section 1015(d).

[11] *See* reg. section 1.1015-1(a)(1) and (2). A sale at an amount somewhere in between the basis for determining loss and the basis for determining gain results in no gain or loss recognized.

[12] Section 1014(a)(1).

[13] *See* section 671; Rev. Rul. 85-13, 1985-1 C.B. 184; Rev. Rul. 2007-13, 2007-1 C.B. 684; ILM 201343021; and reg. section 1.1001-2(c). *But see Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984); and Rev. Rul. 74-243, 1974-1 C.B. 106.

[14] *See also* LTR 9508007 and LTR 9535026 (There is no change in the adjusted basis and holding period of stock "sold" to a grantor trust.).

[15] Reg. section 1.671-2(e)(2)(i). Section 2511(c) also provides that "a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse" under the grantor trust rules of sections 671 through 679.

[16] *See* Rev. Rul. 77-402, 1977-2 C.B. 122; *Madorin v. Commissioner*, 84 T.C. 667 (1985); reg. section 1.1001-2(c), Example 5; TAM 200011005; and GCM 37228 (Aug. 23, 1977).

[17] *E.g.*, section 675(4)(C) power.

[18] *E.g.*, section 674(c) power.

[19] *E.g.*, section 675(c).

1202(h)(2)(A).[20] If the stock in the grantor trust is subject to debt, taxable gain will be recognized to the extent that the debt encumbering the property exceeds its tax basis. Under that circumstance, the IRS could take the position that the transfer should be considered part gift, part sale. The result would be that the sale portion of the transfer would be a disqualifying transfer for qualified small business stock purposes, but the gift portion would be a permissible transfer retaining QSBS status.

The IRS has yet to affirmatively rule on the resulting tax basis of property in a grantor trust (specifically, an IDGT, whose assets generally will not be includable in the grantor's estate[21]) when grantor trust status is terminated, particularly if the termination event is the death of the grantor.[22] Some notable commentators believe that the assets qualify for a step-up in basis under section 1014.[23] Most practitioners and commentators take the position that whatever assets happen to be in the IDGT at the time of the grantor's death carry their historical tax basis (carryover basis), because the assets are treated as if they had been transferred by gift under section 1015(a) (or section 1015(b), as proposed in a recent article[24]). The IRS has implied this result already. For example, it has ruled that when property transferred to a grantor trust is transferred to the grantor under the terms of the trust instrument at the termination of the trust, its basis is the same as the basis of the property in the hands of the grantor upon the original contribution.[25]

Based on the foregoing, we believe a transfer by gift under section 1202(h)(2)(A) would include:

1. a gratuitous transfer of QSBS to another individual;
2. a gratuitous transfer of QSBS to a non-grantor trust (including a non-grantor charitable lead trust), regardless of whether that transfer is considered a taxable gift for gift tax purposes;
3. a gratuitous transfer of QSBS to a charitable remainder trust;
4. a distribution of QSBS from a grantor or non-grantor trust to an individual beneficiary, other than the grantor;
5. a distribution of QSBS from a grantor or non-grantor trust to another non-grantor trust that is a separate taxpayer from the distributing trust, under a decanting or otherwise;[26]
6. a transfer of QSBS from a trust under the exercise of a limited (and, as discussed later, a general) power of appointment,[27] in favor of an individual or another non-grantor trust that is treated as a separate taxpayer;
7. a segregation of stock that is being held for the benefit of a group of beneficiaries into a separate share for the benefit of one or more of those beneficiaries,[28] provided the separate share is treated as a separate taxpayer for income tax purposes, having its own tax identification number and filing a separate tax return; and
8. a deemed transfer upon a termination of grantor trust status for any reason, including

[20] *See, e.g., Crane v. Commissioner*, 331 U.S. 1 (1947); *see also* reg. section 1.1001-2(a)(4)(v) and (c), Example 5; and Rev. Rul. 77-402 in the partnership context. The IRS could take the position that in this instance the transfer would be considered part gift, part sale.

[21] In 2015 the IRS put on its no-rule list the issue of "whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not included in the gross estate of that owner." Rev. Proc. 2015-37, 2015-26 IRB 1196.

[22] *See* ECC 200937028, dealing with a taxpayer who transferred assets into a trust and reserved the power to substitute assets. In the ruling, the chief counsel cites reg. section 1.1014-1(a) and concludes, "it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9)."

[23] Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 *J. Tax'n* 149 (2002); and Elliott Manning and Jerome M. Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements," 24 *Tax Mgmt. Est., Gifts & Tr. J.* 3 (1999).

[24] *See* Austin Bramwell and Stephanie Vara, "Basis of Grantor Trust Assets at Death: What Treasury Should Do," *Tax Notes*, Aug. 6, 2018, p. 793. The authors argue that section 1015(b) specifically should apply to determine the basis of assets in IDGTs when termination of grantor trust status is caused by the death of the grantor. For purposes of this report, the result is the same: carryover basis to the transferee, provided no taxable sale or exchange has occurred.

[25] Rev. Rul. 72-406, 1972-2 C.B. 462. *See also Du Pont v. Commissioner*, 18 B.T.A. 1028 (1930).

[26] Also assuming the trust is not subject to the multiple trust rules under section 643(f), as discussed later.

[27] Restatement Third of Property: Wills and Other Donative Transfers, section 17.1, comment c, provides: "A power of appointment traditionally confers the authority to designate recipients of beneficial ownership interests in or powers of appointment over property that the [powerholder] does not own." Upon the exercise of a power of appointment, the doctrine of relation back provides that the appointed property passes directly from the donor to the appointee. The power holder's appointment is deemed to relate back to and become part of the donor's original instrument. The power holder is akin to the donor's agent.

[28] *See* section 663(c); and reg. section 1.663(c)-3(c).

the death of the grantor (provided there is no deemed taxable event because of debt exceeding basis).

Of course, the foregoing means that any transfer or transaction that is ignored for income tax purposes will *not* be considered a transfer by gift under section 1202(h)(2)(A) (or any other type of transfer for income tax purposes). As such, any transfer of QSBS from a grantor to a grantor trust will be disregarded, including a contribution to a revocable living trust, a taxable gift to an IDGT, an installment sale to an IDGT, and a contribution to a grantor charitable lead trust. Further, in contrast to the IRS's position on the termination of grantor trust status (that is, a recognized transfer for income tax purposes), the IRS has ruled that the conversion from non-grantor trust to grantor trust status is not a transfer.[29] Thus, the conversion is ignored for income tax purposes. It should be noted that all of the foregoing disregarded or ignored transfers are predicated on the grantor being deemed the owner of the entire trust rather than just a portion of the trust.[30]

This analysis regarding a transfer by gift is supported by the 2020 final qualified Opportunity Zone (QOZ) regulations. Gain deferred under an investment in a qualified opportunity fund under section 1400Z-2(a) will be included in income if that investment is sold or exchanged before December 31, 2026.[31] Despite the "sold or exchanged" language of the code, the final regulations restate "sold or exchanged" in terms of an "inclusion event."[32] An inclusion event is generally any transfer to a different taxpayer and includes a "taxpayer's transfer of a qualifying investment by gift, as defined for purposes of chapter 12 . . . whether outright or in trust, . . . regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift."[33]

Regarding grantor trusts, the 2020 QOZ final regulations provide:

> If the owner of a qualifying investment contributes it to a trust and, under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (the grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust), the contribution to the grantor trust is not an inclusion event. Similarly, a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event.[34]

Notably, the 2020 final QOZ regulations expand the foregoing rule originally set out in the 2019 QOZ proposed regulations to provide, in addition, "Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust rules."[35] In other words, an inclusion event would not include, for example, a grantor's sale of a QOZ investment to his or her IDGT. The preamble to the 2020 final QOZ regulations states, "The Treasury Department and the IRS note that a defective grantor trust is a grantor trust for Federal income tax purposes, so its funding does not change the conclusion that the transfer is not an inclusion event under section 1400Z-2." As to "sales" to an IDGT, the preamble provides:

> A commenter also requested clarification that non-gift transactions between a grantor trust and its deemed owner that are not recognition events for Federal income tax purposes are not inclusion events, and that such transactions do not start a new holding period for purposes of section 1400Z. In such transactions, the deemed owner of the trust continues, for Federal income tax purposes, to be the taxpayer liable for the Federal income tax

[29] LTR 201730018 (ruling that the conversion of a non-grantor charitable lead annuity trust to grantor charitable lead annuity trust is "not a transfer of property held by Trust to Grantor as settlor of Trust for income tax purposes") and ILM 200923024 (ruling that the conversion of a non-grantor trust to a grantor trust would not result in taxable income to the grantor). In ILM 200923024, the IRS did not offer an opinion on whether a transfer is deemed to occur upon such a conversion, but it relied in part on Rev. Rul. 85-13 and essentially said no taxable event occurred upon the conversion.

[30] *See* reg. section 1.671-3.

[31] Section 1400Z-2(b)(1).

[32] Reg. section 1.1400Z2(b)-1(c).

[33] Reg. section 1.1400Z2(b)-1(c)(3).

[34] Reg. section 1.1400Z2(b)-1(c)(5)(i).

[35] *Id.*

> on the qualifying investment. Thus, the Treasury Department and the IRS have determined that, like transfers by the deemed owner to the grantor trust, these transactions (including transfers from the grantor trust to its deemed owner) are not inclusion events.

Regarding changes in grantor trust status, the 2020 final QOZ regulations provide, "In general, a change in the income tax status of an existing trust owning a qualifying investment in a QOF, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event."[36] If grantor trust status is changed because of the death of the grantor, it is not considered an inclusion event, but some rules applicable to the death of a taxpayer otherwise apply.[37]

Defining a transfer "at death" under section 1202(h)(2)(B) is a bit more circumspect. No authority addresses the scope of transfers that qualify as transfers at death for section 1202 purposes. Given this silence, we looked for additional income tax rules that might support a reasonable construction of this criterion. Section 1014, describing the basis of property acquired from a decedent or to whom the property is passed from a decedent, provides the closest analog to define transfers at death in the income tax context. The class of property that could be treated as "acquired from" or "passing from" a decedent could be extremely broad based on the general meaning of those terms. However, section 1014(b) specifically defines the types of transfers considered to pass from or be acquired from a decedent, and the basis adjustment is limited to those categories.[38] Thus, while helpful in providing a close conceptual comparison, interpretation of section 1202(h)(2)(B) by analogy to section 1014(b) may be conservative.

Practitioners often describe the basis adjustment under section 1014(b) by shorthand reference as the adjustment for transfers subject to inclusion in the gross estate for estate tax purposes. However, that inclusion is only one potential ground for the adjustment, and the full list applicable to decedents now dying includes the following[39]:

1. property acquired from the decedent by bequest, devise, or inheritance, or by the decedent's estate;
2. property the decedent transferred during lifetime in trust to pay the income for life to, or on the decedent's order or direction, if the decedent reserved the right at all times before his death to revoke the trust;
3. property the decedent transferred during lifetime in trust to pay the income for life to, or on the decedent's order, or direction, if the decedent reserved the right at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;[40]
4. property passing without full and adequate consideration under a general power of appointment the decedent exercised by will;
5. property representing the surviving spouse's one-half share of community property held by the decedent and the surviving spouse, if at least half of the whole community property interest was includable in the decedent's gross estate for federal estate tax purposes;[41]
6. property acquired from the decedent because of death, the form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if as a result the property is included in the

[36] Reg. section 1.1400Z2(b)-1(c)(5)(ii).

[37] *See* reg. section 1.1400Z2(b)-1(c)(5)(ii) and (c)(4).

[38] *Collins v. United States*, 318 F. Supp. 382 (C.D. Cal. 1970), *aff'd per curiam*, 448 F.2d 787 (9th Cir. 1971) (rejecting a spouse's argument that section 1014(b) applies to additional transfers caused by a decedent's death that are not identified in the statute because the statutory categories are not exclusive).

[39] *See* section 1014(b). Further, section 1014(b)(5) also treats as acquired or passing from a decedent who died after August 26, 1937, and before January 1, 2005, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, if the property consists of stock or securities of a foreign corporation, which for its tax year next preceding the date of the decedent's death was, under the law applicable to that year, a foreign personal holding company. That property is excluded from the separate section 1014(b)(9) category for transfers of property included in the gross estate for federal estate tax purposes. Section 1014(b)(9)(B).

[40] For decedents dying after December 31, 1951. Section 1014(b)(3).

[41] For decedents dying after December 31, 1947. Section 1014(b)(6).

decedent's gross estate for federal estate tax purposes, except for some annuities and property described in any other paragraph of section 1014(b);[42] and

7. property of a marital qualified terminable interest property trust includable in the decedent's gross estate under section 2044.

The examples in this statutory list reflect a broad class characterized by the common element that they are effective at a decedent's death, even if the decedent did not directly own the property and if it was held in trust. Section 1014(b) makes clear that the transfer tax (that is, the gift, estate, or generation-skipping transfer tax) character or consequence of a transfer is not the sole or even primary determinant of the basis adjustment for income tax purposes. In fact, the estate tax inclusion category specifies that if it overlaps with any other category (which it certainly does), the other provision operates first to define the grounds for a basis adjustment. In the absence of more specific guidance regarding the meaning of "at death" under section 1202, application of the categories treated as transfers passing or acquired from a decedent for section 1014 purposes seems reasonable. These categories describe more of the transfers typical in modern planning than simple bequests. The expansiveness of the categories to include cases beyond the simple direct transfer at death from a decedent's estate (for example, by powers of appointment) is helpful.

