



AMERICANBARASSOCIATION

Tax Section

2024 MAY TAX MEETING

#24TaxMay

Section 1202 and Partnerships

Partnerships & LLCs

May 3, 2024



The Panel

- Morgan L. Klinzing, Troutman Pepper
- Ryan J. Dobens, Ernst & Young, LLP
- Christopher A. Karachale, Hanson Bridgett, LLP

Background on Section 1202

Section 1202 – In General

- Section 1202 offers an exclusion for an individual (or certain trust) taxpayers to permanently exclude from taxable income \$10 million dollars (and possibly more) of capital gain recognized in conjunction with the sale of qualified small business stock (“QSBS”).
- The QSBS exclusion is not limited to a single investor.
- For each eligible taxpayer, a \$10 million dollar exclusion could result in cash-tax savings of \$2.38 million dollars (exclusive of state-tax savings).

QSBS Qualification

- To meet the definition of QSBS, certain requirements must be met at the time of the stock's issuance, while others must be met during substantially all the shareholder's holding period of the stock.
- In addition, the relevant stock must be held for at least five-years.

QSBS Qualification* (cont'd)

- Requirements that must be met on the date of issuance
 1. C Corporation requirement (Section 1202(c)(1)).
 2. Qualified small business requirement (Section 1202(d)).
 3. Original issuance requirement (Section 1202(c)(1)).
- Requirements that must be met during substantially all of the shareholder's holding period.
 1. The active business requirement (Sections 1202(c)(2) & (e)).

*This is not a complete list of all the QSBS requirements.

QSBS Held in Passthrough Entity

- When QSBS is held by a partnership or S corporation, partners or shareholders may exclude their share of any gain the passthrough entity recognized on the disposition of the QSBS, subject to the certain requirements and limitations below:
 - The stock sold by the passthrough entity must satisfy all of the requirements necessary to qualify as QSBS, including the five-year holding period.
 - Then, partner or shareholder may only exclude gain under Section 1202 if the partner or shareholder held an interest in the partnership or S corporation on the date the passthrough entity acquired the stock and at all times before the sale of the stock by the passthrough entity.
 - Finally, the partner or shareholder may take into account under Section 1202 only the amount of gain the partner or shareholder would have been allocated based on his or her ownership interest on the date the QSBS was originally acquired by the passthrough entity.

QSBS and Carried Interests

QSBS and Carried Interest

- Section 1202(g) provides that the \$10 million exclusion may apply with respect to a partner's share of gain from the sale of QSBS held by a partnership.
 - The gain must be attributable to the partnership's sale or exchange of stock which is QSBS in the hands of the partnership;
 - The individual taxpayer's share of such gain must be attributable to a partnership interest held by such individual taxpayer on the date on which the partnership acquired the QSBS and at all times thereafter until the disposition of the QSBS by the partnership.
- A profits interest is defined as a "partnership interest other than a capital interest." Section 2.02, Rev. Proc. 93-27.
- The legislative history contains an express indication by Senator Lieberman that Section 1202(g)'s definition of "interest" is intended to apply to a profits interest. 139 Cong. Rec. S10680-01, S10732-33 (Aug. 6, 1993).
 - While Senator Lieberman was not a manager of the bill, and therefore his statement cannot be considered directly in the determination of whether substantial authority exists for a tax position (pursuant to Treas. Reg. § 1.6662-4(d)(3)(iii)), it still provides a helpful contextual background.
- Treas. Reg. § 1.1045-1(d)(1)(ii): QSBS deferral only applies to *capital* interests and the smallest percentage held during the QSBS "holding period" is to be used as that capital interest.

