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FEATURED ARTICLES

Qualified Small Business Stock Letters: Best (and Worst) Practices

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Introduction

If a shareholder in a C corporation sells Qualified Small Business Stock (QSBS), some or all of the gain may be tax-free or tax-deferred (though not for California purposes). However, some of the key information to determine whether stock is QSBS is known only to the corporation. In this article, I describe the dynamics surrounding the disclosure of this information from the corporation.

In Part I, I define the key concepts: (A) the definition of QSBS, (B) when a sale of QSBS can be rolled over tax-free into other QSBS, and (C) when a sale of QSBS can be tax-free without the need for a rollover. In Part II, I describe information which the corporation should retain, how the company issues a QSBS letter, and how the shareholder uses this information to file their returns. In Part III, I describe best (and worst) practices surrounding these letters.

I. Key Concepts

A. Definition of Qualified Small Business Stock

To be QSBS, stock must meet three requirements.

- First, it must be stock in a C corporation; issued after October 1993; to the taxpayer at original issue; for cash, services, or other property (but not for stock); while the corporation was a "Qualified Small Business." IRC §1202(c)(1).
- Second, during substantially all of the taxpayer's holding period, the corporation must have been (i) a C corporation (ii) that meets the active business requirements. IRC §1202(c)(2).
- Third, the corporation must not have issued the stock (i) within 2 years before or after buying its own stock from that taxpayer or a related party; or (ii) within 1 year before or after buying an amount of its own stock exceeding 5 percent of the value of all its stock in the year before issuance. IRC §1202(c)(3).

In the rest of this section, I define these terms.

1. QSBS Must Be Original Issue: *Exceptions*

The "original issue" rule in IRC §1202(c)(1) has some exceptions.

First: For a distribution from a pass-through entity, a gift, or a testamentary transfer, treat the transferee as having acquired the stock in the same way as the transferor. IRC §1202(h)(1), (h)(2). If the pass-through entity sells the stock, the "original issue" rule is not applied to the partner/shareholder. IRC §1202(g). However, stock ceases to be QSBS if it is contributed to a partnership. Treas Reg §1.1045–1(f).

Second: If the taxpayer held original issue stock, and exchanged it for stock in an E or F reorganization (a reorganization described in IRC §368–2(e)(1)–(5) or §368(a)(1)(F)), the new stock will be deemed held at original issue. IRC §1202(h)(3).

2. QSBS Cannot Be Acquired for Stock: *Exceptions*

The "not for stock" rule in IRC §1202(c)(1) has some exceptions. These are for stock acquired by conversion of other stock that was QSBS, and for stock acquired by relinquishing QSBS in an exchange under IRC §351 (transfer to controlled corporation) or §368 (reorganization). IRC §1202(f), (h)(4). After an IRC §351 exchange, the issuing corporation must control the corporation whose QSBS stock is contributed. If the stock in the issuing corporation is not QSBS after the IRC §351 or §368 exchange, the QSBS exclusion will only apply to the built-in gain in the contributed stock.

3. Issued by a Qualified Small Business

Stock was issued by a Qualified Small Business, as required in IRC §1202(c)(1), if it was issued by a domestic (U.S.) corporation whose total assets (cash plus "adjusted basis" of noncash property) did not exceed $50 million at any time before the issuance of the stock (including assets contributed in the issuance). IRC §1202(d)(1). For this purpose, treat the following as one corporation: all members of the same 50 percent parent-child control group. IRC §1202(d)(3).

The company must also agree to comply with IRS reporting requirements. IRC §1202(d)(1). While there are currently none, to comply with the literal rule, the company should agree in advance to comply with any reporting requirements that may arise in the future. For an

example of how to do this, see Staley, *How Sections 1202 and 1045 Can Exclude or Defer SOME Stock Gains,* Exhibit A, available at http://staleylaw.com/eventsandoutlines.html.