Given the foregoing, we believe that a permissible transfer at death would reasonably include, at the least, a transfer that (1) is recognized for income tax purposes (but not a taxable sale or exchange), (2) results in a different taxpayer becoming the owner of the stock for income tax purposes, and (3) provides the transferee with basis determined under section 1014. As such, a permissible transfer at death includes:

1. a distribution of QSBS from the estate of the decedent who acquired the QSBS during lifetime to an individual beneficiary or testamentary trust;
2. a distribution of QSBS from a revocable living trust created and funded by a decedent who acquired the QSBS during lifetime to an individual beneficiary or trust created upon the death of the decedent;
3. a transfer of ownership in QSBS upon the death of a joint tenant who acquired the QSBS during lifetime, whether in accordance with a joint tenancy with right of survivorship or a joint tenancy by the entirety; and
4. any other transfer of ownership created upon the death of an individual who acquired the QSBS during lifetime under a beneficiary designation, transfer on death provision, or other similar method of transferring ownership.

2. Transfers related to partnerships.

As discussed previously, distributions of QSBS from a partnership to a partner are permissible transfers that allow for tacking of the holding period and retention of the QSBS status of the stock owned by the partnership, provided specific requirements and limitations are met.[43] There is no provision that allows for a transfer from a partner to a partnership. Thus, a contribution of QSBS stock by an eligible QSBS shareholder to a partnership in exchange for an interest in that partnership, followed by a sale of that stock by the partnership, would certainly not allow the partnership (or its partners) to get the exclusion benefit. The legislative history makes that clear.[44]

Less clear, however, is the situation in which a partner contributes QSBS to a partnership in a nontaxable exchange,[45] but before any sale of the

[42] For decedents dying after December 31, 1953. Section 1014(b)(9).

[43] Section 1202(h)(2)(C). The requirements generally provide that the exclusion benefits of section 1202 will be limited by the interest "held by the taxpayer on the date on which such pass-thru entity acquired such stock," and may not exceed the amount that would have been excludable "by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired." Section 1202(g).

[44] "Transferees 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." H.R. Rep. No. 103-213, at 526 (1993) (conference report on the Omnibus Budget Reconciliation Act of 1993).

[45] *See* Section 721(a).

QSBS, the stock is distributed back to the contributing partner. Presumably the contribution and distribution would not be a taxable event.[46] If the QSBS is then sold by the original taxpayer who acquired it by original issuance, shouldn't that taxpayer still be allowed to claim the QSBS exclusion benefit under section 1202(a)? It seems that no tax policy is violated in this instance, and this might be a way to "save" inadvertent contributions of QSBS to family limited partnerships. In other words, whether specific transfers are disqualifying might best be determined at the time of sale. Again, guidance would be appreciated on this issue.

In contrast, if an individual QSBS shareholder contributed the QSBS to a wholly owned limited liability company that is treated as a disregarded entity, the contribution of the QSBS in exchange for interests in the disregarded entity would not be a transfer for income tax purposes.[47] QSBS status would be retained, unless and until the LLC became another taxable entity like a partnership, at which time it is possible the conversion would disqualify the stock.[48] The IRS has provided guidance on the tax issues involved in a conversion of a disregarded entity to a partnership. In both of the illustrated situations, the IRS ruled that the conversion is treated as if the underlying assets in the disregarded entity are contributed to a newly formed partnership in exchange for an interest in the partnership. Thus, a conversion may be treated as a contribution to a partnership by a partner, which is not a permissible transfer. However, as just discussed, if the QSBS is distributed back to the "contributing" partner because of a conversion before the sale of QSBS and that QSBS is sold by that partner, shouldn't the partner be entitled to the QSBS exclusion benefit?

It is unclear whether a permissible transfer "by gift" includes a gratuitous transfer of an interest in a partnership that holds properly acquired QSBS at original issuance. For a partner to be afforded exclusion benefits on partnership QSBS, section 1202(g)(2)(B) requires not only that the partnership interest be "held by the taxpayer" on the date the QSBS was acquired but also that the partnership interest be held "at all times thereafter before the disposition of such stock by such pass-thru entity."[49] If a donor gifts an interest in the partnership to a grantor trust, the transfer will be ignored, and QSBS status is retained because the donor remains the taxpayer for section 1202 purposes. If, on the other hand, a donor gifts an interest in the partnership to another taxpayer, on its face, the donor did not "at all times thereafter" hold the partnership interest. Thus, the gift of the partnership interest could have disqualified the stock, at least for the gifted portion of the partnership interest. This seems a particularly harsh result because the QSBS could have been distributed to the original taxpayer and then gifted to the donee, and QSBS status would be retained for the benefit of the donee. The partnership rules provide several mechanisms to ensure that any built-in gain or loss or other economic interest associated with the transferred interest passes to a transferee. For example, regulations provide:

> If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.[50]

Also, the regulations provide that in defining an eligible partner for section 1045 rollover purposes, "A taxpayer who acquires from a partner . . . by gift or at death an interest in a partnership that holds QSB stock is treated as having held the acquired interest in the

[46]This is true even if the distribution occurred within seven years of its original contribution, because the mixing bowl provisions do not apply if the contributed property is distributed back to the contributing partner. *See* sections 707(c)(1)(B) and 737.

[47]The entity is "disregarded as an entity separate from its owner if it has a single owner," and this applies for federal tax purposes. Reg. section 301.7701-3(b)(1)(ii).

[48]*See* Rev. Rul. 99-5, 1999-1 C.B. 434.

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

[50]Reg. section 1.704-3(a)(7). Also, the regulations provide that "upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner." Reg. section 1.704-1(b)(2)(iv)(*l*) and (b)(5), Example 13.

partnership during the period the partner . . . held the interest in the partnership."[51] This regulation may not, however, apply for all section 1202 purposes. Thus, until the IRS provides guidance on this issue, practitioners should avoid making gifts of interests of partnerships that hold QSBS.

On the other hand, the transfer of an interest in a disregarded entity holding QSBS to a grantor trust, like a grantor-retained annuity trust (GRAT), would not be considered a transfer for income tax purposes unless and until the disregarded entity became another taxable entity, like a partnership. If, for example, the GRAT term expires, and the disregarded entity shares are distributed to another grantor trust for the benefit of the grantor's children, QSBS status would be retained. On the other hand, if (1) the GRAT term expires and a portion of the disregarded entity shares are distributed to children or a non-grantor trust, or (2) the grantor dies, thereby terminating grantor trust status, the disregarded entity will convert to a different taxable entity (that is, a partnership), and QSBS status is lost. Given the risk of losing QSBS status, practitioners should consider liquidating the disregarded entity before the event that will cause it to convert to a different taxable entity.

3. Powers of appointment.

It is unclear how a transfer under the exercise or lapse of a testamentary general power of appointment should be treated for these purposes. As noted earlier, a transfer under a limited power of appointment would qualify in part as a transfer by gift because the powers of appointment under common law are treated as if the power holder is acting as the agent of the donor. Upon the exercise of a power of appointment, the doctrine of relation back provides that the appointed property passes directly from the donor to the appointee, without any ownership by the power holder. This applies whether the power of appointment is limited or general. For transfer tax purposes, a general power of appointment, whether exercised or not, causes estate and gift tax inclusion of the assets subject to the power, resulting in a step-up in basis under section 1014,[52] and the power holder is deemed the transferor.[53] For income tax purposes, however, the regulations provide that for a grantor trust, if a power holder exercises a general power of appointment (not a lapse) in favor of a transferee trust, the power holder is treated as the grantor of the transferee trust.[54]

Ultimately, we believe that the step-up in basis resulting from the exercise of a testamentary general power of appointment does not alter the treatment of the transfer as one "by gift." This is because the step-up in basis is caused by inclusion at the power holder's death, not the original donor's death (which is needed, in our opinion, for the transfer to be considered a permissible transfer at death under section 1202(h)(2)(B)). Indeed, the transfer of QSBS under the exercise of an *inter vivos* general power of appointment would provide a carryover basis to the transferee. Thus, we conclude that the transfer of QSBS under the exercise of a limited or a general power of appointment, whether exercised during the lifetime or at the death of the power holder, is a permissible transfer by gift under section 1202(h)(2)(A). The lapse of a general or limited power is ignored for QSBS purposes, and it makes no difference whether the transferee acquires a carryover basis or a step-up in basis on the QSBS.

4. Summary of movement of QSBS shares.

The appendix summarizes how different transfers or deemed transfers are treated for section 1202 purposes, denoting when the transfer is (1) a permissible transfer, (2) a disqualifying transfer that results in the loss of QSBS status, (3) an ignored transfer that retains QSBS status, or (4) a transfer that results in an additional $10-million-per-taxpayer limitation for the transferee.

B. Can You 'Stack' and 'Pack' the Per-Issuer Limitation?

1. Generally.

As discussed previously, the per-issuer limitation is on a per-issuer (per-corporation),

[51] Reg. section 1.1045-1(g)(3)(ii).

[52] Sections 2041, 1014(b)(9), and 1014(b)(4).

[53] *See* section 2652(a); and reg. section 26.2652-1(a).

[54] Reg. section 1.671-2(e)(5).

per-taxpayer basis. Further, the per-issuer limitation has two mutually exclusive limitations: (1) the $10-million-per-taxpayer limitation, and (2) the 10-times-basis limitation. At an initial glance, it may seem that taxpayers are limited to one or the other, but a careful reading of the statute makes it clear that taxpayers are entitled to both the limitations, not just the greater of the two. Section 1202(b)(1) provides that the QSBS exclusion benefit "for the taxable year" may not exceed the greater of the two limitations. Thus, each tax year in which the taxpayer has eligible gain on QSBS, either the $10-million-per-taxpayer limitation or the 10-times-basis limitation will be applied (the greater of the two of them).

The $10-million-per-taxpayer limitation is reduced by eligible gains taken in previous tax years, and once the taxpayer has recognized an aggregate of $10 million of eligible gain under this limitation, the taxpayer no longer has this limitation available. On the other hand, the 10-times-basis limitation is taken into account only for the tax year in question, and it is not reduced by eligible gains taken in previous years. This means that the order in which QSBS is sold is extremely important. Assume taxpayer A acquires two lots of QSBS: lot 1 (100 shares) for $800,000 in 2011, and lot 2 (also 100 shares) for $1.2 million in 2012 (each qualifying for the 100 percent exclusion with an aggregate tax basis of $2 million). Assume that A holds both lots of QSBS for more than five years, and A's total holdings in QSBS are worth $30 million (each lot is worth $15 million).

Scenario 1: If A sells all the QSBS for $30 million in 2018, the total realized gain is $28 million. The greater of the two limitations is the 10-times-basis limitation, allowing A to exclude $20 million (excluded section 1202 gain) and recognize $8 million of long-term capital gain (non-section 1202 gain).

Scenario 2: If A sells lot 1 for $15 million in 2018 (realizing $14.2 million of gain) and lot 2 for $15 million the next year (realizing $13.8 million of gain), the per-issuer limitation would be applied in the following manner: Lot 1 has a tax basis of $800,000, and the 10-times-basis limitation would be only $8 million. Therefore, in 2018 the $10-million-per-taxpayer limitation must be applied, and A recognizes $4.2 million of gain. Lot 2 has a tax basis of $1.2 million, and the 10-times-basis limitation would be $12 million. Therefore, in 2019 A recognizes $1.8 million. Over the two years, A recognizes an aggregate of $6 million of gain.

Scenario 3: If A sells lot 2 for $15 million in 2018 (realizing $13.8 million of gain) and lot 1 for $15 million in 2019 (realizing $14.2 million of gain), the per-issuer limitation would be applied in the following manner: Lot 2 has a tax basis of $1.2 million, and the greater of the two limitations is the 10-times-basis limitation ($12 million). Therefore, on the sale of lot 2 in 2018, A recognizes $1.8 million of gain. Lot 1 has a tax basis of $800,000, and the 10-times-basis limitation would be only $8 million. Thus, one would hope to use the $10-million-per-taxpayer limitation. However, the code says the $10 million cap is "reduced by the aggregate amount of eligible gain taken into account by the taxpayer under [section 1202(a)] for prior taxable years."[55] In this example, A excluded $12 million of gain in 2018, and as a result, A no longer has any of the $10-million-per-taxpayer limitation remaining. Thus, for the sale of lot 1 in 2019, only $8 million can be excluded, and A recognizes $6.2 million of gain. Over the two years, A recognizes an aggregate of $8 million (the same result as in Scenario 1).