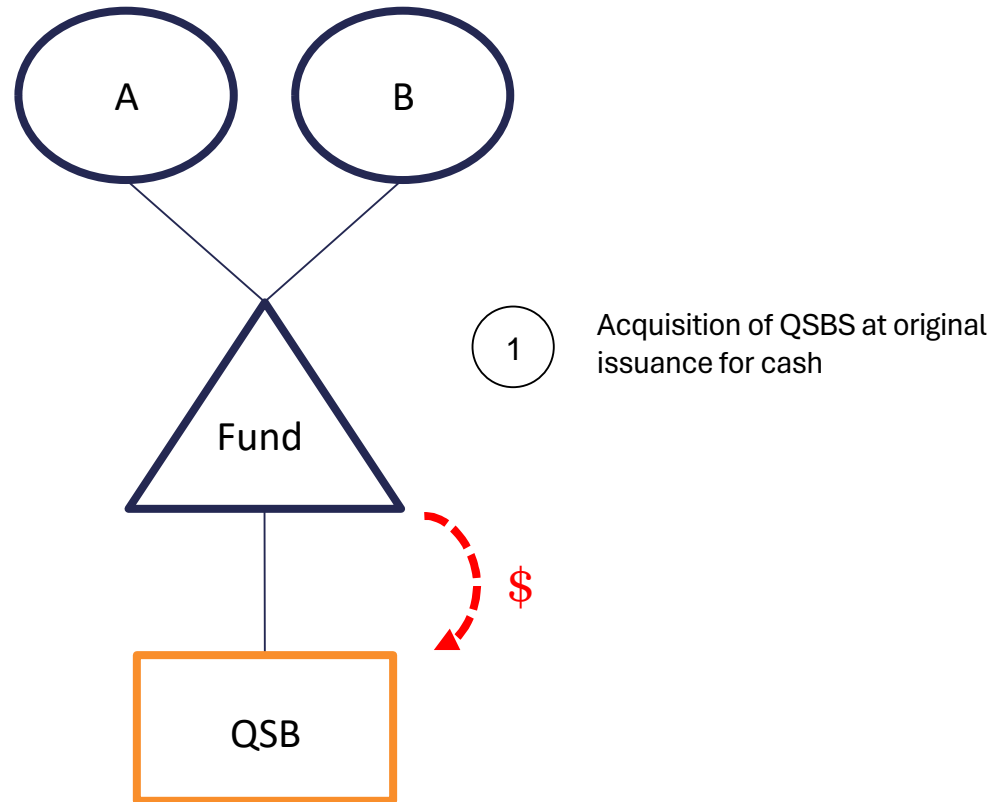
QSBS and Carried Interest

- Rev. Proc. 2001-43 provides that:
 - the determination of whether an interest granted to a service provider is a profits interest is made when the interest is granted, even if the interest is "substantially nonvested" at that time; and
 - the partnership and the service provider must "treat the service provider as the owner of the partnership interest from the date of its grant."
- No language under section 1202 itself or the regulations indicates a partner's "interest" is based on the smallest percentage in partnership capital.
- Section 710(a)(6) of the Ending Wall Street Tax Giveaway Act of 2023*, H.R. 2686, 118th Cong (2023-2024) would have removed any QSBS exclusion “allocated with respect to any investment services partnership interest.”

* Reps. Bill Pascrell, Don Beyer, and Katie Porter sponsored and introduced the proposed Ending Wall Street Tax Giveaway Act on April 18, 2023.

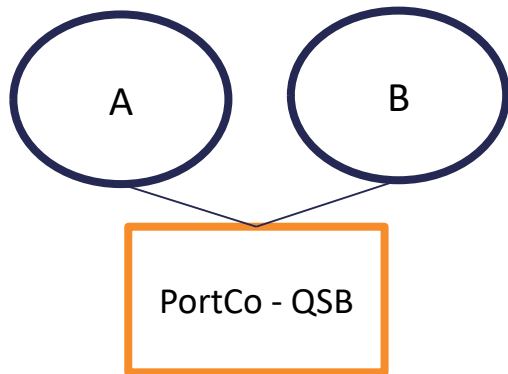
Transaction Examples

Base Case - Acquiring QSBS Through a Partnership



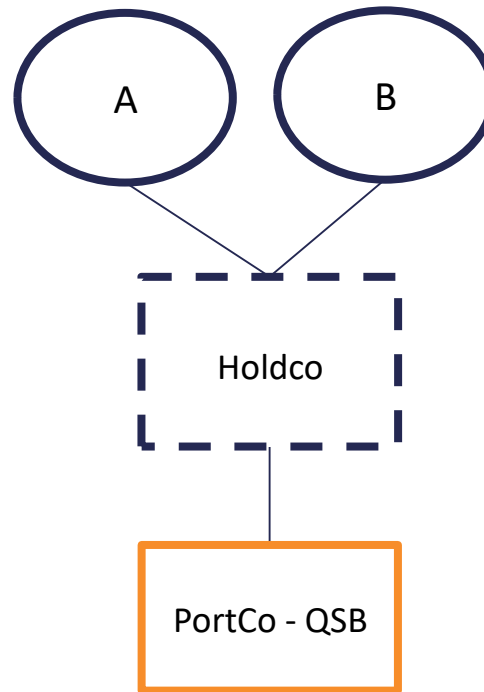
Example #1 – Contribution of QSBS

Starting structure



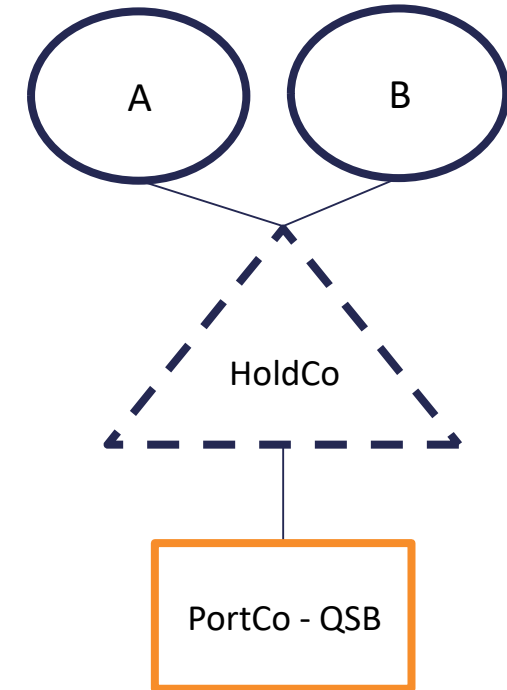
Alternative A

Stock transferred to Holdco corporation



Alternative B

Stock transferred to Holdco partnership



Example #1 – Contribution of QSBS (cont'd)

