Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 2

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Many owners operating their businesses through limited liability companies (LLCs) and limited partnerships (LPs) grapple with the issue of whether to convert their business into a C corporation issuer of qualified small business stock (QSBS), making their stockholders potentially eligible to claim Section 1202's gain exclusion.[1] We have discussed in previous articles the generous tax benefits associated with Section 1202's gain exclusion.[2] The benefits of Section 1202 are available only if the issuer is a domestic (US) C corporation.

This two-part article provides a guide for business owners who have decided to convert their businesses into C corporation. Part 1 (published separately) addresses general business and tax issues associated with converting LPs or LLCs (each, a "Partnership") to C corporations (a "Conversion").[3] This Part 2 addresses Section 1202 issues associated with the Conversion.

VI. Section 1202 issues associated with Partnership conversions

VI.A. Considering the potential benefits of Section 1202 in the planning process.

There are several factors that go into considering whether to convert a Partnership into a C corporation where qualifying for Section 1202's gain exclusion is a factor:

- During the period a stockholder holds QSBS, the company issuing the QSBS must remain a domestic (US) C corporation. The corporation issuing QSBS can hold foreign assets and the equity of foreign subsidiaries and branch offices.
- C corporations can take advantage of the favorable 21% corporate tax rate, but distributions to stockholders can

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result in double taxation of the corporation's income.

- A stockholder's holding period for his QSBS must exceed five years in order to be eligible to claim Section 1202's gain exclusion.
- QSBS must be sold or exchanged in a taxable transaction before a stockholder can claim Section 1202's gain exclusion. [4]
- During a stockholder's holding period for QSBS, at least 80% (by value) of the issuing corporation's assets must be used in qualified business activities.
- C corporations are eligible to participate in tax-free reorganizations governed by Section 368.
- QSBS must be acquired in an original issuance for money, property (other than stock) or services.
- With limited exceptions, the stockholder who acquired QSBS in an original issuance from the corporation must be the stockholder who sells the QSBS and claims Section 1202's gain exclusion.[5]
- Changes in tax laws could reduce the attractiveness of the C corporation in comparison to the pass-through tax treatment of Partnerships. Section 1202 could be modified or repealed.
- Section 1202 has a number additional issuing-corporation level and taxpayer level eligibility requirements, and there are various circumstances that could result in stockholders being ineligible to claim Section 1202's gain exclusion.

Both the potential benefits and detriments associated with operating in corporate form should be considered when choosing the form of entity through which to operate a business See the article "*Reconsidering the Choice of Entity Decision*" for a more in-depth discussion, with particular emphasis on QSBS planning issues.

Where the benefits of Section 1202 weigh heavily in the decision, a factor that that should be considered is whether all of a Partnership's owners are eligible to benefit from selling QSBS. C corporations are excluded from the benefits of Section 1202 and tax-exempt entities and nonresident foreign investors don't need to rely on Section 1202's gain exclusion. Owners who won't benefit

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from QSBS status may oppose conversion of a Partnership based on concerns that operating the business in corporate form will ultimately prove to be tax inefficient or reduce the aggregate purchase consideration paid when the business is sold. A stock sale is the preferred method for obtaining the benefits of Section 1202's gain exclusion and buyers who purchase stock do not qualify for a step-up in tax basis. In contrast, an asset purchase paves the way for the buyer's 15-year amortization of the purchased goodwill. Because of this, buyers may attempt to impose a purchase price "haircut" if forced to purchase C corporation stock. While it can't be predicted whether buyers in a competitive sale process will fully or even partially offset the loss of future tax benefits against the purchase price, the possibility must be considered. These issues certainly highlight the fact that working through the benefits of operating in corporate versus Partnership form is a nuanced analysis, requiring consideration of all relevant factors.

Once the decision is made to chase the Section 1202 golden ring, the next steps will be to decide when and how to convert.

VI.B. Issues associated with the timing of a Partnership's conversion.