As one can see, if a taxpayer holds 100 percent exclusion shares of QSBS, the taxpayer should seek to use the $10-million-per-taxpayer limitation first, choosing to sell the lowest-tax-basis lots first until that limitation is exhausted. Afterward, only the 10-times-basis limitation will be available, and selling higher-basis lots in those subsequent sales obviously increases the amount of eligible gain that can be excluded. If, however, a taxpayer holds 50 percent, 75 percent, and 100 percent exclusion shares of QSBS in the same issuer, the calculation of which lot to sell becomes more complicated because the 50 percent and 75 percent exclusion shares will create section 1202 gain, which is taxable at a maximum rate of 28 percent (31.8 percent), and will also reduce a taxpayer's $10-million-per-taxpayer limitation if sold first. The determination of which lots to sell becomes even more complicated if appreciated

[55] Section 1202(b)(1)(A).

assets are exchanged for QSBS in a section 351 exchange, since the unrecognized built-in gain inherent in the shares will not be excluded at all because they are non-section-1202 gain, which is taxable at the long-term capital gain tax rate.

2. 'Stacking' or multiplying the $10-million-per-taxpayer limitation.

One method of maximizing the potential section 1202 exclusion benefit is by multiplying the number of taxpayers entitled to the $10-million-per-taxpayer limitation. As discussed, each transfer by gift or at death to another taxpayer would create another $10-million-per-taxpayer limitation. Further, as noted, as long as the transferee of that transfer is an eligible QSBS shareholder like an individual or a non-grantor trust (but not a partnership, S corporation, or other passthrough entity), QSBS status is retained in the hands of the transferee. Subject to the multiple trust rules, discussed later, each transfer to a non-grantor trust would allow each trust to claim a separate $10-million-per-taxpayer limitation (in addition to the 10-times-basis limitation).

If QSBS is contributed to a non-grantor trust and the transfer is taxable for gift tax purposes, the donor will be able to take advantage of the temporary doubling of the "applicable exclusion amount" under the Tax Cuts and Jobs Act.[56] If a portion of the taxable gift qualifies for the annual gift tax exclusion because one or more of the trust beneficiaries has a *Crummey*[57] power to withdraw a portion of the QSBS contribution, and that power lapses, the IRS has ruled that the beneficiary will be treated as a part owner of the trust under section 678(a).[58] Under those circumstances, the donor's contribution of the QSBS to the trust will be treated as a permissible transfer by gift, and that transfer will result in at least two different taxpayers: the non-grantor trust and the deemed partial owner-beneficiaries under section 678(a). Those taxpayers would all presumably be able to claim a separate $10-million-per-taxpayer limitation.

For taxpayers who do not wish to make a taxable gift but desire to make a transfer by gift for section 1202 purposes, one possibility seems to be a transfer of QSBS to an "incomplete gift, non-grantor trust." Practitioners have used these trusts mostly for state income tax purposes, often taking advantage of the laws of Delaware (Delaware incomplete non-grantor trusts, or DINGs) and Nevada (Nevada incomplete non-grantor trusts, or NINGs).[59] These DINGs and NINGs ostensibly allow a donor to make a nontaxable gift of assets to a non-grantor trust that is treated as a separate taxpayer from the donor for income tax purposes, even though the donor is a permissible beneficiary of that trust.

Before 1997, a self-settled trust (a trust that provides for the benefit of the grantor) would not have qualified as a non-grantor trust. The regulations provide: "Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor."[60] Thus, if under state law creditors of the grantor can reach the assets of the trust, the trust will be considered a grantor trust for income tax purposes. Before 1997, all the states provided that creditors of a grantor could reach the assets of any self-settled trust. Since 1997, several states like Delaware and Nevada have enacted "domestic asset protection trust" statutes that allow grantors to create self-settled trusts but prohibit creditors of the grantor from reaching the assets in the trust. The contribution to the trust is deemed nontaxable because of specific powers of appointment, retained consent powers, and the imposition of distribution committees.[61]

A full discussion of DINGs and NINGs is beyond the scope of this report, but for QSBS

[56] Section 2010(c)(3).

[57] *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

[58] *See* LTR 200747002, LTR 200104005, LTR 200022035, LTR 200011058, LTR 200011054, LTR 200011056, LTR 199942037, LTR 199935046, LTR 199935047, and LTR 9812006.

[59] *See* Michael Gordon, "Using Self-Settled Asset Protection Trusts for Tax Planning Purposes," 53d Annual Southern Federal Tax Institute, at Outline Y (Oct. 2018); Peter Melcher and Steven J. Oshins, "New Private Letter Ruling Breathes Life Into Nevada Incomplete Gift Non-Grantor Trusts," Wealthmanagement.com, Apr. 16, 2013; and Oshins, "NING Trusts Provide Tax and Asset Protection Benefits," *CCH Estate Planning Review — The Journal*, at 150 (Aug. 20, 2013).

[60] Reg. section 1.677(a)-1(d).

[61] *See, e.g.*, LTR 201310002, LTR 201426014, LTR 201510006, LTR 201550005, LTR 201507008, and LTR 201614006.

purposes, the planning implications are straightforward. A transfer to a DING or NING would be a permissible transfer by gift, thereby allowing the DING or NING to claim its own $10-million-per-taxpayer limitation, even though the donor is a permissible beneficiary of that trust.

As mentioned, the $10-million-per-taxpayer limitation is reduced to $5 million per spouse if spouses file separately. So a transfer of QSBS to a spouse who files separately will not "stack" the $10-million-per-taxpayer limitation. This reduction does not apply to spouses filing jointly. Thus, a transfer of QSBS to a spouse with spouses filing jointly seemingly works to double the $10-million-per-taxpayer limitation. Because taxable gifts to spouses automatically qualify for the gift tax marital deduction,[62] this could be an easy way to double the exclusion limitation without incurring gift tax. For practitioners wary about uncertainty in the QSBS treatment of spouses filing jointly, a gift to an *inter vivos* QTIP trust can also be used.[63]

3. Multiple trust rules.

Section 643(f) authorizes Treasury to issue regulations under which two or more trusts would be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries; and (2) a principal purpose of the trust is the avoidance of a tax.[64] For this purpose, spouses are treated as one person.[65] Treasury recently issued final regulations under section 643(f),[66] in conjunction with its release of the final section 199A regulations. The new section 643(f) final regulations provide:

> For purposes of subchapter J of chapter 1 of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.[67]

The proposed section 643(f) regulations issued in 2018[68] provided a "principal purpose" provision, which read: "A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts."[69] This provision and the examples noted below were stricken from the final regulations. The preamble, in response to comments to the proposed regulations, explained:

> The Treasury Department and the IRS have removed the definition of "principal purpose" and the examples illustrating this rule that had been included in the proposed regulations, and are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as "principal purpose" and "substantially identical grantors and beneficiaries" should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms. Nevertheless, the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts

[62] *See* sections 2523(a) and section 1041 ("No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse. . . . The property shall be treated as acquired by the transferee by gift.").

[63] Section 2523(f).

[64] Section 643(f).

[65] *Id.* (flush language).

[66] T.D. 9847.

[67] Reg. section 1.643(f)-1(a).

[68] REG-107892-18.

[69] Prop. reg. section 1.643(f)-1(b).

entered into or modified before the effective date of these final regulations.

The proposed regulations under section 643(f) provided two examples. The first was a straightforward example in which multiple and nearly identical trusts were created solely to maximize the section 199A deduction, and the trusts were aggregated into a single trust.[70] The second example read as follows:

> *Example 2*. (i) X establishes two irrevocable trusts: one for the benefit of X's son, G, and the other for X's daughter, H. G is the income beneficiary of the first trust and the trustee is required to apply all income currently to G for G's life. H is the remainder beneficiary of the first trust. H is an income beneficiary of the second trust and the trust instrument permits the trustee to accumulate or to pay income, in its discretion, to H for H's education, support, and maintenance. The trustee also may pay income or corpus for G's medical expenses. H is the remainder beneficiary of the second trust and will receive the trust corpus upon G's death.
>
> (ii) Under these facts, there are significant non-tax differences between the substantive terms of the two trusts, so tax avoidance will not be presumed to be a principal purpose for the establishment or funding of the separate trusts. Accordingly, in the absence of other facts or circumstances that would indicate that a principal purpose for creating the two separate trusts was income tax avoidance, the two trusts will not be aggregated and treated as a single trust for Federal income tax purposes under this section.[71]

Even though that example was removed, it seems to imply that the aggregation of multiple trusts into one trust would not be applicable if, for example, a grantor created separate trusts for each of his or her children (and their descendants as remainder beneficiaries) even if each of the trust provisions were otherwise identical. Moreover, if significant differences existed between different trusts for the same group of beneficiaries, it would seem that aggregation would not be applicable either. The issue is how significant must these nontax differences be to avoid the aggregation of the trusts.

The effective date for the final section 643(f) regulations applies to tax years ending after August 16, 2018.[72] Although the preamble to the proposed regulations explains that it could apply to arrangements and trusts created before that point, "In the case of any arrangement involving multiple trusts entered into or modified before August 16, 2018, the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f)."[73] Significantly, the preamble to the proposed regulations points out that "the application of proposed [reg.] section 1.643(f)-1, however, is not limited to avoidance of the limitations under section 199A and proposed [reg.] sections 1.199A-1 through 1.199A-6."[74] As such, it is reasonable to expect these rules to be applied to some attempts to stack the $10-million-per-taxpayer limitation by using multiple trusts.

4. 'Packing' or maximizing the 10-times-basis limitation.

Because each QSBS taxpayer may ultimately exhaust its $10-million-per-taxpayer limitation and there are practical limitations on the amount of stacking or multiplying of different taxpayers that can be achieved, the 10-times-basis limitation is often more valuable to taxpayers. As mentioned, for purposes of the 10-times-basis limitation, if a taxpayer contributes property (other than money or stock) to a qualified small business (QSB), the basis "shall in no event be less than the fair market value of the property exchanged."[75] This gives taxpayers an opportunity to greatly increase the per-issuer limitation by contributing appreciated property in a section 351 nonrecognition transaction

[70] Prop. reg. section 1.643(f)-(1)(c), Example 1.

[71] Prop. reg. section 1.643(f)-(1)(c), Example 2.

[72] Prop. reg. section 1.643(f)-(1)(b).

[73] Preamble to REG-107892-18, 83 F.R. 40884, 40902 (Aug. 16, 2018).

[74] *Id.*

[75] Section 1202(i)(1)(B).

(including a conversion of a partnership to a corporation).

It is common for founders to contribute intellectual property to their start-up companies, and as such, the founders should be able to claim FMV of the property as their basis for purposes of the 10-times-basis limitation. From a planning standpoint, it is important that the values used be consistent with the values that are used for other purposes, including those used for section 409A purposes[76] and for different rounds of investor funding. Also, contributions of appreciated property need to be coordinated with the aggregate gross asset requirement (that is, $50 million). Although the aggregate gross asset requirement is based on the cash and adjusted bases of property held by the corporation, for this purpose the basis of contributed property is equal to its FMV at the time of the contribution.[77]

Often founders of companies will start their business as an entity taxed as a partnership (or a disregarded entity) so that the losses that are incurred at the beginning of the enterprise can be used by the founders on their individual income tax returns. When private equity or venture capital funding becomes available, they will often set a pre-funding, pre-money valuation for the enterprise. If, for example, the enterprise is valued at a pre-funding value of $40 million, the conversion of the partnership to a C corporation before the funding would set the per-issuer limitation for the founders at $400 million ($40 million FMV of enterprise value, which is contributed in exchange for shares in the QSB, multiplied by the 10-times-basis limitation). It is critical in the planning process that taxpayers properly document this conversion, including obtaining contemporaneous valuation appraisals. As noted earlier, one of the qualifications to be a QSB is that the corporation must agree to "submit such reports to the Secretary and to shareholders as the Secretary may require."[78]

5. 'Packing' the 10-times-basis limitation with non-eligible gain.

An interesting way to "pack" or maximize the 10-times-basis limitation is to coincide the taxable sale of QSBS that creates eligible gain (that is, five-year holding period QSBS) with the taxable sale of QSBS that is not eligible gain (that is, QSBS held for less than five years) in the same tax year. The code defines the 10-times-basis limitation as "10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year."[79] The code does *not* require that in calculating the aggregate adjusted bases of QSBS disposed of by the taxpayer during the tax year, it include only the bases of QSBS that would create eligible gain. Eligible gain includes only gain from QSBS that has been held for more than five years.[80] Therefore, a taxpayer can increase the 10-times-basis limitation by selling high-tax-basis QSBS that does not satisfy the five-year holding requirement (recognizing little or no gain) with very-low-tax-basis QSBS that does satisfy the five-year holding requirement.

This situation is not as unusual as it may seem at first. For example, imagine a founder of a corporation who has a great idea that has significant value but no tax basis (for example, a patent, copyright, process, or other type of IP). The value of the founder's shares is worth $30 million today, and over the years, her stake has been diluted by many rounds of financing over time. To keep the founder motivated, the company has granted her stock options. The stock options, if exercised, give the founder the right to purchase $4 million of stock at a strike price of $1 million ($3 million of ordinary income on exercise). The corporation is about to be sold to a buyer through a tender offer. If the founder sells her shares in the corporation along with the stock options, she would be limited to the $10-million-per-taxpayer limitation on the sale of the stock, and the options would not qualify for QSBS treatment at all.[81] Instead, the founder exercises

[76] *See* section 409A (determining gross income on nonqualified deferred compensation). If a privately held company issues options to a service provider at a valuation below the FMV, section 409A applies. *See* T.D. 9321 and reg. sections 1.409A-1 to -9.