4. Substantially All—Definition

"Substantially all" in IRC §1202(c)(2) is not defined. Many practitioners treat 4 out of 5 years as sufficient. See, *e.g.,* Lee, Comeau, Kwon & Syida, *Qualified Small Business Stock: Quest for Quantum Exclusions,* 168 Tax Notes Fed 15 (July 6, 2020).

5. Active Business Requirements—Definition

To meet the "Active Business" requirement in IRC §1202(c)(2), there are two requirements.

First, the corporation must be an "eligible corporation." This means any domestic corporation that is not a Domestic International Sales Corporation (DISC) or former DISC, a Regulated Investment Company (RIC)/Real Estate Investment Trust (REIT)/Real Estate Mortgage Investment Conduit (REMIC), or a cooperative. IRC §1202(e)(4).

In addition, of its assets (measured by value; looking through subsidiaries owned greater than 50 percent by vote or value) (IRC §1202(e)(1)(B), (e)(5)(B), (e)(7)),

- It must use 80 percent or more in the active conduct of "qualified trades or businesses"; *and*
- Not more than 10 percent can be real property used in the active conduct of qualified trades or businesses; *and*
- Not more than 10 percent can be corporate stock or securities, other than subsidiaries owned greater than 50 percent by vote or value; this test is applied to assets net of liabilities.

The Active Business requirement is also met by any Specialized Small Business Investment Company, but no new SSBICs have been licensed since 1996. See https://sgp.fas.org/crs/misc/R41456.pdf.

a. Qualified Trade or Business

"Qualified Trade or Business" means any trade or business, *other than* any of the following:

- Businesses relying as a principal asset on the reputation or skill of employee(s);
- Businesses involving services in health, law, accounting, actuarial services, engineering, architecture, consulting, finance/brokerage, sports, or performing arts;
- Banking, selling insurance, financing, leasing, investing, or similar businesses;
- Farming businesses;
- Businesses producing or extracting oil, gas, or similar items in IRC §613 or §613A;
- Businesses operating a hotel, motel, restaurant, or similar; or
- For the 10 percent limit on real property, businesses owning, dealing in, or renting real property.

b. Active Conduct

The phrase "active conduct" is not defined. Complicating this further, the phrase has different meanings throughout the Code.

However, IRC §1202 does provide a few safe harbors. Assets will qualify if

- In connection with a *future* qualified trade or business, the corporation is engaged in (or uses its assets in) activities involving start-up expenditures under IRC §195(c)(1)(A), research and experimentation under IRC §174, or in-house research under IRC §41(b)(4), regardless of whether these activities earned income. IRC §1202(e)(2).
- The assets are rights to computer software that produces active business computer software royalties. IRC §1202(e)(8).
- The assets are held as part of the reasonably required working capital needs of a qualified trade or business, or are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in, or increases in the working capital needs of, a qualified trade or business. After the corporation has been in existence for 2 years, no more than 50 percent of its assets may qualify for these working capital exceptions. IRC §1202(e)(6).

B. QSBS Eligible for Tax-Free Rollover Into Other QSBS

When QSBS is sold, it is possible to roll the gain into other QSBS. This is analogous to an IRC §1031 like-kind exchange of real property. To be eligible, the seller cannot be a C corporation and must have held the relinquished QSBS for at least 6 months. Within 60 days of selling that QSBS, the seller must buy the replacement QSBS, in a transaction that would otherwise have generated a cost basis. IRC §1045; Treas Reg §1.1045–1.

One benefit of this election is that the replacement stock will inherit the holding period of the previous stock. IRC §§1202(a)(4), 1223(13). In addition, if the shareholder reinvests 100 percent of their proceeds, they will recognize no gain. On the other hand, if the shareholder reinvests less than 100 percent of their proceeds, the remainder will be taxed like "boot" in a §1031 exchange. That is: All the shareholder's gain will be recognized, except to the extent the amount rolled over exceeds the shareholder's basis.