Alternative A

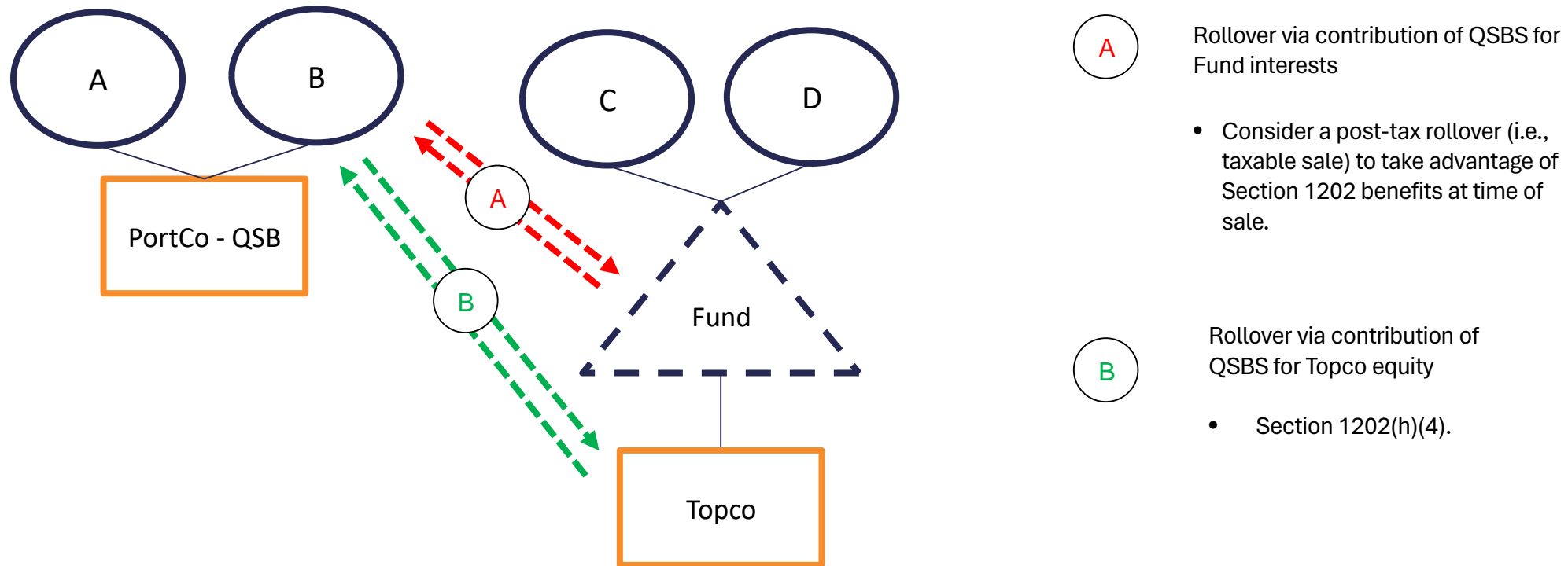
- Stock acquired via a Section 351 transaction may still qualify as QSBS.
 - Section 1202 benefits limited to built-in 1202 gain at the time of the contribution, unless the stock received qualifies as QSBS. See Section 1202(h)(4).

Example #1 – Contribution of QSBS (cont'd)