[77] Section 1202(d)(2)(A) and (B).

[78] Section 1202(d)(1)(C).

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

[80] *See* section 1202(b)(2).

[81] *See Natkunanathan v. Commissioner*, T.C. Memo. 2010-15, *aff'd*, 479 Fed. App'x 775 (9th Cir. 2012).

the options before the sale and then immediately sells the newly acquired stock, along with the original stock held by her, to the buyer. The stock option shares are QSBS but do not meet the five-year holding requirement. However, because the founder is selling the option QSBS in the same tax year in which she is selling QSBS that satisfies the five-year holding period (that is, the zero-basis founder's stock), for purposes of the 10-times-basis limitation, the founder can use $4 million of aggregate adjusted bases to exclude as much as $40 million of eligible gain. As a result, $30 million of gain is excluded, at the cost of $3 million of ordinary income.

C. Can a Preexisting Trade or Business Become a QSB?

Some practitioners are surprised to discover that a preexisting business, even one that was in existence before the enactment of section 1202, can nonetheless become a QSB and provide its shareholders with the benefits of QSBS. Section 1202(c)(1) provides that QSBS is "any stock in a C corporation which is originally issued after the date of enactment of the Revenue Reconciliation Act of 1993." Of course, QSBS status also requires that the corporation meet the other requirements of section 1202. None of the other qualifications (that is, the active business requirement, the aggregate gross asset requirement, and the original issuance requirement) mandate that a QSB be a newly created start-up business. Further, as discussed earlier, in determining the acquisition dates for QSBS purposes, the legislative history makes it clear that historical holding periods of assets contributed to a QSB (under section 1223) do not apply for purposes of the formation of a C corporation or the conversion of a preexisting passthrough entity to a corporation.

Individuals, disregarded entities, and other noncorporate taxpayers doing business as sole proprietorships can contribute cash or property to a newly formed C corporation in a section 351 transaction, and the shares acquired will qualify for potential QSBS treatment. This can be accomplished in a series of exchanges, and as long as the corporation continues to meet the aggregate gross asset requirement at each issuance and the active business requirement, the shares acquired will continue to qualify as QSBS.

Partnerships are eligible holders of QSBS and have the option of contributing cash and other property to a newly created (or controlled) C corporation in a section 351 transaction in exchange for QSBS shares.[82] Those shares can be retained by the partnerships or distributed to the partners without jeopardizing their QSBS status.[83] Preexisting business entities taxed as partnerships (S corporations are discussed in the next section of this report) can also meet the original issuance requirement by converting to a C corporation. As noted earlier, that can be accomplished by making the appropriate check-the-box election or converting to a corporation under an assets-over, assets-up, or interests-up conversion. Typically, the owners of the partnership prefer to convert to a C corporation in a nontaxable manner, relying on section 351. Note, however, that built-in gain on appreciated property that is contributed to a QSB is non-section-1202 gain and, as such, is not excludable under section 1202. Owners should consider offsetting gains with losses if at all possible, before the contribution, thereby increasing the adjusted tax basis of contributed assets and reducing the non-section-1202 gain in the QSBS shares.

As already mentioned, each of the foregoing conversion transactions essentially involves a contribution of property to a newly formed corporation and liquidation of the partnership, but each involves a different contribution of property and in a different order. Each transaction can result in the corporation and the shareholders receiving different adjusted tax bases in their exchanged assets. Each transaction can also result in gain or loss being recognized either upon liquidation of the partnership or as a result of the mixing bowl or disguised sale rules. Understanding these nuances is important because tax basis is critically important in calculating the aggregate gross asset requirement and the 10-times-basis limitation.

Because the aggregate gross asset requirement is calculated on the FMV of contributed assets,

[82] Section 1202(g)(4)(A).

[83] Section 1202(g) and (h)(2)(C).

partnerships that have more than $50 million in assets will need to reduce the value of the assets contributed in the conversion. This can be accomplished in several ways, including simply contributing less than $50 million in property to the corporation under section 351 in a check-the-box, assets-over, or assets-up conversion, or distributing partnership property to the partners before the conversion to a C corporation. Distributions of property are generally nontaxable events,[84] but they result in a reduction of the outside basis of the distributee partner.[85] The parent-subsidiary limitation of section 1202(d)(3) applies only to corporations, so any transaction that has the effect of reducing the value of the assets below $50 million is allowable, provided the reduction occurs before the conversion to a C corporation (the deemed original issuance).

A restructuring of a preexisting partnership that exceeds the $50 million aggregate gross asset requirement can also be accomplished through a partnership division under section 708(b)(2)(B).[86] A partnership division is any transaction that converts a single partnership into two or more resulting partnerships. Like conversions to a corporation, a division of a partnership can be accomplished in several different ways — assets-over, assets-up, and interests-over.[87] The regulations issued under sections 708 and 752 in 2001[88] provide that the IRS will not respect the interests-over form of partnership division. Also, although both an assets-over and an assets-up division are respected, there is a preference to treat the transaction as an assets-over division.[89] In the assets-over form, the divided partnership transfers assets to the recipient partnership in exchange for interest in the recipient partnership, followed by a distribution of the recipient partnership interests to the partners.[90]

In a "vertical slice" division, both of the resulting partnerships retain the same ownership as the original partnership. The distribution of the recipient partnership interest to the partners will be current distributions rather than liquidating distributions because no partner is terminating his or her interest in the divided partnership. Because of this parity of ownership, it is unlikely that the mixing bowl transaction will trigger any gain or loss.[91] Further, the preamble to the regulations points out that when a division results in a pro rata division, there are no section 704(c) implications.[92] Similarly, given the parity of ownership before and after the division, there should be no gain resulting from a deemed distribution of cash under section 752 because the division will not result in a change in the share of the partners' liabilities. The resulting basis that the partners have in their respective interests in the divided partnership and the recipient partnership depend on what assets and liabilities are contributed and distributed as a result of the division.

In a division, the regulations provide that a "resulting partnership"[93] (a partnership that has at least two partners from the prior partnership) will be considered a continuation of the prior partnership if the partners in the resulting partnership had an interest of more than 50 percent in the capital and profits of the prior partnership.[94] All resulting partnerships that are considered a continuation of the prior partnership are subject to all preexisting tax elections (for example, a section 754 election) that were made by the prior partnership.[95] Thus, in pro rata divisions in which all the partners retain the same ownership in the resulting partnerships, all the resulting partnerships will be considered

[84] *See* section 731(a) and (b); and reg. section 1.731-1(a)-(b).

[85] Section 733.

[86] *See also* reg. section 1.708-1(d).

[87] Cassady V. Brewer, "Coming Together and Breaking Apart: Planning and Pitfalls in Partnership Mergers and Divisions," 43d Annual Southern Federal Tax Institute, Outline F, F-13 (2008).

[88] T.D. 8925.

[89] *See* reg. section 1.708-1(d)(3).

[90] Reg. section 1.708-1(d)(3)(i)(A). The divided partnership's transitory ownership of all the interests in the recipient partnership is ignored. Reg. section 1.708-1(d)(5), examples 3-6.

[91] Sections 704(c)(1)(B) and 737; and reg. sections 1.704-4(c)(4) and 1.737-2(b)(2).

[92] Preamble to T.D. 8925, 66 F.R. 715, 718 (Jan. 4, 2001). Non-pro-rata divisions are still being reviewed.

[93] Reg. section 1.708-1(d)(4)(iv).

[94] Reg. section 1.708-1(d)(1).

[95] Reg. section 1.708-1(d)(2)(ii).

continuing partnerships, retaining all prior tax elections of the divided partnership.[96]

Thus, a vertical slice division can be used to divide a preexisting business into two smaller partnerships with identical ownership at the partner level, one or both of which can be converted to a C corporation and possibly qualify as a QSB. As mentioned, the parent-subsidiary aggregation rule of section 1202(d)(3) likely does not apply to partnerships, and significantly, section 1202 does not have any rule regarding brother-sister entities. Thus, a division like this is a nontaxable reorganization that can qualify a preexisting business into one or more QSBs. For example, consider a partnership that has a trade or business related to healthcare. It derives revenue by directly providing medical services to patients but uses proprietary software to maximize the revenue from those services. As noted, a trade or business involving the performance of services in the field of health is not considered a qualified trade or business for QSBS purposes.[97] However, a software company would be considered a qualified trade or business. In that instance, a vertical slice division would allow the partnership to divide into a healthcare services partnership and a software company that can be converted to a C corporation that would qualify as a QSB.

If a partnership has over $50 million in assets, a division could possibly be used to qualify the trade or business as a QSB before its conversion to a C corporation. For example, consider a partnership that has a trade or business that, in aggregate, is worth $80 million. The trade or business consists of a manufacturing division that is worth $45 million and a distribution division that is worth $35 million. A vertical slice division of the partnership into a manufacturing partnership and a distribution partnership would reduce the value of each partnership to allow each of the separate businesses to qualify as a QSB upon conversion to a C corporation.

[96] *See* LTR 9015016 (seven continuing partnerships with same owners in the same proportions).

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

D. Can S Corporation Shareholders Benefit From QSBS?

Section 1202(c)(1) requires that shareholders acquire their QSBS through original issuance by a C corporation, the foregoing requirement embedded in the definition of a QSB.[98] Thus, shareholders of existing S corporations who were issued shares when the corporation was an S corporation can never qualify for QSBS treatment by simply revoking the corporation's S election. That doesn't necessarily mean that the shareholders of this corporation can never get the benefit of the QSBS exclusion, as long as they subsequently acquire, and are originally issued, shares in the C corporation. Of course, the C corporation must meet all the additional QSBS requirements, specifically including the twofold requirement that for substantially all of the taxpayer's holding period the corporation must be a C corporation and meet the active business requirement.

Section 1202(c)(2)(A) provides, "Stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of subsection (e) and such corporation is a C corporation." Although not entirely clear, the better interpretation of the foregoing is that the "substantially all" holding period requirement applies to both the active business requirement and to the C corporation requirement (rather than only to the active business requirement).[99] The distinction is significant in that it allows a company that initially starts as an S corporation but later converts to a C corporation (perhaps because of subsequent rounds of funding) to provide QSBS treatment to the shareholders who acquired stock after the conversion (including, for example, founding shareholders who receive shares as part of ongoing compensation arrangements). However, the shares that were issued when the

[98] *See* section 1202(d)(1).

[99] Also, under the active business requirement, the corporation must be an eligible corporation, which is defined (with some exceptions) as "any domestic corporation," without any requirement that the corporation be a C corporation. *See* section 1202(e)(4).

company was an S corporation will never qualify for the QSBS exclusion.

Some advisers and promoters have mistakenly taken the position that an S corporation can merge with a C corporation (typically a publicly traded shell corporation, sometimes referred to as a special purpose acquisition company or SPAC), in accordance with which the S corporation shareholders do a tax-free exchange of shares, receiving shares in the surviving C corporation that would be eligible for QSBS treatment. Section 1202(h)(4)(A), dealing with a reorganization under section 368, applies only when QSBS is exchanged for other stock that would not qualify for QSBS. In this instance, this is an exchange of non-QSBS stock for purported QSBS stock, and as such, section 1202(h)(4)(A) is inapplicable.

Also, S corporations, like partnerships, are eligible holders of QSBS for the benefit of the S corporation shareholders who would otherwise be qualified QSBS shareholders (that is, individuals, trusts, and estates).[100] As a result, an S corporation can give its shareholders QSBS benefits by contributing assets to a C corporation under section 351 in exchange for shares of a QSB. The S corporation would then need to retain the QSBS shares because a distribution of them to the shareholders (unlike a distribution from a partnership to a partner) is a disqualifying transfer that is not described in section 1202(h)(2). Further, the distribution of the QSBS is also a recognition event for income tax purposes.[101]

Under these circumstances, the S corporation essentially serves as a holding company of the QSB on behalf of its shareholders. If the S corporation holds the QSBS for at least five years and sells, the shareholders will get the benefit of the QSBS exclusion. The S corporation will pass through all items of income and deduction, including nontaxable items like excluded section 1202 gain (tax-exempt income).[102] The excluded section 1202 gain will increase the basis of each shareholder's stock in the S corporation,[103] thereby allowing the S corporation to distribute the cash proceeds from the sale of QSBS tax free to its shareholders.[104] As discussed in the context of partnerships, it is unclear whether a transfer by gift of the shares of the S corporation will "stack" or multiply the $10-million-per-taxpayer limitation, and to make things worse, there is no option to distribute the QSBS to the shareholders so they can gift the QSBS shares.

One option is for the S corporation to contribute assets to a wholly owned subsidiary corporation and fail to elect to treat the subsidiary as a qualified subchapter S subsidiary (QSub), which, if elected, would have been treated as a disregarded entity.[105] An S corporation with a preexisting QSub can also terminate its QSub election.[106] The effect of the termination is that the former QSub is treated as a new corporation acquiring all its assets (and assuming all its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation.[107] This exchange would qualify as an original issuance under section 1202.