C. QSBS Eligible for Tax-Free Sale

Alternatively, when the non-C-corporation taxpayer sells QSBS, they may be able to exclude some of the gain

(eligible gain). Eligible gain is a gain from a sale or exchange of QSBS that the taxpayer held for more than 5 years. IRC §1202(b). This holding period "tacks" in some cases. See IRC §1202(a)4) (QSBS rollover), §1202(f) (conversion of stock), §1202(h)(1) (acquisition by gift, at death, or from a partnership), §1202(h)(3) (E or F reorganization).

The total exclusion is limited to the *greater* of $10 million or 10 times the taxpayer's initial basis in the stock. IRC §1202(b). The latter term is helpful in cases in which the taxpayer's initial basis exceeded $1 million. In particular, it is helpful when the QSBS is acquired for a contribution of appreciated property. Although IRC §1202 does not exempt that appreciation from taxation (IRC §1202(i)(1)(B)), the taxpayer can now enjoy the "ten times initial basis" regime, because the stock's basis for purposes of IRC §1202 will be deemed to equal the fair market value (FMV) of the contributed property, rather than the transferred basis that applies for all other tax purposes. Compare IRC §1202(i) with IRC §358.

If the taxpayer acquired the stock before September 28, 2010, the savings are less generous, and the alternative minimum tax (AMT) applies. IRC §1202(a). Finally, the exclusion does not apply if the value of the stock is protected by an "offsetting short position." IRC §1202(j)(2).

What if the shareholders are allowed to "put" their stock, either to other shareholders or to the company, in case of certain disputes or significant events? Planners have differing opinions whether this is an "offsetting short position." Compare Rappaport & Friedman, *Section 1202: A Big Deal for Small Business,* 37 ABA Tax Times 28 (Aug. 2, 2018) (disqualifying), with Andolina & LeMaster, *Candy Land or Sorry: Thoughts on Qualified Small Business Stock,* 158 Tax Notes 205 (Jan. 8, 2018) (not disqualifying).

II. Steps to Obtain QSBS Benefits

A. Annual Recordkeeping

If a company plans to qualify for QSBS, it should document compliance annually. Doing so is not strictly mandatory, but it helps prevent confusion when shareholders inquire years later. In particular:

- Each year when shares are issued, the corporation should determine whether total assets (cash plus adjusted "Section 1202 basis" of noncash property) of the corporation (and any members of its 50 percent parent-child control group) are less than $50 million.
- During the year, determine whether the corporation has any "subsidiaries" (*i.e.,* corporations owned 50 percent by vote or value).
- Determine when, during the year, the company was a C corporation, and determine whether during the year it was a DISC or former DISC, a RIC/REIT/REMIC, or a cooperative.
- Determine what trade(s) or business(es) the company engaged in during the year.
- Identify all the assets of the company during the year.
- Determine the assets' value during the year, looking through subsidiaries owned greater than 50 percent by vote or value.
- Determine whether these assets meet the tests for constituting an "active business" during the year. This may require further inquiry by company counsel, and/or counsel may need to assist the company's officers so they can make this determination themselves.
- Determine whether the company redeemed stock during the year. If so, from whom? (We also need this information for redemptions occurring 2 years before the date that the company first issued the candidate QSBS stock.) And what was the value of the redeemed stock, and the aggregate value of the corporation's stock on the date of the redemption? (We also need this information for redemptions occurring 1 year before the company first issued the candidate QSBS stock.)

Some of the relevant information could also be determined independently by the shareholders:

- Determine when, and from whom, the shareholder acquired their stock.
- Determine the nature of those transactions (*e.g.,* redemption, distribution, reorganization, §351 contribution, gift, death, and so on).
- Determine what consideration the company received in exchange for the shares (and, if issued for property, the property's basis and value; if issued for whether the stock was restricted at the time).
- Determine whether the company has ever redeemed stock from the shareholder or a related party. (We also need this information going back to 2 years before the shareholder was first issued candidate QSBS stock.)

The questions regarding redemptions are a headache. Frequently, only the corporation knows whose stock it redeemed, and only the shareholder knows who they are related to.