In many cases, both the desire to start the QSBS five-year+ holding period clock running and investor demands will dictate organizing a start-up as a C corporation. But some business owners will elect to operate first as a Partnership for one or more of several reasons and later elect convert to a C corporation.

Reasons for operating first as a pass-thru Partnership include:

- ***Electing pass-thru tax treatment as a default***. Many closely-held businesses default to operating as an LLC taxed as a partnership. There has been a persistent perception that the corporation's potential for double taxation of profits at the corporate and stockholder levels puts the corporation in second place behind the Partnership.
- ***Taking advantage of the favorable tax features of Partnerships***. Partnerships can pass through early-stage operating losses and depreciation and amortization losses to partners. C corporations can carry forward net operating

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losses but do not pass losses through to stockholders.

- ***Operating as a Partnership before converting to a C corporation in order to grow the value of the business in order to position stockholders for the future benefits of the 10X gain exclusion cap***. Section 1202 has a "10X" gain exclusion cap that allows a stockholder to claim Section 1202's gain exclusion in a given year in an amount up to 10 times the aggregate tax basis of that corporation's QSBS sold by the stockholder during that year. Section 1202(i)(1)(B) provides that where a taxpayer transfers property to a corporation in exchange for stock, "*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*." Based on this rule, if a Partnership converts to C corporation when the fair market value of its assets is $40 million and the aggregate tax basis is $10 million, if the QSBS issued in the Partnership conversion is later sold for $500 million, the first $30 million of gain would not qualify for the gain exclusion and the next $400 million would potentially be eligible for Section 1202's gain exclusion. Obviously, the 10X gain exclusion cap provides a powerful incentive to grow the value of a business in a Partnership before converting to corporate form. However, there are some downsides to this strategy.

In order to claim Section 1202's gain exclusion, a stockholder's holding period for the applicable QSBS must exceed five years. Section 1202(i)(1)(A) provides that in the case where a taxpayer transfers property to a corporation in exchange for QSBS, "*such stock shall be treated as having been acquired by the taxpayer on the date of such exchange*." So, one drawback to operating for any extended period in Partnership form is that the holding period for Section 1202 purposes doesn't commence until the QSBS is issued and that rule doesn't change when property is exchanged for QSBS (i.e., when a partnership converts to a C corporation and QSBS is issued in the process).

Another possible drawback to not electing C corporation status from day-one can be illustrated by the following example. Assume that a Partnership converts when the assets are worth $20 million

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and the aggregate tax basis is $5 million. If the Partnership sells for $40 million, then the first $15 million of gain would be taxable as capital gains and the next $20 million for Section 1202's gain exclusion. If instead the business had incorporated from day one with $5 million and sold for $40 million, the Section 1202 gain exclusion would have been $35 million in on our facts rather than $20 million. In order to capture the benefits of the 10X gain exclusion cap, an appraisal of the fair market value of the contributed assets should be obtained. A fair market value number is also required under Treasury Regulation Section 1.351-3 to be included on a statement required to be included with returns filed for the year of the nonrecognition exchange.

Finally, another test for QSBS eligibility is that the issuing corporation's "aggregate gross assets" must not exceed $50 million at any time prior to and immediately after the issuance of the applicable stock (see the discussion in Section VI.E. below). So, this size requirement places a limit on operation in Partnership form. If an appraisal of the Partnership's assets indicates that the fair market value of Partnership's assets exceeds $50 million, there should be an opportunity to prune out some assets from those included in the conversion to bring the value under $50 million.

VI.C. When does the holding period start for QSBS issued in a Partnership conversion?

As noted above, Section 1202(i)(1)(A) provides that where a taxpayer transfers property to a corporation in exchange for QSBS, "*such stock shall be treated as having been acquired by the taxpayer on the date of such exchange*." This means that the clock starts running on the five-year holding period requirement on the date that the partnership conversion occurs. Outside of the context of Section 1202, the holding period for stock issued in exchange for contributed capital gain or Section 1231 property in a Section 351 nonrecognition exchange includes the holding period for contributed property that is a capital asset as defined in Section 1221 or property described in Section 1231.[6]

VI.D. The tax basis of stock issued in a Partnership conversion.