Alternative B

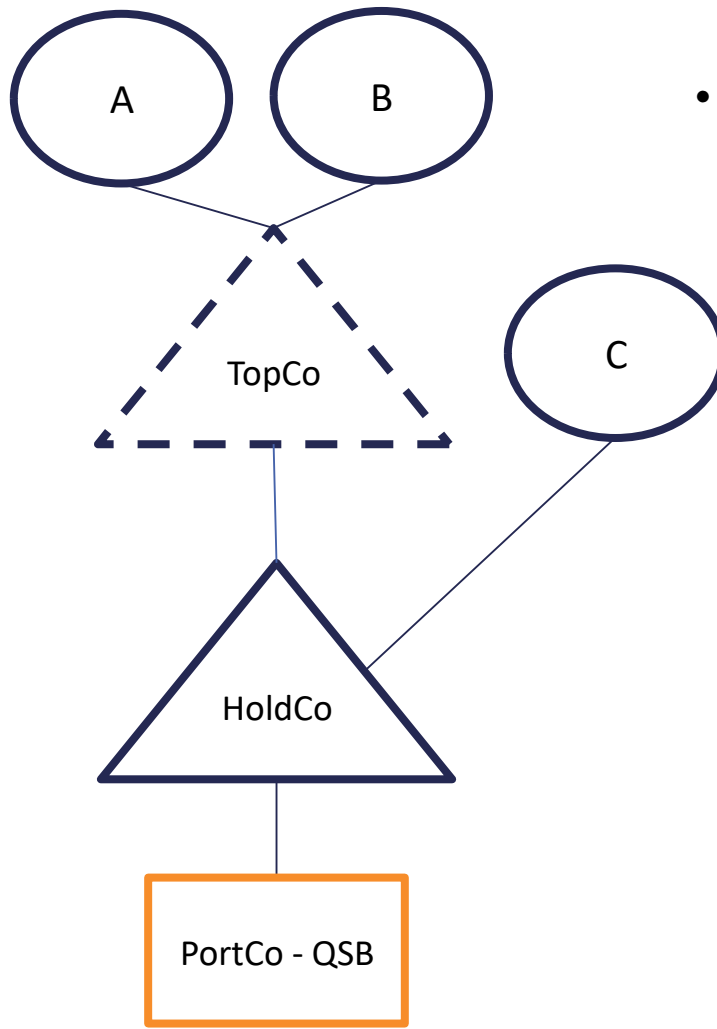
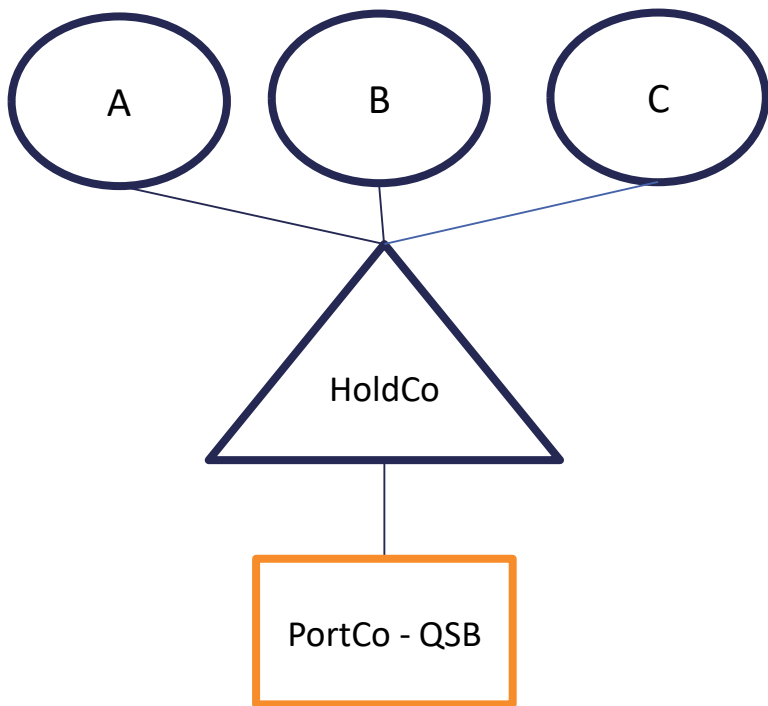
- A contribution of QSBS to a partnership under Section 721 turns off Section 1202 benefits. See Treas. Reg. § 1.1045-1(i), Example 12.
 - What about a partnership recap? Or conversion of a Limited Partnership (LP) to an limited liability company (LLC)?
 - See e.g., Rev. Rul. 84-52, 1984-1 C.B. 157 (stating the conversion of a general partnership to a limited partnership resulted in a Section 721 exchange); *cf.* CCA 201517006 (general partner's exchange of incentive distribution rights (IDRs) for other common units and new IDRs was not a Section 721 exchange).