B. Issuing the QSBS Letter

When a shareholder inquires whether their stock is QSBS, corporate counsel first needs to know which shareholder or shareholders are asking, and during what years they held the stock. Potentially, the shareholders provide that information. Next, counsel should discuss with the officers whether they want to opine on those items (described above) to which, in theory, the shareholder could also know the answer. If so, it would be as a courtesy.

Then, counsel will ask the officers to provide records, allowing counsel to answer each question the corporation wishes to address, for each shareholder to whom the corporation intends to provide a QSBS letter. These records might include the stock ledger, stock certificates, relevant minutes, CP261 notice (approval of conversion from C to S corporation), tax returns, or year-end balance sheets. Alternatively, the company could simply provide an unsupported assertion (*e.g.,* "The company has always been a C corporation"). In that case, counsel should request a signed certificate from an officer, stating that the determination was made by that officer after a reasonable inquiry.

Using this information, counsel will reach an opinion on the relevant legal questions. This opinion should be kept confidential (*i.e.,* attorney-client privileged with the corporation). Depending on the conclusion, counsel may then authorize the company to issue a letter affirming that the stock is QSBS, or affirming certain facts relevant to that determination.

C. Taxpayer's Obligations

When the shareholder receives the corporation's letter, they (or their tax advisor) should confirm that the corporation has answered all the questions that only the corporation can answer, that they are comfortable answering any of the questions that the corporation could answer but has not answered, and that they can answer all the questions that only they will know the answer to. In this last category, the shareholder should

- Confirm that they will be relinquishing their stock in a "sale or exchange."
- For a QSBS rollover, confirm that the shareholder "purchased" replacement stock within 60 days of the sale, in a transaction that otherwise would have a cost basis, that the replacement stock is also QSBS, and that they will make the election on their return for the year of the sale.
- For a QSBS exclusion, confirm that the value of their relinquished stock was not protected by an "offsetting short position."

The procedure for claiming an IRC §1045 QSBS rollover is described in Rev Proc 98–48. The election must be made by the due date (including any extensions) for filing the income tax return for the year in which the QSBS was sold. The election is made by (1) reporting the gain on Schedule D, and (2) on the next line, writing "§1045 rollover" and entering the same amount as a loss.

For a §1202 QSBS exclusion, the shareholder reports this on IRS Form 8949, Part II, and (if required for AMT) IRS Form 6521. See Instructions to IRS Schedule D (Form 1040) at "How to Report," available at https://www.irs.gov/instructions/i1040sd#en_US_2021_publink1000285561, and Instructions to IRS Form 8949, available at https://www.irs.gov/instructions/i8949. See also IRS Publication 550, Investment Income and Expenses (Including Capital Gains and Losses) (2020), available at https://www.irs.gov/publications/p550#en_US_2020_publink100010416.

III. Tensions Between the Shareholder and the Corporation

A. Shareholder Needs Evidence of QSBS

Shareholders should not claim that their stock was QSBS unless they can prove it. This is important for two reasons. First, if the IRS disagrees, it can impose the tax, interest, underpayment penalties, and accuracy-related penalties ranging from 20 percent to 40 percent. It could also extend the statute of limitations from 3 to 6 years. Second, even if the taxpayer's proof is not sufficient to persuade the IRS of the correctness of the taxpayer's position, the IRS will not apply penalties if it finds that the taxpayer had "reasonable cause" for the position. Reasonable reliance on documentation—even erroneous documentation—can supply this.

To the extent that the relevant information is in the corporation's hands, the support takes the form of a letter from the company. Some advisors prefer the formality of an "Officer's Certificate" over a letter. My feeling is that shareholders should be satisfied with anything that puts the company on the hook for a legal claim. The signature of an authorized agent should do that.

In theory, a QSBS letter can be as short as a word or two: "Yes" or "No/Maybe." Then, the company can (optionally) provide that if the shareholder claims their stock is QSBS and the IRS disagrees, it will indemnify the shareholder in some way. If the shareholder controls the company, the letter can be this simple.