Unlike partnerships, the parent-subsidiary aggregation rule under section 1202(d)(3) likely applies to S corporations (although the controlled group of corporation rules are only used in the context of C corporations). As such, if an S corporation's assets already exceed the $50 million threshold, then even if the S corporation contributes less than $50 million in assets to a wholly owned C corporation or revokes the QSub election on an entity that has less than $50 million in assets, the newly created corporation would not be considered a QSB because the aggregate gross asset requirement is not met. In that instance, the S corporation could distribute cash or property to its shareholders to get below the $50 million threshold, but the distribution of cash is tax free only to the extent of each shareholder's basis in his or her S corporation shares, and property distributions are taxable events.

[100] Section 1202(g)(4)(B).

[101] *See* section 311(b).

[102] *See* section 1366(a)(1)(A).

[103] Section 1367(a)(1).

[104] *See* section 1368(b)(1).

[105] *See* section 1361(b)(3) and reg. section 1.1361-3(a)(2).

[106] *See* reg. section 1.1361-5(a)(1).

[107] Reg. section 1.1361-5(b)(1)(i).

Another alternative is to divide the S corporation in a tax-free division under section 355. Generally, section 355(a) mandates that (1) a corporation distribute stock or securities of a corporation that constitutes control, (2) both corporations conduct an active trade or business, and (3) the distribution not constitute a device to distribute earnings and profits. There are other requirements, most notably that the distribution of the stock must have a corporate business purpose.[108] The regulations provide that a shareholder purpose does not constitute a corporate business purpose.[109]

Note that if a C corporation converts to an S corporation, QSBS is not automatically lost, provided the corporation converts back to a C corporation. The business must only be a C corporation during "substantially all"[110] of the taxpayer's holding period. However, as noted already, no guidance has been issued on what constitutes "substantially all" for purposes of section 1202.

E. Can You Get the Benefit of QSBS Through Carried Interest?

As discussed earlier, partnerships are eligible QSBS shareholders for the benefit of their noncorporate partners,[111] allowing the noncorporate partners the benefit of the section 1202 exclusion, if the following requirements are met: (1) the gain results from the partnership's sale of QSBS that has been held by the partnership for more than five years;[112] (2) the gain is includable in the gross income of the taxpayer (partner) by "reason of holding an interest in such entity";[113] (3) the interest in the entity was "held by the taxpayer on the date on which such pass-thru entity acquired such stock";[114] and (4) the interest was also held by the taxpayer "at all times thereafter before the disposition of such stock" by the partnership.[115] Also, the code mandates that the amount of gain eligible for exclusion may not exceed the amount that would have been excludable "by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired."[116] Thus, a partner would be unable to claim a larger share of the QSBS gain when recognized if the partner's share of the partnership is larger than it was when the stock was acquired. To date, the IRS has not issued any guidance under section 1202 on how "by reference to the interest the taxpayer held" is to be determined. The partner's "proportionate share of the adjusted basis of the pass-thru entity in such stock"[117] is used for determining that partner's 10-times-basis limitation.

As mentioned, distributions of QSBS from a partnership to a partner are permissible transfers that allow for tacking of the holding period and retention of the QSBS status of the shares if "requirements similar to the requirements of subsection (g) are met at the time of the transfer (without regard to the 5-year holding period requirement)."[118] Thus, whether a partnership sells the QSBS or it distributes the QSBS to a partner, the exclusion benefits of section 1202 will be limited by the interest "held by the taxpayer on the date on which such pass-thru entity acquired such stock," and may not exceed the amount that would have been excludable "by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired."

The regulations provide special rules for changes in a partner's interest in a partnership resulting from the admission or withdrawal of partners or other transactions that change the relative partner share of continuing partners in a partnership. These rules, often referred to as reverse section 704(c) adjustments, permit revaluations of the partner's capital accounts to reflect the FMV of partnership assets and any book-tax disparities at that time. They generally

[108] Reg. section 1.355-2(b)(1).

[109] Reg. section 1.355-2(b)(2).

[110] Section 1202(c)(2)(A).

[111] Section 1202(g)(4)(A).

[112] Section 1202(g)(2)(A).

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

[114] *Id.*

[115] *Id.*

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

[117] Section 1202(g)(1)(B).

[118] Section 1202(h)(2)(C).

require equivalent adjustments that allocate unrealized gain or loss to continuing partners[119] (1) for property distributed in kind,[120] and (2) on adjustments of partnership interests as a result of (a) contributions of money, property, or services, or (b) distributions of money or property.[121] These reverse section 704(c) adjustments do not specifically provide for adjustments attributable to QSBS considerations, but they could provide a mechanism and insight on how "by reference to the interest the taxpayer held" is to be determined.

As discussed earlier, many investments in QSB companies are through private equity or venture capital funds. Commonly, these funds are compensated in part through carried interest, which vests when the underlying portfolio investments meet specified profit or valuation targets. Carried interest is generally defined as a share of the profits of an investment that is paid to the investment manager in excess of the amount of capital that the manager contributes to the partnership. Typically, carried interest is paid in the form of an interest in the partnership (the fund).

In Rev. Proc. 93-27, 1993-2 C.B. 343, the IRS provided guidance on the receipt of a partnership interest for services provided to a partnership. In the ruling the IRS defined a capital interest as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership"[122] as determined at the time of the receipt of the partnership interest. A profits interest is defined as a "partnership interest other than a capital interest."[123] The ruling provides that if a person receives a profits interest for providing services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the receipt of the interest is not a taxable event for the partner or the partnership. This safe harbor does not apply, however, if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets (for example, high-quality debt securities or high-quality net leases), (2) within two years after receipt, the partner disposes of the profits interest, or (3) the profits interest is an interest in a publicly traded partnership.

In Rev. Proc. 2001-43, 2001-2 C.B. 191, the IRS clarified the 1993 revenue procedure, providing that the determination of whether an interest granted to a service provider is a profits interest is tested when the interest is granted, even if, at that time, the interest is "substantially nonvested."[124] The 2001 revenue procedure provides: "Where a partnership grants an interest in the partnership that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date of its grant," provided the following conditions are met[125]:

- "the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest";
- "upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest"; and
- all the conditions of the 1993 revenue procedure are also satisfied.

Rev. Proc. 93-27 and Rev. Proc. 2001-43 provide a safe harbor method for private equity and venture capital funds to grant carried interest to the manager of the fund (and its employees) in a manner that is not considered compensation upon grant, when the profits interest vests, or importantly, when the carried interest is earned (upon meeting specified profit or valuation

[119] Reg. sections 1.704-1(b)(2)(iv)*(d)(3)*, (iv)*(e)*, and (iv)*(f)*; 1.704-1(b)(4)(i); 1.704-1(b)(5), examples 14(i), 14(ii), 14(iv), 18(ii), 18(vii), 18(ix), and 18(x); and 1.704-1(b)(1)(iv).

[120] Reg. section 1.704-1(b)(2)(iv)*(e)*.

[121] Reg. section 1.704-1(b)(2)(iv)*(f)*.

[122] Rev. Proc. 93-27, section 2.01.

[123] *Id.* at section 2.02.

[124] *See* reg. section 1.83-3(b).

[125] Rev. Proc. 2001-43, section 4.

targets). Rather, it allows the manager and its employees to be treated as a partner upon grant and taxed as a partner on its distributive share of partnership profits and losses. For this reason, carried interest is often structured to meet the requirements of the revenue procedures.

It is unclear, however, how the section 1202 exclusion will be applied to carried interest. Rev. Proc. 2001-43 requires that the service provider be treated as "the owner of the partnership interest from the date of its grant," and the service provider is required to take into account "the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest." This applies regardless of whether the carried interest is vested or subject to a substantial risk of forfeiture, and regardless of an election under section 83(b).[126] Thus, the IRS recognizes situations in which a taxpayer will be treated as a partner even if profits have not yet been realized and even before the taxpayer has vested in that profits interest.

This would seem to sufficiently satisfy the requirement under section 1202(g)(2)(B) that interest must be "held by the taxpayer on the date on which such pass-thru entity acquired such stock." It may also satisfy the limitation under section 1202(g)(3), which limits the exclusion "by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired," because once carried interest is earned, it retroactively applies to give the partner an interest in a portfolio company (that is, the QSBS company) that has already been acquired by the partnership fund. The regulations provide, "The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners."[127] The regulations specify some factors to consider in determining a partner's interest in the partnership, including the partner's relative contribution to the partnership, the partner's interest in economic profit and loss, the partner's interest in cash flow and other non-liquidating distributions, and the partner's rights to distributions of capital upon liquidation.[128]

In contrast, the regulations under section 1045 dealing with partnerships and the rollover election may provide a very different answer if they apply for section 1202 purposes. As noted, however, rollover elections under section 1045 by partnerships and their eligible partners are subject to a nonrecognition limitation. The amount of gain that an eligible partner does not recognize (under a sale of QSBS by a selling partnership) and that can be rolled over into replacement QSBS under section 1045 cannot exceed that limitation.[129] The nonrecognition limitation is generally determined by multiplying the partnership's realized gain on the QSBS sale against the eligible partner's "smallest percentage interest in partnership capital."[130] The regulations under section 1045 state:

> An eligible partner's smallest percentage interest in partnership capital is the eligible partner's percentage share of capital determined at the time of the acquisition of the QSB stock as adjusted prior to the time the QSB stock is sold to reflect any reduction in the capital of the eligible partner including a reduction as a result of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the eligible partner or the transfer of an interest by the eligible partner, but excluding income and loss allocations.[131]

Although the regulations specifically provide that the foregoing provision applies "for purposes of this section"[132] (not referencing section 1202), given the extensive linkages and cross-references between sections 1202 and 1045, the smallest percentage interest in partnership capital limitation could apply for purposes of section

[126] "Taxpayers to which this revenue procedure applies need not file an election under section 83(b) of the Code." *Id.* at section 3.

[127] Reg. section 1.704-1(b)(3)(i).

[128] Reg. section 1.704-1(b)(3)(ii).

[129] Reg. section 1.1045-1(d)(1).

[130] Reg. section 1.1045-1(d)(1)(ii).

[131] *Id.*

[132] Reg. section 1.1045-1(d)(1).

1202(g)(2)(B) and (g)(3). If that limitation did apply for purposes of section 1202, the partners of the fund manager (general partner) of a private equity and venture capital fund would not be afforded the benefits of QSBS treatment to the extent the stock is attributable to the fund manager's carried interest (noncapital interest). This limitation, if applicable, would presumably also apply to any interest in the fund manager to the extent the fund manager received additional partnership fund interests as the result of a fee waiver (that is, forgoing the annual management fee for additional carried interest in the fund) or other cashless contribution.

To date, there is no published guidance on point. Note, however, that section 1045 was enacted in 1997, and the partnership regulations under section 1045 were finalized in 2007, whereas section 1202 was enacted in 1993. Section 1202 refers generally to the interest "held by the taxpayer on the date on which such pass-thru entity acquired such stock," and to the exclusion benefits being limited "by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired." It does not specifically require a determination that the interest be based on the smallest percentage interest in partnership capital. Rev. Proc. 93-27 and Rev. Proc. 2001-43, dealing with profits interests, were published before the section 1045 partnership regulations were released, and nothing in those regulations refers to or contradicts those revenue procedures. Therefore, without further guidance that specifically provides that the section 1045 partnership limitations also apply in determining eligibility under section 1202, taxpayers may be able to take a position that stock acquired or sold as a result of earned carried interest is still eligible for QSBS status and the gain exclusion benefits thereunder.

The IRS has been asserting penalties more often as a strategic device, especially in areas in which the law is undeveloped or otherwise uncertain. All tax advisers need to be cognizant of their potential penalty exposure for paid advice regarding filing positions taken in client tax returns based on that advice. It is especially important for the adviser to understand when a client can take a position without penalty risk but the adviser cannot — without disclosure in the client's tax return. For example, an adviser may tell a client there "is a position" for claiming a section 1202 exclusion, and in fact that position may have a reasonable basis. The client potentially can take that position without penalty in that case. However, that does not protect the paid adviser whose advice is incorporated into that filing position. Only with a properly filed Form 8275, "Disclosure Statement" — something that is unnecessary for client protection and might actually increase the client audit risk — can the adviser be penalty-protected.

F. How Should Installment Sales Be Treated?

An installment sale is generally defined as a disposition of property in which one or more payments are to be received after the close of the tax year in which the disposition occurs.[133] To qualify as an installment sale, at least one payment must be received in a tax year after the year of sale, but there is no requirement that there be more than one payment. Under section 453, the installment method permits gain from installment sales to be reported as the taxpayer receives the payments.[134] Each payment received is treated in part as a tax-free return of a portion of the seller's adjusted basis in the property, a taxable realization of the seller's gain, and interest. Assuming the QSBS is not publicly traded at the time of its sale,[135] if the seller receives payments in different tax years, the installment method is required unless the seller elects not to have the installment method apply to the sale.[136]

According to the instructions for Schedule D:

> If all payments aren't received in the year of sale, a sale of QSB stock that isn't traded on an established securities market generally is treated as an installment sale and is reported on Form 6252. . . . Figure the allowable section 1202 exclusion for the year by multiplying the total amount of the exclusion by a fraction, the numerator of which is the amount of

133 Section 453(b)(1).

134 Section 453(c).

135 Section 453(k)(2).

136 Section 453(d)(1).

eligible gain to be recognized for the tax year and the denominator of which is the total amount of eligible gain.[137]

As such, the instructions essentially prorate the excluded section 1202 gain.