Example #2 – Rollover Considerations with QSBS



Example #3 – Indirect Contribution of QSBS

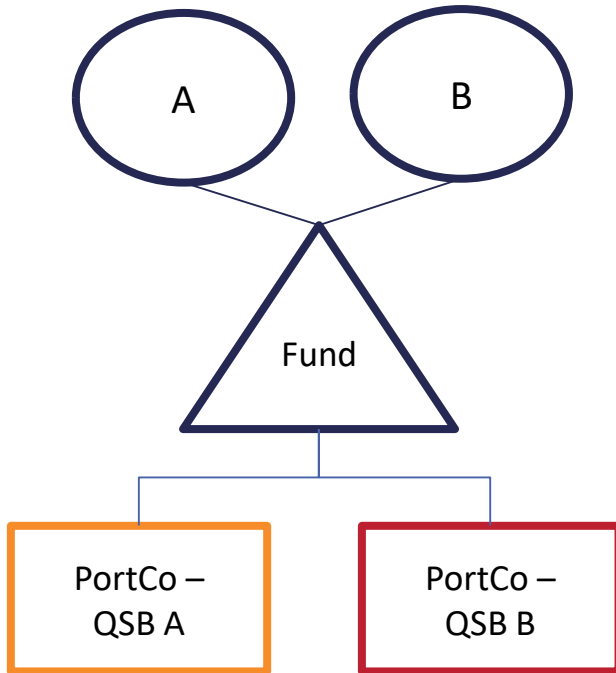
Starting structure



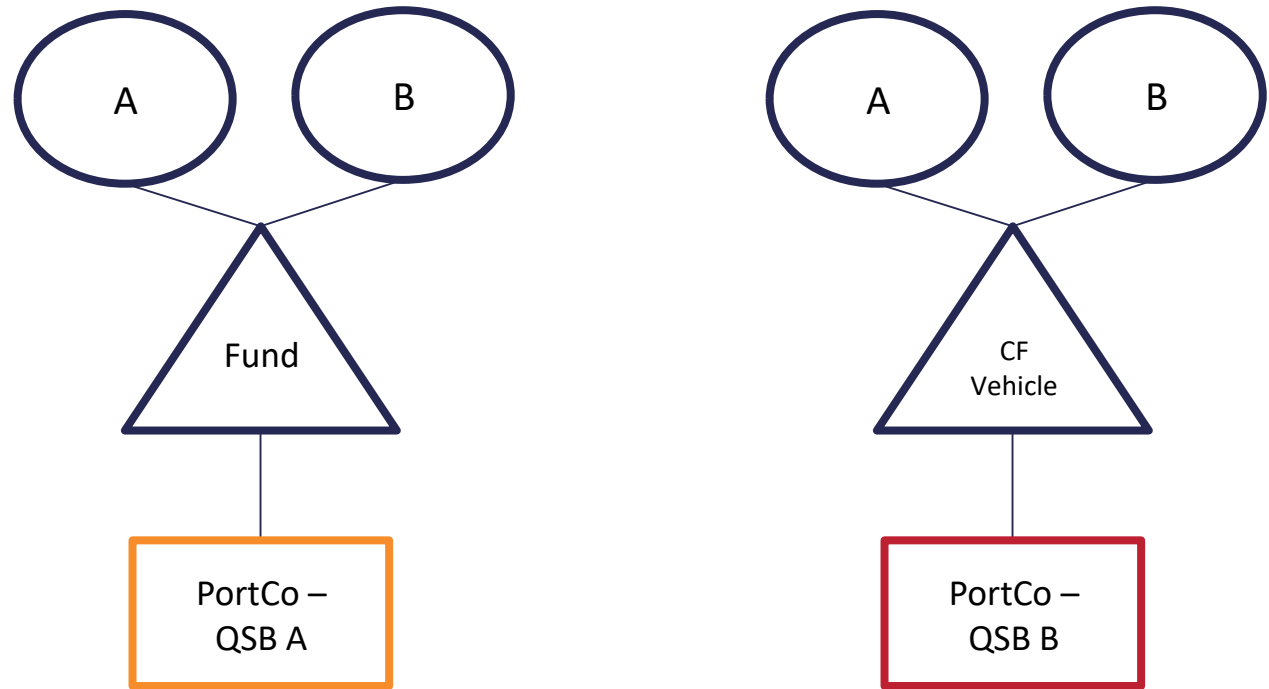
- Holdco interests transferred to Topco (partnership)
- Lower-tier partnership effectively ignored for purposes of Section 1045 rollovers. See Treas. Reg. § 1.1045-1(b)(3)(ii)(B).
- However, A and B did not hold an interest in Topco when the QSBS was acquired. Section 1202(g)(2).
- Is a partnership an aggregate or entity for this purpose?

Example #4 - Partnership Division

Starting structure



Ending structure



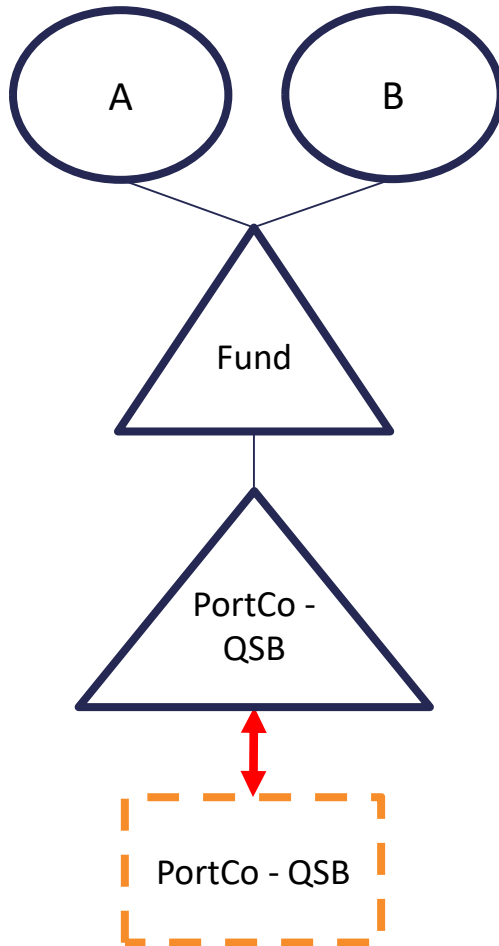
Example #4 – Partnership Division (cont'd)

- Assets Over Form
 - Divided partnership contributes certain assets and liabilities to the recipient partnership in exchange for interests in the recipient partnership, and then the divided partnership distributes interests in the recipient partnership to its partners. Treas. Reg. § 1.708-1(d)(3)(i).
 - Important to determine which is the divided partnership and which is the recipient partnership. QSBS benefits are lost for one of these entities.

Example #5 - Partnership Incorporation – “Assets Over”

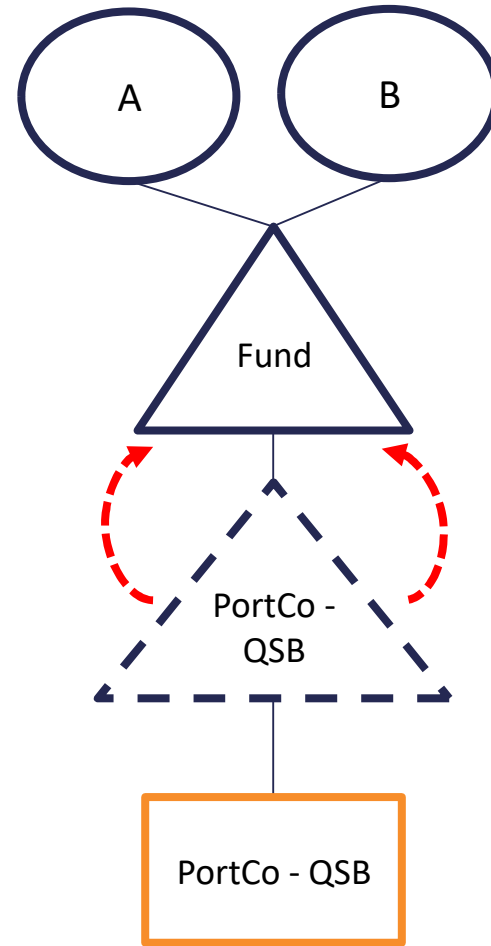
1

Assets & liabilities transferred by PortCo partnership in exchange for stock of newly formed corporation

