New IRS Private Letter Ruling Helps Define the Scope of Proscribed Excluded Activities Under Section 1202

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Categories:

QSBS Fundamentals
Qualified Small Business Stock (QSBS)
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During the past several years, there has been a marked increase across the country in the use of C corporations as the vehicle for start-ups. Much of this interest can be attributed to the reduction in the corporate rate several years ago from 35% to 21%, but founders and investors have also focused on structuring investments to qualify for Section 1202's attractive gain exclusion (generally $10 million per shareholder per issuing corporation). Section 1202's gain exclusion should be even more attractive if it survives "tax reform" and capital gains rates are increased for high-income taxpayers.

This is one in a series of articles addressing planning issues relating to qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Internal Revenue Code.

Background

The IRS released Private Letter Ruling 202114002 on April 9, 2021. This PLR considers whether an insurance agency is engaged in an eligible business activity under Section 1202. Engaging in certain activities listed in Section 1202 (referred to in this article as proscribed excluded activities) can cause a corporation's stock to not qualify as QSBS.

Although Section 1202 has been in existence since 1993, tax guidance has been very limited and practitioners are often reduced to interpreting the wording of the statute when analyzing how Section 1202 functions. While PLRs are only binding authority with respect to the taxpayer for whom the PLR was issued, Treasury Regulation Section 1.6662-4(d)(3)(iii) does provide that a PLR issued after October 31, 1976, is an "authority" for purposes of determining whether there is substantial authority for a return

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position. This means that PLR 202114002 can be taken into account as a positive authority when considering for purposes of the substantial authority analysis whether the weight of authority supporting a taxpayer's return position outweighs the adverse authority.

We believe that PLR 202114002 is a significant ruling, both from the standpoint of how the IRS addressed the specific issue at hand, but more importantly for the IRS' apparent message that it intends to interpret narrowly the scope of proscribed excluded activities. The PLR is consistent with the IRS' approach in the Section 199A regulations in defining the scope of activities excluded from the benefits of Section 199A.[i] Also, we find it instructive that the IRS chose not to send a message through the PLR that it would use available opportunities to narrow or reduce Section 1202's benefits to founders and investors in domestic corporate start-ups.

Discussion of PLR 202114002

One of Section 1202's eligibility requirements is that at least 80% of a corporation's assets must be used in undertaking eligible business activities. Section 1202 includes a list of activities that are proscribed excluded activities. Two of the proscribed excluded activities are "brokerage services" and "insurance." The IRS concluded in PLR 202114002 that acting as an insurance agency does not constitute "brokerage services" or "insurance" activities. Assuming Section 1202's other eligibility requirements are satisfied, a corporation operating an insurance agency can issue QSBS.

PLR 202114002 focused on the Merriam-Webster definition of "broker" as being "one who acts as an intermediary." The IRS noted that insurance brokers are required by insurance companies to "perform various administrative services beyond those that would be performed by a mere intermediary facilitating a transaction between two parties." The IRS noted that insurance agents must report claims to insurance companies and cooperate in the investigation, settlement and payment process, along with maintaining records and accounts. The PLR did not specifically address why acting as an insurance broker falls outside of Section 1202's proscribed excluded "insurance" activity. Selling insurance

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and engaging in related administrative activities is apparently not engaging in an "insurance" activity, which presumably indicates that engaging in an "insurance" activity is limited to issuing policies and insurance underwriting activities.

PLR 202114002 is certainly good news for anyone who is engaging in the insurance brokerage business and is hoping to be eligible for Section 1202's gain exclusion. Beyond the specific result, however, is the question of whether the PLR can shed any light on the broader issue of how taxpayers should define the scope of Section 1202's list of proscribed excluded activities.

The first thing to note is that there is very little useful guidance to assist taxpayers in defining the scope of Section 1202's proscribed excluded activities. The IRS has never issued regulations under Section 1202 beyond one set dealing with the impact of redemptions on QSBS status. In fact, since Section 1202 was enacted in 1993, the authority addressing Section 1202's proscribed excluded activities has basically been limited to one Tax Court case, a couple of PLRs, Section 199A's regulations (which expressly state they are not authority with respect to Section 1202's proscribed excluded activities) and Section 448's regulations.[ii] For an in-depth discussion, see the article *"Dissecting Section 1202's 'Active Business' and 'Qualified Trade or Business' Qualification Requirements."*

In our opinion, the most significant takeaway from PLR 202114002 is that can be read as recent evidence confirming the IRS' continued willingness to narrowly draw the scope of Section 1202's proscribed excluded activities. The PLR's approach is consistent with the few previous Section 1202 authorities and Section 199A's regulations. For example, under these prior authorities, the activity of "health" was limited to the activities performed by licensed healthcare professionals for patients. The IRS chose not to extend the scope of "health" activities to products and services that are a part of providing healthcare services, such providing personal and domestic care services to senior citizens, operating specialty surgical centers, or providing tests used to detect medical conditions and analyzing test results. At this point, it seems to be a reasonable conclusion based on the available authority that the

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scope of the proscribed excluded activities can be narrowly drawn.

The IRS' analysis of the definition of "broker" is also instructive. The PLR focuses on the dictionary definition of "broker" as being "one who acts as an intermediary" and concludes that an insurance broker's activities are broader than merely acting as an intermediary. The IRS could have approached the issue by looking at the scope of an insurance broker's activities and concluded that since one of those activities is acting as an intermediary, insurance agents are brokers for Section 1202 purposes. But consistent with its overall narrow view of how to define the scope of proscribed excluded activities, the IRS took the view that if a company's activities are broader in scope than the generic "ordinary, contemporary, common meaning" for the activity in question, the company would not be classified as engaging in the activity. We note that many of today's successful start-ups engage in activities that fall within range of Section 1202's proscribed excluded activities, but also engage in a broader scope of activities (e.g., start-ups that develop and operate internet-based platforms, marketplaces, software and apps for businesses and consumers seeking products and services associated with Section 1202's proscribed excluded activities such as "health," "financial services," "brokerage services," "insurance," "financing," "leasing" and "investing").

Finally, the IRS' conclusions in PLR 20211402 are also consistent with its analysis of the scope of "brokerage" activities in the Section 199A regulations, which the IRS limited to the services of stockbrokers and similar professionals while excluding the services provided by real estate and insurance agents and brokers. This bolsters the conclusion that, while technically not constituting a tax "authority" for Section 1202 purposes, the Section 199A regulations do provide useful guidance to understanding the IRS' position with respect to the various proscribed excluded activities addressed in some detail in those regulations.

Closing Remarks

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Section 1202 and

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Section 1045 tax planning. Venture capitalists, founders and investors who want to learn more about QSBS planning opportunities are directed to several articles on the Frost Brown Todd website:

- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount

Contact Scott Dolson if you want to discuss any QSBS issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[i] Section 199A, which was enacted in 2017 and provides for a 20% deduction for certain activities by a pass-thru entity, cross-references a part of Section 1202's list of proscribed excluded activities. The Section 199A regulations go through each of the activities and provide examples of activities that fall within or outside of the scope of the excluded activity. The Section 199A regulations also pointedly state that they aren't authority outside of their application for Section 199A purposes (i.e., excluding them as qualifying as a tax "authority" for purposes of Section 1202).

[ii] See *Owen v. Commissioner*, T.C. Memo 2012-21; PLR 201436001 and PLR 20717010.

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