Consider a taxpayer who sells his or her QSBS shares in a corporation that qualifies for the 100 percent exclusion percentage in 2018 for a total consideration of $14 million, but $4 million of the proceeds will be held in escrow to be paid in 2019. Assume the taxpayer's per-issuer limitation is $10 million (and zero basis in the QSBS), and the taxpayer will have, in aggregate, $10 million of excluded section 1202 gain and $4 million of non-section-1202 gain. How should the taxpayer report the sale for 2018 and 2019?

The first option is to follow the Schedule D instructions, which call for prorating of the excluded section 1202 gain. Under this approach, the taxpayer should multiply the total $10 million of excluded section 1202 gain by a fraction equal to current-year recognized eligible gain divided by the total eligible gain. Total eligible gain would be $14 million, and the current-year amount would be $10 million, so the exclusion would be approximately 71 percent or $7.1 million, leaving $2.9 million for 2019 — if received. However, the instructions appear to have no basis in the tax law. Section 1202(a) explicitly excludes from gross income *any* gain from the sale of QSBS stock held for five years. There is no exception for installment sales.

The second option is to claim the entire excluded section 1202 gain in 2018 based on a reasonable reading of sections 453 and 1202. The regulations provide, "Under the installment method, the amount of any payment which is income to the taxpayer is that portion of the installment payment received in that year which the gross profit realized or to be realized bears to the total contract price (the 'gross profit ratio')."[138] In this example, $10 million is realized in 2018 of a total contract price of $14 million. Because there is no tax basis, the installment gain for 2018 would be $10 million. Apply section 1202(a) and (b) to the 2018 tax return to determine the amount of exclusion. The recognized gain is $10 million, so the $10-million-per-issuer limitation would eliminate the full gain for 2018. For the 2019 tax year, the installment sale computation, assuming full collection of the remaining $4 million, would generate installment non-section-1202 gain of $4 million. There is no remaining exclusion available for 2019. This result is practical since it does not require taxpayers to recalculate gains or exclusion under section 1202 and amend tax returns in the event the anticipated payments to be paid after 2018 are not collected.

Installment sale treatment on the sale of QSBS likely may not be relied on to satisfy, in part, the five-year holding period requirement. For example, consider a taxpayer who has held QSBS for four years. The taxpayer sells the QSBS, agreeing to receive equal payments over the next three tax years. The taxpayer may not rely on installment sale treatment and claim that the last two installment payments (received more than five years after original issuance) qualify as eligible gain, thereby entitling the gain attributable to those payments to exclusion under section 1202(a). Although there is no direct guidance on this issue, allowing a taxpayer to satisfy the five-year holding requirement through deferred installment payments would conflict with the provisions on disqualifying hedging transactions under section 1202(j), as discussed earlier in this report.

On the other hand, installment treatment might be useful for a section 1045 rollover. As discussed, section 1045(a) provides a relatively short 60-day period to defer and reinvest recognized QSBS gain into a new acquisition of QSBS stock. The issue is if a taxpayer sells QSBS stock in an installment sale, can the taxpayer qualify for a section 1045 rollover by reinvesting, within 60 days, each payment of principal on the installment sale in replacement QSBS as the taxpayer receives it, or must the taxpayer reinvest the total sales price within 60 days of the closing, regardless of the amount of cash or other consideration the taxpayer may have received? There is no guidance under section 1045 on this issue. However, the 2020 final QOZ regulations may shed some light on how the IRS could rule on it.

[137] 2017 Instructions for IRS Schedule D, "Exclusion on Qualified Small Business (QSB) Stock."

[138] Reg. section 15a.453-1(b)(2)(i).

Under section 1400Z-2, eligible taxpayers have a 180-day period to reinvest capital gain in a QOF in order to defer (and possibly exclude a portion of) that original gain. The regulations allow an eligible taxpayer to elect to choose the 180-day period to begin on either (1) the date a payment under the installment sale is received for that year, or (2) the last day of the tax year in which the eligible gain under the installment method would be recognized but for deferral under section 1400Z-2.[139] Thus, "if an eligible taxpayer receives one or more payments on an installment sale and treats the date the payment on the installment sale is received as the beginning of the 180-day period, each payment will begin a new 180-day period."[140]

Note that installment payments may not be used in this manner for purposes of the 180-day like-kind exchange period under section 1031. Perhaps the distinction lies in the language of the statutes. Unlike sections 1045 and 1400Z-2, the reinvestment period under section 1031 starts "the date on which the taxpayer transfers the property relinquished in the exchange,"[141] whereas for both sections 1045 and 1400Z-2, the reinvestment period starts "beginning on the date of such sale."[142] More importantly, in the absence of significant rulings, regulations, or other IRS authority under sections 1045 and 1202, it seems more appropriate to look to the QOZ rules for guidance, given that QSBS and QOZs share many of the same goals. Namely, both are meant to encourage specific types of investments (that is, small business growth investments and economic growth in distressed communities), and both provide mechanisms of gain deferral, exclusion, and rollover to achieve those results.

G. When to Die With QSBS or Donate It?

1. The step-up in basis.

Appreciated QSBS is unlike other appreciated property in which a step-up in basis under section 1014(a) can be highly beneficial. However, QSBS carries exclusion percentage benefits that can be transferred (and possibly stacked or multiplied) by gift during the lifetime of the taxpayer. Generally, taxpayers will benefit more from lifetime transfers of QSBS than from the step-up in basis because the step-up is often at the cost of estate tax inclusion. However, the step-up in basis can be beneficial in some circumstances, particularly if the taxpayer has no resulting estate tax liability.

For purposes of the 10-times-basis limitation, the "adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued."[143] Further, if a taxpayer contributes property (other than money or stock) to a QSB in exchange for stock in the corporation, for section 1202 purposes, the "basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged."[144] Depending on the acquisition date of the QSBS, the exclusion percentage attributable to QSBS can be 50 percent, 75 percent, or 100 percent, and taxpayers will have varying per-issuer limitations on eligible gain depending on several factors, including whether the taxpayer has exhausted his or her $10-million-per-taxpayer limitation and the tax basis of the QSBS for purposes of the 10-times-basis limitation. Finally, at death, a taxpayer may have significant QSBS that is not considered eligible gain because the taxpayer has not held the stock for more than five years. All of the foregoing factors and circumstances will determine the amount of excluded section 1202 gain, section 1202 gain, and non-section-1202 gain that is unrealized at death and ultimately eliminated by the step-up in basis.

If the step-up in basis can be achieved with the payment of little or no federal estate and state death tax, the tax savings are achieved with essentially no cost (sometimes referred to as a "free base" situation). This can occur if the decedent had a sufficient applicable exclusion amount (including the temporary doubling of this amount under the TCJA) to cover the estate tax cost of inclusion, or if the QSBS is transferred to or for the benefit of a surviving spouse under the

[139] *See* reg. section 1.1400Z2(a)-1(b)(11)(viii)(A) and (B).

[140] Reg. section 1.1400Z2(a)-1(b)(11)(viii)(B).

[141] Section 1031(a)(3)(B)(i).

[142] *See* sections 1045(a)(1) and 1400Z-2(a)(1)(A).

[143] Section 1202(b)(1) (flush language).

[144] Section 1202(i)(1)(B).

marital deduction of section 2056. As a result, a step-up in basis would be most beneficial to taxpayers if, at the time of death, some or all of the following factors are present regarding the QSBS includable in the estate:

1. very low adjusted tax basis in the QSBS;
2. QSBS entitled to an exclusion percentage of 50 percent (resulting in 50 percent of the unrealized gain treated as section 1202 gain, to the extent of the taxpayer's per-issuer limitation at the time of death);
3. significant unrealized non-section-1202 gain (because of (1) contributions of very-low-basis property at the time of conversion but not at a sufficiently high value at the time of contribution to dramatically increase the 10-times-basis limitation, and (2) significant appreciation above the taxpayer's remaining per-issuer limitation at the time of death); and
4. significant unrealized appreciation on QSBS that has been held for less than five years at the time of death.

It bears repeating that the step-up in basis can result in a step-down in basis if the FMV of the QSBS is less than its adjusted tax basis on the date of death. For example, if a taxpayer purchases 100 percent exclusion QSBS for $3 million in cash and dies when the QSBS has an FMV of $2 million, the basis in the QSBS will step down to $2 million. If the QSBS is subsequently sold for $32 million (realizing $30 million of gain), the 10-times-basis limitation would exclude $20 million of the realized gain (not $30 million, based on the original cost). If the taxpayer had made a transfer by gift of the $2 million of QSBS immediately before death, the transferee would have been entitled to exclude up to $30 million of gain.[145]

Even if the QSBS is appreciated at the time of death, the IRS may argue there is a step-down in basis for purposes of the 10-times-basis limitation. For example, a taxpayer holds 100 percent exclusion QSBS that has zero adjusted tax basis, but for purposes of the 10-times-basis limitation, the basis under section 1202(i)(1)(B) is $5 million because the taxpayer contributed zero-basis property valued at $5 million in a section 351 transaction when he or she acquired the QSBS. On the date of the taxpayer's death, the QSBS has an FMV of $4 million. The estate will get a step-up in adjusted tax basis from zero to $4 million under section 1014. If the QSBS is later sold for $54 million (realizing $50 million of gain), for purposes of the 10-times-basis limitation, is the exclusion limitation $50 million or $40 million?

We believe the exclusion limitation remains at $50 million. Although there has been an "addition to basis after the date on which such stock was originally issued," it's important to remember that this language applies only for purposes of the 10-times-basis limitation. The basis used in the tenfold calculation is still $5 million, and to that figure there has not been "any addition to basis." Section 1202(i) trumps any argument to reduce the basis because it clearly provides, "For purposes of this section — in the case where the taxpayer transfers property (other than money or stock) to a corporation in such corporation — the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged."[146]

2. Contributions to charitable entities.

As noted earlier, the unrealized gain in QSBS can be excluded section 1202 gain, section 1202 gain, non-section-1202 gain, and non-eligible gain. As such, QSBS is not necessarily the best candidate to give to a charitable entity (private foundation, donor-advised fund, public charity, charitable lead trust, or charitable remainder trust) if one of the reasons for the gift is to save income taxes through a charitable income tax deduction under section 170 or by avoiding recognition of the gain. That being said, donors do make contributions of QSBS to charitable entities.

If a donor contributes QSBS that is not publicly traded to a private foundation, the resulting income tax deduction will be limited to the adjusted basis of the QSBS. Private foundations are also subject to an excise tax on investment income under section 4940. It is unclear whether excluded section 1202 gain can be used to reduce the excise tax, assuming that QSBS status can be retained. To that end, QSBS status can be retained only if the private

[145] *See* section 1015 and reg. section 1.1015-1(a)(1) and (2).

[146] Section 1202(i)(1)(B).

foundation is a trust. If the trust is a corporation, the QSBS status is lost. The QSBS factors listed previously that would favor inclusion in the estate to benefit from a step-up in basis are the same factors that would favor contribution of the QSBS to a charitable entity (like a donor-advised fund or other public charity) that is able to shelter the taxable gain resulting from the sale of the QSBS.

Also, appreciated QSBS can be contributed (transfer by gift) to split-interest charitable trusts like charitable remainder trusts and charitable lead trusts. A charitable remainder trust is tax exempt, so the sale of QSBS by the trust will not be taxable. On the other hand, the distributions to the non-charitable beneficiary are taxable under the "category and class" tier rules of accounting.[147] If a charitable remainder trust sells QSBS, the section 1202 gain (taxed at the maximum rate of 28 percent [31.8 percent]), excluded section 1202 gain (not taxable), and the non-section-1202 gain (taxable as long-term capital gain) will each be accounted for differently in the category and class tier rules. Under those rules, all of the charitable remainder trust's income is first divided into three categories of income: ordinary, capital gains, and other (excluded income). Then, within each category, the income is further subdivided into different classes based on the federal income tax rate applicable to the income, beginning with the class of income with the highest federal income tax rate.[148]

In the context of QSBS, this means section 1202 gain will be deemed to be distributed first (that is, taxed at 28 percent plus 3.8 percent), followed by non-section-1202 gain and non-eligible gain (that is, taxed at 20 percent plus 3.8 percent).[149] It is unclear, however, how or if excluded section 1202 gain should be accounted for in the tier rules.

One interpretation is that the excluded section 1202 gain is the gain subject to the lowest rate of tax (0 percent) and as such would be distributed at the end of the capital gain category. Under that interpretation, it's unclear how this would be calculated. The amount of excluded section 1202 gain would be subject to the taxpayer's per-issuer limitation, but the taxpayer for these purposes could be the charitable remainder trust (as a separate taxpayer who received the QSBS in a transfer by gift) or the grantor who contributed the QSBS since the tier rules function as a way to tax the retained interest of the grantor.