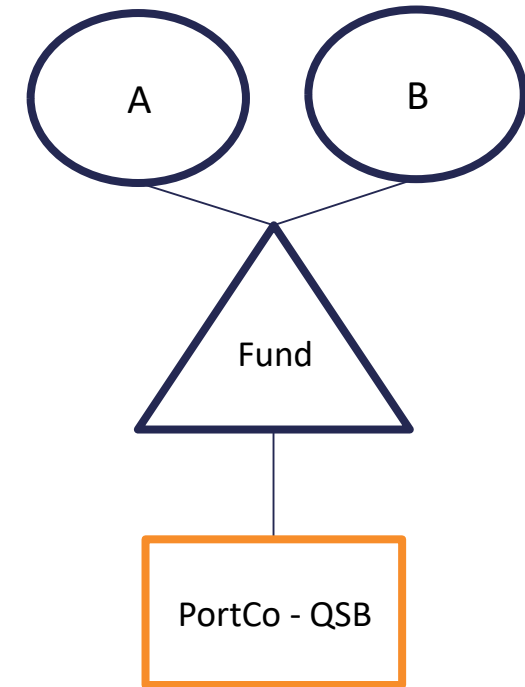


2

Stock transferred in complete liquidation of PortCo partnership



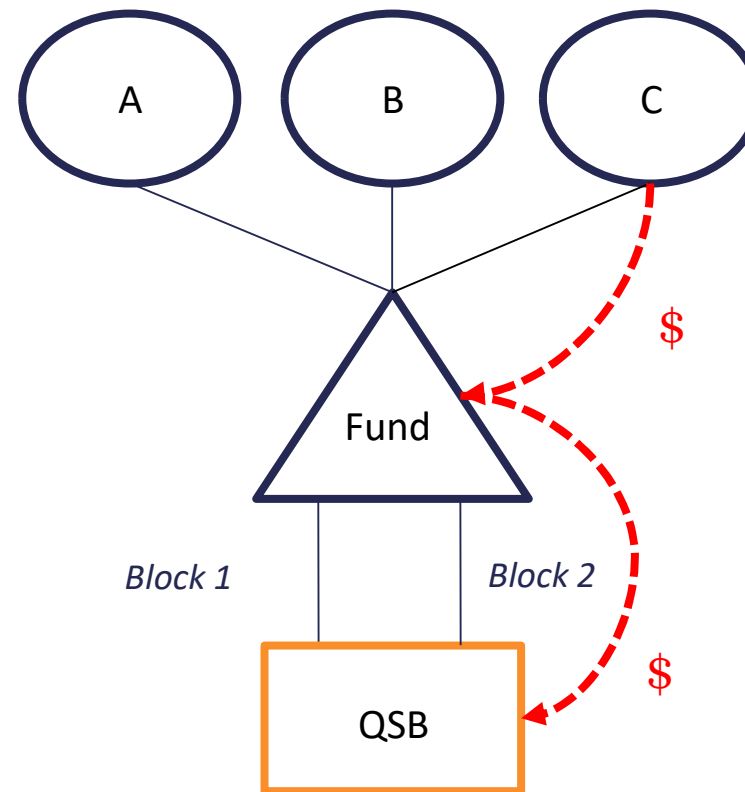
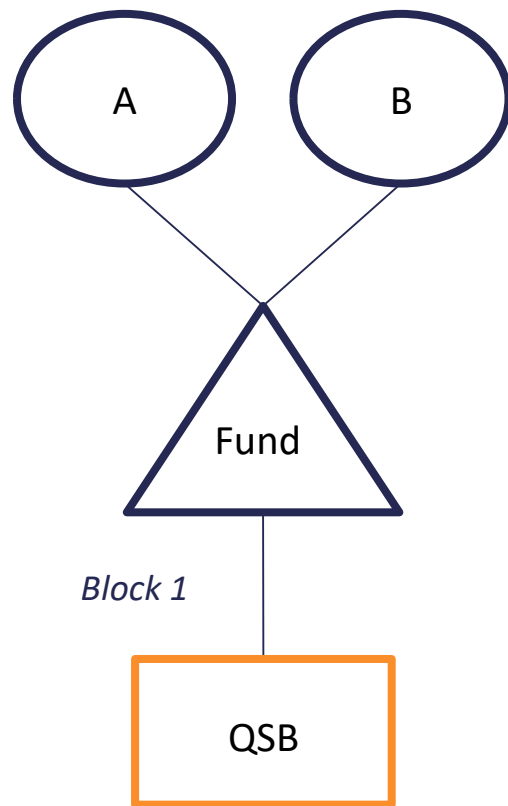
Ending structure



Example #5 - Partnership Incorporation – “Assets Over” (cont’d)

- Consider:
 - Gain or loss on partnership incorporation.
 - See generally Rev. Rul. 84-111, 1984-2 C.B. 88. For example, Section 357(c) (contribution of property to a corporation with a tax basis less than the amount of liabilities transferred can result in gain being recognized).
 - Determining whether the incorporated partnership is a “qualified small business”.
 - See Section 1202(d)(2) which requires the fair market value of the property contributed for purposes of this test (i.e., \$50m of aggregate gross assets). Is it clear how this special rule applies to future financings?
 - Special basis provisions.
 - See Section 1202(i) – basis in stock for Section 1202 purposes may differ from Section 1012 cost basis because of a special rule that requires the QSBS basis equals the fair market value of the stock at the time of the incorporation.