However, in any other case, corporations are rarely this generous, because writing a QSBS letter is risky. If the IRS disagrees and imposes penalties on the shareholder, the taxpayer might sue the corporation for negligent misrepresentation. The IRS might also impose the "aiding and abetting understatement" penalty on the corporation under IRC §6701. If the shareholder is a former employee who was fired for cause, the corporation might be affirmatively looking for legal reasons *not* to cooperate.

B. QSBS Letters When There Is No Agreement

Still, QSBS letters do get written, because liability also cuts the other way: If the corporation does not provide a meaningful letter, the shareholder might claim breach of fiduciary duty, or of their right to review books and records. But these letters are rarely of the "Yes" or "No" variety. They usually contain a list of factual statements.

As a byproduct of being cautiously written, they are sometimes incomplete.

The letter can be incomplete because it omits key facts. This omission may even be intentional: Perhaps the corporation wants to conceal the fact that it tried, but failed, to cause the stock to be QSBS, or perhaps it does not know because it failed to keep adequate records. However, if a reasonable reader would understand the letter to be a long-winded yes, this arguably constitutes a yes and could lead to a claim of misrepresentation. In that case, the corporation might as well just say so. Note that if the shareholder is audited on the QSBS issue, the IRS has the right to test that claim by demanding records from the *corporation*. IRC §7602. If the stock failed to be QSBS because of something the corporation failed to do, this will come out in the audit.

Other times, the letter contains purely factual statements but no legal conclusions. The goal of such a letter is to outsource the legal analysis (and thus, liability for that analysis) to the shareholder's advisors. For example, some letters simply identify the nature of the business and its assets, without opining whether 80 percent of assets was used in a qualified trade or business.

However, these just-the-facts style letters can also be inadequate. When these letters fall short, it is because they do not provide enough information for the shareholder to draw key inferences. For example: How can the shareholder decide what the "reasonably required" working capital needs of the company are, if they do not know the risks faced by the company, its strategy, or its proposed investments? How can the shareholder know if a principal asset of the company is the "reputation or skill" of a key employee, if they are not personally familiar with the industry? How can the shareholder know whether assets were "used in the active conduct of" a trade or business, unless they had first-hand knowledge of the business activities?

I can understand why corporate counsel would rather write a cautious letter. However, unless the corporation discloses all the necessary information that only the corporation can know, in substantially the same language as the elements in the QSBS statute, this style of letter does not give the shareholder "reasonable cause" (for penalty purposes) to claim QSBS benefits. The company might as well have not provided a letter.

C. NVCA Investors' Rights Agreement

The best practice is for the investors and company to agree to the corporation's QSBS obligations ahead of time. A good example is the National Venture Capital Association's Investors' Rights Agreement, available at https://nvca.org/model-legal-documents/. Under the NCVA agreement, the company "shall use commercially reasonable efforts to refrain from taking any action that could reasonably be expected to cause the shares" to not qualify as QSBS, unless its board decides in its "good-faith business judgment" that qualifying is not in the company's best interests.

Also, the document contains a model QSBS checklist (Annex I). Within 20 days of a request, the company commits to deliver this checklist to all investors. Under the agreement, the company "shall use commercially reasonable efforts to ensure the accuracy of any such checklist," but it shall not be liable "for any damages arising from any errors or inaccuracies" unless made "in a manner either grossly negligent or fraudulent." The information on this checklist, along with information in the investor's possession, would be sufficient for the investor's tax professional to conclude whether the investor's stock is QSBS and whether it is eligible for tax benefits.

Conclusion

The cat-and-mouse games described in this article could be avoided if the parties agree to use the NVCA template ahead of time. Even if they do not, I recommend that shareholders use this checklist to evaluate the QSBS letter that they actually do receive. The shareholder should not be satisfied with anything that is not materially identical to this checklist, at least when it comes to the items to which only the corporation can know the answer.