Another interpretation is that the excluded section 1202 gain is not capital gain at all. One can find support for this interpretation in the regulations that address stock under former section 1202, which generally provided for a 60 percent deduction on net capital gain for noncorporate taxpayers under the idea that a deduction has the same effect as an exclusion over a portion of the gain. The regulations on charitable remainder trusts provide that the deductions allowable to a trust under section 1202 "are not allowed in determining the amount or character of any class of items within a category of income described in [reg. section 1.664-1(d)(1)(i)(a)] or to corpus."[150]

Unlike charitable remainder trusts, charitable lead trusts are not tax exempt. They can either be structured as non-grantor charitable lead trusts or as grantor charitable lead trusts. As discussed, a contribution to a non-grantor charitable lead trust would be considered a permissible transfer by gift, allowing the trust to become the taxpayer of the QSBS and thus include an additional per-issuer limitation. By contrast, a contribution to a grantor charitable lead trust is ignored as a transfer, so the stock retains its QSBS status but there is no additional per-issuer limitation.

Non-grantor charitable lead trusts do not provide the donor with an income tax deduction upon contribution, but the trust is entitled to a charitable income tax deduction under section 642(c) for the annual payments made to charity. The charitable deduction under section 642(c) is

[147] Section 664(b) and reg. section 1.664-1(d)(1).

[148] *See* reg. section 1.664-1(d)(1)(i)(a).

[149] "The rules in this paragraph (d)(1) that require long-term capital gains to be distributed in the following order: first, 28-percent gain (gains and losses from collectibles and section 1202 gains); second, unrecaptured section 1250 gain (long-term gains not treated as ordinary income that would be treated as ordinary income if section 1250(b)(1) included all depreciation); and then, all other long-term capital gains are applicable for taxable years ending on or after December 31, 1998." Reg. section 1.664-1(d)(1)(ix).

[150] Reg. section 1.664-1(d)(2). Former section 1202 was repealed by section 301(a) of the Tax Reform Act of 1986.

limited only by the taxable income of the trust and the annual payment to charity.[151] Unlike section 170, which limits individual donors, the section 642(c) deduction is not limited by concepts of contribution base and adjusted gross income. As such, it is a good mechanism to shelter gain resulting from the sale of QSBS that has significant section 1202 gain and non-section-1202 gain, particularly if the QSBS is given in satisfaction of the required annual payment to charity (a recognition event).[152]

Grantor charitable lead trusts entitle the donor to an income tax deduction, but the grantor continues to be the owner of the grantor trust's assets for income tax purposes.[153] The grantor remains responsible for the income tax liability associated with the trust's assets. The IRS has ruled that the annual payment by a charitable lead trust to charity will result in recognition of gain if the payment is satisfied with appreciated securities.[154] Thus, for grantors who wish to minimize this tax liability, it is better to contribute 100 percent exclusion percentage QSBS that has a higher tax basis if at all possible. Both non-grantor and grantor charitable lead annuity trusts can have additional significant transfer tax benefits for the remainder beneficiaries, and those can be amplified by backloading the payments. QSBS that is expected to appreciate would be a good candidate to contribute toward that goal.[155]

H. Can QSBS and QOZ Investments Be Combined?

As discussed earlier, QSBS and QOZ investments encourage specific types of investments (that is, small business investments and economic growth in distressed communities), and both provide mechanisms of gain deferral, exclusion, and rollover. Interestingly, there seems no prohibition against a taxpayer getting the benefits of both QSBS and QOZ investments, as long as all the requirements under sections 1202 and 1400Z-2 are simultaneously satisfied. If, indeed, this is a possibility, taxpayers may be able to use the QOZ 180-day reinvestment period,[156] in lieu of section 1045's relatively short 60-day reinvestment period, and exclude under section 1202(a) all or a portion (as limited by the $10-million-per-taxpayer limitation) of the deferred gain that otherwise would be recognized when the investment or a portion thereof is sold or exchanged before December 31, 2026, under section 1400Z-2(b)(1). Of course, a taxpayer can defer any recognized capital gain (even gain from the sale of a marketable security) by making a QOZ investment, and if that investment also qualifies for QSBS benefits, as discussed herein, that original gain or a portion thereof can be entirely excluded.

For example, in 2020 a taxpayer recognizes $10 million of capital gain[157] and elects under section 1400Z-2(a) to defer that gain by making an investment, within the 180-day period, in a QOF, which can be organized as a corporation or a partnership.[158] Assume the QOF is a partnership[159] and that it invests the entire $10 million in QOZ stock.[160] If the QOZ stock is issued by a C corporation that meets all the QSB and QSBS requirements, the taxpayer should be able to combine the QOZ and QSBS benefits. For purposes of this illustration, all other partners in the QOF partnership are ignored. Assume that more than five years after the initial investment but before December 31, 2026, the $10 million

[151] "In the case of an estate or trust . . . there shall be allowed as a deduction in computing its taxable income (in lieu of the deduction allowed by section 170(a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c) (determined without regard to section 170(c)(2)(A))." Section 642(c).

[152] *See* Rev. Proc. 2007-45, 2007-2 C.B. 89, section 5.02(2); and Rev. Rul. 83-75, 1983-1 C.B. 114.

[153] *See* Rev. Proc. 2007-45; and Rev. Proc. 2007-46, 2007-2 C.B. 102.

[154] LTR 200920031.

[155] For a more complete discussion of charitable lead trusts and this backloading concept, see Paul S. Lee, Turney P. Berry, and Martin Hall, "Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse," 37 *ACTEC L. J.* 93 (Summer 2011).

[156] Section 1400Z-2(a)(1)(A).

[157] This could be a taxpayer who sells QSBS which results in $10 million of capital gain that is not subject to exclusion under section 1202(a) (that is, the taxpayer has not held the QSBS for five years, or the gain exceeds the taxpayer's per-issuer limitation). Rather than attempting to roll over the gain under section 1045 (which would include a rollover of the tax basis in the QSBS, if any) within 60 days, the taxpayer elects to defer the $10 million of capital gain by making a QOZ investment.

[158] "The term 'qualified opportunity fund' means any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property." Section 1400Z-2(d)(1).

[159] *See* reg. section 1.1400Z2 (a)-1(b)(25).

[160] Section 1400Z-2(d)(2)(A)(i).

investment in the QOZ stock appreciates to $30 million in value, and the QOF partnership sells a portion (approximately 37 percent) of the QOF stock for $11 million and distributes the proceeds to the taxpayer. What is the resulting tax liability for the taxpayer, and will the taxpayer be able to exclude taxable gain under section 1202(a) and still qualify for additional benefits under section 1400Z-2?

Section 1400Z-2(b)(1)(A) provides that deferred gain will be included in income on "the date on which such investment is sold or exchanged," and section 1202(a) provides an exclusion for "any gain from the sale or exchange" of QSBS held for more than five years. In this example, there is no question that a sale or exchange of QSBS/QOF stock has occurred at the partnership level. However, with QOFs, the mere sale or exchange doesn't necessarily result in taxable gain.

By way of example, the regulations provide that a QOF has 12 months from the time of the sale or disposition of QOZ property, or from the return of capital from investments in QOZ stock, to reinvest the proceeds in other QOZ property before the proceeds are not considered QOZ property under the 90 percent investment requirement.[161] In other words, without a corresponding inclusion event for the taxpayer, no recognition of gain has occurred for the taxpayer. Section 1202(a) requires a "sale or exchange" by the taxpayer, so the inclusion event may also need to be considered a sale or exchange. Further, QSBS gain recognized at the partnership level requires an amount to be "included in gross income by reason of holding an interest in a pass-thru entity."[162] So some inclusion events, like a transfer by gift of a qualifying interest in a QOF partnership,[163] would not be considered a taxable sale or exchange and might disqualify the stock's QSBS status, as discussed earlier. Therefore, to be sure that the taxpayer will get the benefit of the QSBS exclusion, it seems that a sale at the partnership level needs to have a corresponding inclusion event at the taxpayer level that is also considered a taxable sale or exchange.

The regulations provide that an inclusion event is any event that "reduces an eligible taxpayer's direct equity interest for Federal income tax purposes in the qualifying investment"[164] or under which the taxpayer receives property "with respect to its qualifying investment and the event is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the eligible taxpayer's ownership of the QOF."[165] Specific to partnerships, the regulations provide that "an actual or deemed distribution of property, including cash, by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of the partner's basis in its qualifying investment."[166] In effect, that provision mimics section 731(a)(1), which provides that distributions of money exceeding the partner's adjusted basis of that partner's interest in the partnership will result in gain (although distributions of property other than money are generally nontaxable). Importantly, section 731(a) states that "any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner."[167] The preamble to the 2020 final QOZ regulations explicitly confirms sale or exchange treatment on this inclusion event:

> The Treasury Department and the IRS have determined that an election under section 1400Z-2(c)[168] should be available for gain resulting from . . . section 731(a) . . . on a qualifying investment because such gain is treated as gain from the sale or exchange of

[161] *See* reg. section 1.1400Z2(f)-1(b).

[162] Section 1202(g)(1).

[163] *See* reg. section 1.1400Z2(b)-1(c)(3).

[164] Reg. section 1.1400Z2(b)-1(c)(1)(i).

[165] Reg. section 1.1400Z2(b)-1(c)(1)(ii).

[166] Reg. section 1.1400Z2(b)-1(c)(6)(iii). *See also* reg. section 1.1400Z2(b)-1(c)(7)(ii) for the corresponding rule for S corporation distributions.

[167] Section 731(a) (flush language).

[168] Referring to the taxpayer election to adjust the basis of a QOZ investment held for at least 10 years to FMV on the date that investment is sold or exchanged.

property for Federal income tax purposes.[169]

Note that simply holding the QOF partnership interest on December 31, 2026, would also be an inclusion event, but that event would likely not be considered a sale or exchange.[170]

Assuming the sale of the QSBS/QOF stock and the corresponding distribution of $11 million of money to the taxpayer in this example will satisfy the sale or exchange requirement under section 1202(a), the taxpayer will recognize $10 million of net capital gain. The regulations provide, "In the case of an inclusion event described in [reg. section 1.1400Z2(b)-1(c)(6)(iii)] . . . the amount of gain included in gross income is equal to the lesser of — (i) The remaining deferred gain; or (ii) The amount that gave rise to the inclusion event."[171] The taxpayer's initial basis in the QOF partnership is zero, but because the taxpayer has held the qualified investment for more than five years, the basis at the time of the distribution is $1 million (10 percent of the deferred gain).[172] Assuming the QOF stock also qualifies as QSBS, the taxpayer can exclude the $10 million of recognized gain under section 1202(a). The relevant per-issuer limitation for the taxpayer is the $10-million-per-taxpayer limitation, not the 10-times-basis limitation, because for this purpose any additions to the zero-basis QOF investment are ignored, and this results in no exclusion under the 10-times-basis calculation.[173]

Section 1400Z-2(c) provides that if a taxpayer holds a qualifying investment for at least 10 years and the taxpayer so elects, "the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged." In this example, assume that after more than 10 years from the date of investment, the QOF partnership sells the remaining QOF stock for $19 million (no change in value from the date of the distribution to the taxpayer), and the taxpayer makes the appropriate election to get the benefits of the section 1400Z-2(c) basis adjustment. Does the taxpayer, who had a prior inclusion event recognizing the entire deferred gain, get the benefit of the basis adjustment to FMV on all, or a portion, of the QOF stock sold?

The regulations provide a specific set of rules for inclusion events that result from partnership distributions (and distributions by QOF S corporations). The preamble explains that for inclusion events under reg. sections 1.1400Z2(b)-1(c)(6)(iii) (partnership distributions) and 1.1400Z2(b)-1(c)(7)(ii) (distributions by a QOF S corporation), "the section 1400Z-2(c) election continues to be available to a partner or S corporation shareholder, respectively, as long as the QOF owner continues to hold a qualifying investment in the QOF partnership or QOF S corporation, despite the distribution that caused an inclusion event."[174] Specifically, the regulations provide:

> The occurrence of an inclusion event described in [reg.] section 1.1400Z2(b)-1(c)(6)(iii), which addresses a distribution of property by a QOF partnership to a QOF partner where the distributed property has a fair market value in excess of the QOF partner's basis in its qualifying investment, does not prevent the QOF partner from making a subsequent election described in section 1400Z-2(c) with respect to the QOF partner's qualifying QOF partnership interest.[175]

Significantly, partnership distribution inclusions are not subject to the portion reduction rules,[176] as are other inclusion events (that is, a sale or gift of a portion of the taxpayer's QOF interest). These rules generally calculate the amount of gain based on the FMV of the disposed QOF interest and the FMV of the total qualifying investment.[177] These portion rules, under some circumstances,

[169] Preamble to T.D. 9889, 85 F.R. 1866, 1893 (Jan. 13, 2020).

[170] *See* section 1400Z-2(b)(1). Deferred gain is recognized upon the earlier of a sale or exchange of the investment *or* December 31, 2026.

[171] Reg. section 1.1400Z2(b)-1(e)(2).