Example #6 – Tracking Allocations and QSBS



- 1 Sometime after Block 1 was acquired, C contributes cash in exchange for a partnership interest in Fund
- 2 Acquisition of new QSBS at original issuance for cash

Example #6 - Tracking Allocation Considerations

- Under the facts of this Example 2, partner C does not have an “interest” in the pass-through entity (i.e., Fund) related to the Block 1 shares at the time they were acquired. See Section 1202(g)(3). Hence, any gains from the sale of Block 1 (even if all other QSBS requirements are met) allocated to C are not eligible for the QSBS exclusion.
- Could Fund setup “tracking allocations” to ensure that only gains from Block 1 are split between A and B, and gains from Block 2 are split among A, B, and C?

Example #6 - Tracking Allocation Considerations

- Tracking Allocation Example
 - Treas. Reg. § 1.704-(1)(b)(5), Example (10) - the “travel agency” example. In this example, the partnership agreement provided that T, a resident of a foreign country will be allocated 90 percent of income, gain, loss, and deduction from the travel agency operations in that county, and his partner only 10 percent. All remaining income, gain, loss, and deduction amounts were shared among the partners equally.
- Substantiality Considerations
 - In order for an allocation to be “substantial” there must be a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. See Treas. Reg. § 1.704-1(b)(2)(iii).
- What is “partnership property”?
 - Rev. Rul. 55-39, 1995-1 C.B. 403, explains that the investment by a partnership of a member's contributed capital in securities of his own choice, and for his own account, is in effect a withdrawal of such capital from the firm and an investment by him in the securities purchased, resulting in a deemed distribution of such securities to the relevant partner.

QSBS and Simple Agreements for Future Equity (SAFEs)

QSBS and SAFEs

- Y Combinator Partner Kirsty Nathoo: “A SAFE is an instrument where the investor will give a startup money now in exchange for a promise from the company to give shares to the investor at a future date when the startup raises money on a priced round....a SAFE is not debt.”
- Section 5(g) of the Y Combinator SAFE states:
 - The parties acknowledge and agree that for United States federal and state income tax purposes this Safe is, and at all times has been, intended to be characterized as stock, and more particularly as common stock for purposes of Sections 304, 305, 306, 354, 368, 1036 and **1202** of the Internal Revenue Code of 1986, as amended. Accordingly, the parties agree to treat this Safe consistent with the foregoing intent for all United States federal and state income tax purposes (including, without limitation, on their respective tax returns or other informational statements). **(Emphasis Added)**.

QSBS and SAFEs

- H. R. Rep. No. 103-111 (1993), at 824: "Stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue."
- PLR 201636003 (Sept. 2, 2016): While ownership of a corporation is normally tied to stock ownership, and under state law LLC owners hold a member interest and not formal stock, the term "stock" for federal tax purposes is not restricted to cases where formal stock certificates have been issued. Rather, it has been a consistent Service position that for federal tax purposes stock ownership is a matter of economic substance, i.e., the right to which the owner has in management, profits, and ultimate assets of a corporation.

QSBS and SAFEs

- Is a SAFE a forward contract?
- Generally, a forward contract is an executory contract under which a buyer agrees to purchase from the seller a fixed quantity of property at a fixed price in the future. When the subject asset of the contract is an "appreciated financial position" including stock, Section 1259 treats the transaction as a constructive sale.

For more information

- If you have any questions, please do not hesitate to reach out to us.

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Questions?

Appendix

Section 1202

- Section 1202
 - Section 1202(a) allows a noncorporate shareholder to exclude 50% of the gain from the sale of qualified small business stock (**QSBS**) that has been held for five years.
 - The 50% exclusion percentage was increased to 75% for stock acquired from Feb. 18, 2009, to Sept. 27, 2010, and then again to 100% for stock acquired on or after Sept. 28, 2010.

QSBS Qualification – C Corporation Requirement

- On the date of issuance, the issuing corporation must be a domestic C corporation, and the stock must be issued after Aug. 9, 1993.
 - Stock issued while a corporation is an S corporation will never meet the definition, even if the S corporation later revokes its S election, because the stock was not issued while the corporation was a C corporation.
 - A corporation that issued stock as a C corporation could have a brief period as an S corporation without tainting its status as QSBS.

QSBS Qualification – Qualified Small Business Requirement

- On the date a corporation issues its stock, the corporation must meet two tests for its gross assets (the gross-assets test):
 1. Immediately after the date of issuance (and after considering amounts the corporation received in the issuance), the aggregate gross assets of the corporation must not exceed \$50 million.
 2. At all times from Aug. 9, 1993, through the date of issuance, the aggregate gross assets of the corporation (or any predecessor) must not have exceeded \$50 million.