[172] Section 1400Z-2(b)(2)(B)(i), (ii), and (iii); and reg. sections 1.1400Z2(b)-1(c)(6)(iii) and (v), 1.1400Z2(b)-1(e)(5), and 1.1400Z2(b)-1(g)(4). *See also* reg. section 1.1400Z2(b)-1(f)(10) and (11) (dealing with debt-financed distributions from a partnership).

[173] Section 1202(b)(1) (flush language).

[174] Preamble to T.D. 9889, 85 F.R. at 1893.

[175] Reg. section 1.1400Z2(c)-1(b)(1)(v).

[176] The portion rule applies except as provided in reg. section 1.1400Z2(b)-1(e)(2) and (4). Section 1.1400Z2(b)-1(e)(1).

[177] *See* reg. section 1.1400Z2(b)-1(e)(1)(i) and (ii).

could limit a taxpayer's benefit under section 1400Z-2(c). For example, a gift of 90 percent of a taxpayer's QOF interest would be an inclusion event of 90 percent of the deferred gain but would also prevent the taxpayer from getting the section 1400Z-2(c) basis election on 90 percent of the QOF investment.[178] In contrast, the QOF partnership distribution in this example provides for an inclusion event of 100 percent of the deferred gain (also excludable under section 1202(a)) but still allows the taxpayer to get the benefits of the basis adjustment under section 1400Z-2(c).

In this example, the QOF partnership sells the remaining QOZ stock after the 10-year holding period has been satisfied.[179] Under reg. section 1.1400Z2(c)-1(b)(2)(ii)(A), the taxpayer can make an election to exclude all gain allocable to the sale of the qualifying investment.[180] The taxpayer is treated as receiving a distribution of cash and immediately recontributing the cash to the QOF partnership in exchange for a nonqualifying investment in the QOF partnership.[181] That contribution and recontribution is only for purposes of determining the taxpayer's qualifying or nonqualifying investment in the QOF partnership; it has no other federal income tax consequences.[182] The deemed contribution and re-contribution is unnecessary if the QOF partnership distributes the cash proceeds from the sale within 90 days.[183] If the QOF partnership sells the remaining QOZ stock for $19 million and within 90 days distributes the proceeds, the taxpayer can elect to exclude that gain, and when the proceeds from the sale are distributed to the taxpayer, the basis of the taxpayer's QOF partnership interest will be increased by $19 million to reflect the exempt income,[184] allowing the taxpayer to receive the proceeds free of tax. If, in this example, the remaining QOF stock is distributed to the taxpayer and the taxpayer then sells it, the taxpayer can elect under section 1400Z-2(c) to adjust the basis to FMV at the time of the sale.[185]

There seems no policy reason or any provision in the code or the regulations that would prevent a taxpayer from combining the benefits of QSBS and QOZ investments. However, getting both benefits will happen only under a narrow set of circumstances. The QOF stock must satisfy all the QSBS qualifications, including the aggregate gross asset requirement and the active business requirement, whose definition of a qualified trade or business is narrower than for the businesses that would be considered QOZ businesses. Like QSBS, QOZ stock must be acquired by original issuance from a domestic corporation that is a QOZ business during substantially all of the QOF's holding period for that stock.[186] A QOZ business is defined as a trade or business (within the meaning of section 162)[187] (1) in which substantially all of the tangible personal property owned or leased by the taxpayer is QOZ business property;[188] (2) that satisfies the requirements of section 1397C(b)(2), (4), and (8);[189] and (3) that is not described in section 144(c)(6)(B).[190]

The section 1397C(b) requirements are similar to, but not the same as, the active business requirements under section 1202, as discussed earlier. Section 1397C(b)(2) requires that for each tax year at least 50 percent of the gross income of a QOZ business is derived from the active conduct

[178] Reg. section 1.1400Z2(c)-1(b)(1)(i) provides: "To the extent a taxpayer described in the preceding sentence has an inclusion event described in Section 1.1400Z2(b)-1(c) with respect to any portion of a qualifying investment, that portion is no longer a qualifying investment and the taxpayer is not eligible to make an election pursuant to section 1400Z-2(c) and this section with respect to that portion." Reg. section 1.1400Z2(b)-1(c) refers generally to the "inclusion events."

[179] After the initial sale of QSBS/QOF stock and corresponding distribution of the proceeds, it is not necessary that the QOF partnership continue to hold the QOF stock. The QOF stock can be sold and reinvested, within 12 months, into a QOZ investment that would not be considered QSBS and still maintain the ongoing QOZ benefits.

[180] Reg. section 1.1400Z2(c)-1(b)(1)(v).

[181] Reg. section 1.1400Z2(c)-1(b)(2)(ii)(B)(1).

[182] *Id.*

[183] Reg. section 1.1400Z2(c)-1(b)(2)(ii)(B)(2)(ii) and -1(d)(4), Example 4.

[184] "With respect to the taxpayer making an election under paragraph (b)(2)(ii) of this section, the excess of any gains over losses excluded from income under paragraph (b)(2)(ii) of this section is treated as income of the partnership . . . that is exempt from tax under the Internal Revenue Code for purposes of section 705(a)(1)(B)." Reg. section 1.1400Z2(c)-1(b)(2)(ii)(C)(*1*).

[185] *See* reg. section 1.1400Z2(c)-1(b)(1)(i).

[186] Section 1400Z-2(d)(2)(B)(i).

[187] *See* reg. section 1.1400Z-1(d)(1).

[188] Section 1400Z-2(d)(3)(A)(i). *See* reg. section 1.1400Z-1(d)(1)(i) and (2), establishing a 70 percent tangible property standard.

[189] Section 1400Z-2(d)(3)(A)(ii). *See* reg. section 1.1400Z-1(d)(3).

[190] Section 1400Z-2(d)(3)(A)(iii). *See* reg. section 1.1400Z-1(d)(1)(iii).

of a trade or business[191] in the QOZ.[192] Section 1397C(b)(4) requires that, for any tax year, a substantial portion of the intangible property of an Opportunity Zone business be used in the active conduct of a trade or business in the QOZ.[193] Section 1397C(b)(8) limits, in each tax year, the average of the aggregate unadjusted bases of the property of a QOZ business that may be attributable to nonqualified financial property. Section 1397C(e)(1) defines "nonqualified financial property" for purposes of section 1397C(b)(8) and excludes from that term reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less (working capital assets).[194]

The reference to section 144(c)(6)(B) provides that the following trades or businesses cannot qualify as a QOZ business: any (1) private or commercial golf course, (2) country club, (3) massage parlor, (4) hot tub facility, (5) suntan facility, (6) racetrack or other facility used for gambling, or (7) store whose principal business is the sale of alcoholic beverages for consumption off premises.[195] These are often referred to as the "sin businesses." However, outside the enumerated sin businesses, all other trades or businesses would qualify. As such, there should be a significant amount of active trades or businesses that would fall within the qualified trade or business definition of section 1202(e)(3) and the QOZ business definition of section 1400Z-2(d)(3). Notably, however, although the ownership, operation, and leasing of real property is considered a QOZ business, it would likely not satisfy the active business requirement for QSBS purposes.

IV. Conclusion

QSBS has finally matured. More than 25 years after the enactment of section 1202, the tax landscape has finally evolved such that the benefits of QSBS should be considered for all clients who own an interest in a closely held trade or business (or who are planning to start one). It's not just for technology start-ups anymore. The time is finally here for sole proprietorships, disregarded entities, partnerships, LLCs, and S corporations (with some limitations) to consider a reorganization that might involve a conversion to a C corporation or the creation of a new C corporation.

The benefits of QSBS can be extraordinary: (1) 100 percent exclusion of gain on the sale of QSBS; (2) the ability to roll over gains and defer taxable gains; and (3) the opportunity to stack and pack the exclusion so that the potential exclusion can be in the hundreds of millions. Unfortunately, section 1202 can present unusual challenges to taxpayers. It is easy to inadvertently lose the benefits of QSBS, and the lack of official guidance and the quirks of section 1202 make planning difficult at times. This report is an attempt to provide a complete and balanced discussion of the qualifications, the potential pitfalls, the unresolved issues, the answers to those issues, and the significant opportunities with QSBS for careful planners and their clients.[196]

[191] Solely for purposes of section 1400Z-2(d)(3)(A), the ownership and operation (including leasing) of real property is considered the active conduct of a trade or business, although merely entering into a triple-net lease will not qualify. Reg. section 1.1400Z-1(d)(3)(iii)

[192] *See* reg. section 1.1400Z-1(d)(3)(i).

[193] *See* reg. section 1.1400Z-1(d)(3)(ii) (defining "substantial portion" to mean at least 40 percent).

[194] *See* reg. section 1.1400Z-1(d)(3)(iv).

[195] *See* reg. section 1.1400Z-1(d)(4).

[196] The views and opinions expressed in this article are solely those of the authors and do not necessarily reflect the views and opinions of the institution that each represents. The information herein is provided solely for educational purposes. While this material is based on information believed to be reliable, no warranty is given as to its accuracy or completeness and it should not be relied upon as such. Information and opinions provided herein are as of the date of this material only and are subject to change without notice.

Appendix

Movement of QSBS Shares

Description of Transfer	QSBS Treatment of Transfer	QSBS Status Retained?	Additional Per-Issuer Limitation?
Contribution of QSBS to revocable living trust	Ignored	Yes	No
Gift of QSBS to IDGT	Ignored	Yes	No
Contribution of QSBS to GRAT	Ignored	Yes	No
Payment of QSBS to grantor from GRAT in satisfaction of annuity payment	Ignored	Yes	No
QSBS transferred upon expiration of the GRAT term to grantor trust	Ignored	Yes	No
QSBS transferred upon expiration of GRAT term to individual (other than grantor) or to non-grantor trust	By gift	Yes	Yes
Sale of QSBS to IDGT in exchange for installment note	Ignored	Yes	No
Transfer of QSBS from IDGT to grantor in satisfaction of installment note debt held by grantor	Ignored	Yes	No
Taxable sale of QSBS to individual or non-grantor trust	Disqualifying transfer	No	No
Gift of QSBS to individual	By gift	Yes	Yes
Transferring QSBS to spouse who is filing separately	By gift	Yes	No
Transferring QSBS to spouse who is filing jointly	By gift	Yes	Unknown
Transferring QSBS incident to divorce	By gift	Yes	Yes
Contribution of QSBS to non-grantor trust	By gift	Yes	Yes
Contribution of QSBS to DING, NING, or other incomplete gift non-grantor trust	By gift	Yes	Yes
Distribution of QSBS from grantor or non-grantor trust to a beneficiary (other than the grantor)	By gift	Yes	Yes
Distribution (or decanting) of QSBS from grantor or non-grantor trust to another non-grantor trust that is considered a separate taxpayer	By gift	Yes	Yes
Splitting pot trust holding QSBS into separate trusts for specific beneficiaries	By gift	Yes	Yes
Termination of grantor trust status when trust holds QSBS	By gift	Yes	Yes
Termination of grantor trust status when trust holds QSBS and it collateralizes debt that exceeds basis	By gift; and disqualifying transfer	Yes and no	Yes and no
Conversion of non-grantor trust to grantor trust status when trust holds QSBS	Ignored	Yes	No
Conversion of non-grantor trust to grantor trust status when trust holds QSBS and it collateralizes debt that exceeds basis	Ignored	Yes	No

Movement of QSBS Shares *(Continued)*

Description of Transfer	QSBS Treatment of Transfer	QSBS Status Retained?	Additional Per-Issuer Limitation?
Transfer of QSBS under the exercise of a limited or general power of appointment	By gift	Yes	Yes
Contribution of QSBS to family limited partnership and sale by FLP	Disqualifying transfer	No	No
Contribution of QSBS, distribution back to contributing partner, and sale by the partner	Unknown	Unknown	Unknown
Distribution of QSBS from FLP to a partner	Partnership to partner	Yes	No
Contribution of QSBS to disregarded entity LLC	Ignored	Yes	No
Conversion of disregarded entity LLC holding QSBS to partnership (may depend on whether the QSBS is sold by the partnership or by the “contributing” partner)	Unknown	Unknown	Unknown
Gift of interest in FLP holding QSBS to individual or non-grantor trust	Unknown	Unknown	Unknown
Gift of interest in FLP holding QSBS to GRAT or IDGT, whether a zeroed-out gift or a taxable gift	Ignored	Yes	No
Sale of interest in FLP holding QSBS to an IDGT in exchange for installment note	Ignored	Yes	No
Contribution of QSBS to S corporation	Disqualifying transfer	No	No
Distribution of QSBS from S corporation to shareholder	Disqualifying transfer	No	No
Gift of interest in S corporation holding QSBS to individual or non-grantor trust	Unknown	Unknown	Unknown
Contribution of QSBS to charitable remainder trust	By gift	Yes	Unknown
Contribution of QSBS to grantor charitable lead trust	Ignored	Yes	No
Contribution of QSBS to non-grantor charitable lead trust	By gift	Yes	Yes
Bequest of QSBS	By death	Yes	Yes
Transfer of QSBS in joint account by right of survivorship	By death	Yes	Yes
Distribution of QSBS from a revocable living trust upon the death of the grantor	By death	Yes	Yes

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