QSBS Qualification – Original Issuance Requirement

- QSBS must be acquired by the current holder at “original issuance.”
 - The stock must be acquired directly from the issuing corporation in exchange for money or other property (not including stock) or as compensation for services provided to the corporation (other than services performed as an underwriter).
 - Therefore, a shareholder who acquires stock from an existing shareholder in a cross-purchase will not be treated as having received the stock at original issuance.
 - The committee reports to the Revenue Reconciliation Act of 1993 clarify that stock a shareholder acquired through the exercise of options or warrants or through the conversion of convertible debt is treated as acquired at original issuance.

QSBS Qualification – Original Issuance Requirement (cont'd)

- The situations below can result in the stock being treated as having been received at original issuance even if the shareholder is not the original owner of the shares:
 - Gift
 - Death
 - **Distribution from a partnership.** Note that while a distribution of stock from a partnership to a partner allows the partner to “step in the shoes” of QSBS treatment, a *contribution* from a partner to a partnership of QSBS is fatal to the qualification in the hands of the partnership.
- If the stock was acquired by the transferor at original issuance, the transferee will be treated as having done the same.

QSBS Qualification – Original Issuance Requirement – Partnership Distribution

- For stock distributed from a partnership to a partner to meet the definition of QSBS in the hands of the partner:
 - The stock must have been QSBS in the partnership's hands (ignoring the five-year holding period requirement).
 - The partner must have been a partner from the date the partnership acquired the stock through the date of the distribution.
 - The partner cannot treat stock the partnership distributed as QSBS to the extent the partner's share of the distributed stock exceeds the partner's interest in the partnership at the time the partnership acquired the stock.

QSBS Qualification – Special Basis Rules

- To prevent abuse of Section 1202 whereby shareholders attempt to exclude gain attributable to pre-investment appreciation, special rules are prescribed for determining a shareholder's initial basis in QSBS.
- If a shareholder transfers property (other than cash or stock) to a corporation in exchange for stock, for the purposes of Section 1202, the shareholder's basis in the stock is treated as not less than the FMV of the property exchanged.
 - This is contrary to the general rule of Section 358, which gives a shareholder in Section 351 transfer a basis in the stock received equal to the adjusted basis of any property transferred to the corporation.
 - The effect of this rule, however, is to ensure that only appreciation that occurs after the acquisition of the stock is eligible to be excluded under Section 1202.

QSBS Qualification – Holding Period Requirements

- To meet the definition of QSBS, two requirements must be met for "substantially all" of the shareholder's holding period specifically:
 - The corporation must be a **C corporation**
 - Satisfy the "**active business**" requirement
- These tests do not apply to the entire lifespan of the corporation but rather to the period that a shareholder attempting to qualify for the benefits of Section 1202 holds the corporation's stock.
 - Thus, while these tests are measured at the corporate level, the period for which they are measured is determined at the shareholder level.
 - Unfortunately, neither Section 1202 nor the underlying regulations define the term "substantially all."

C Corporation and Active Business Requirements

- C Corporation Requirement
 - For stock to meet the definition of QSBS, the corporation must be a C corporation on the date of issuance and during substantially all of the shareholder's holding period. A brief period as an S corporation – less than 10% of the owner's holding period for the stock – may be acceptable, provided the stock was not issued to the shareholder at that time.
- Active Business Requirement
 - For stock in a corporation to meet the definition of QSBS, during substantially all of the shareholder's holding period, the corporation must be an "eligible corporation," and at least 80% (by value) of the assets of the corporation must be used by the corporation in the active conduct of one or more "qualified trades or businesses."

Active Business Requirement

- For substantially all of the shareholder's holding period, at least 80% of the assets of the corporation must be used in the active conduct of one or more "qualified trades or businesses."
 - Qualified business means any trade or business other than:
 - Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees
 - Any banking, insurance, financing, leasing, investing or similar business
 - Any farming business (including the business of raising or harvesting trees)
 - Any business involving the production or extraction of products of a character for which a deduction is allowable under Section 613 (percentage depletion of mines, wells and other natural deposits) or 613A (percentage depletion of oil and gas wells)
 - Any business operating a hotel, motel, restaurant or similar business

Active Business Requirement

- 80% of gross assets test
 - After determining that the corporation has been an eligible corporation engaged in a qualified trade or business during substantially all of the shareholder's holding period of the corporation's stock, it must be established that during that period more than 80% of the corporation's gross assets were used in the active conduct of that trade or business.
 - Section 1202 provides that the value of the corporation's assets is measured for these purposes, meaning that the value of all assets, including self-created intangibles such as goodwill, should be taken into consideration in applying the 80% test.
 - Compare this to the \$50 million gross-assets test, which looks to the adjusted basis of the corporation's assets, so self-created intangibles are not taken into consideration

Section 1045

- A critical counterpart to Section 1202
 - If QSBS has been held longer than six months, but not five years, upon a sale the taxpayer has 60 days to reinvest proceeds into replacement QSBS.
 - Gain on the sale of the relinquished QSBS will be deferred to the extent the proceeds are reinvested.
 - The replacement corporation must meet the 80% active business test for at least the first six months in order for the deferral to be assured.
 - The holding period of the relinquished QSBS tacks to the replacement QSBS.

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