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Section 1202(i)(B) provides that where a taxpayer transfers property to a corporation in exchange for QSBS, "*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*." This means that if property worth $1,000 and with a zero tax basis is contributed in a Section 351 nonrecognition transaction in exchange for QSBS, if the QSBS is eventually sold and Section 1202's gain exclusion is claimed, the first $1,000 of gain won't qualify for Section 1202's gain exclusion, but instead would be subject to tax at capital gains rates if the property is a capital asset as defined in Section 1221 or property described in Section 1231. Except for the special basis rule applicable to Section 1202's gain exclusion, the normal tax basis rules apply – the tax basis of stock issued in a Section 351 nonrecognition exchange carries over from the tax basis of the contributed property.

VI.E. The issuing corporation must not have more than $50 million in "aggregate gross assets" immediately after the conversion (the "$50 Million Test").

Generally, the $50 Million Test involves determining whether the sum of a corporation's money, plus the adjusted tax basis of its properties, exceeded $50 million prior to the applicable stock issuance, plus the "aggregate gross assets" of the corporation when the money and/or property QSBS being vetted for QSBS eligibility is included in the calculation. But in connection with the conversion of a Partnership to a corporation, the $50 Million Test requires a determination of the fair market value of the contributed assets.[7] Section 1202(d)(2)(B) provides that for purposes of determining a corporation's "aggregate gross assets," property contributed to the corporation in a tax-free reorganization or Section 351 nonrecognition exchange "*shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution*."

Although the language is somewhat ambiguous, we believe the language of Section 1202(d)(2)(B) can be read to provide that, in a partnership conversion, actual or deemed contributed assets go onto a "Section 1202 balance sheet" (a tax balance sheet adjusted

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by Section 1202(d)(2)(B)) at fair market value for purposes of the $50 Million Test, and are subject to normal tax adjustments thereafter if the $50 Million Test needs to be run in subsequent years.[8] For example, if assets are contributed into a corporation as part of a partnership conversion in 2024, the tax basis (FMV) of the contributed assets would need to be adjusted as required by the normal depreciation and amortization rules for purposes of calculating the corporation's "aggregate gross asset" in 2027 in connection with determining whether the corporation was eligible to issue additional QSBS.

Assuming that a Partnership conversion involves a contribution of assets in a Section 351 nonrecognition exchange, then the $50 Million Test would be based on the fair market value (FMV) of the assets contributed in the conversion. Any liabilities assumed by the corporation or liabilities that the contributed assets are subject to, would be ignored. The situation becomes less clear when the form of Partnership conversion is an "interest over" (i.e., contribution of equity interest) contribution under Revenue Ruling 84-111. In that case, the "property" being contributed is the Partnership (LP/LLC) interest, and a straightforward reading of Section 1202(d)(2)(B) suggests that the property valued at FMV would be the equity interests, not the Partnership's underlying gross assets. Under that interpretation, the Partnership's liabilities would indirectly be included in the valuation, as those liabilities might affect the FMV of the equity interests. On the other hand, if 100% of the Partnership's equity interests are valued based on an earnings multiple or other valuation methodology that doesn't rely on the Partnership's balance sheet, then the Partnership's liabilities could well be ignored in the determination of fair market value. The preceding discussion assumes that no assets other than Partnership assets or equity interests would be part of the conversion transaction. If cash or other properties are also contributed, then those would also need to be included in the $50 million computation. Further, if the corporation was not organized in connection with the conversion, then any previously held assets would also need to be accounted for when running the $50 Million Test.

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If it is determined that the $50 million test would not be met in connection with a Partnership conversion, it might be possible to reduce the amount of property held by the Partnership or contributed to the corporation in order to keep the FMV of the contributed properties below the $50 million mark. For an in-depth discussion of the $50 Million Test, see the Scott Dolson article "*How Section 1202's Million Aggregate Gross Assets Limitation Works*."

VI.F. Determining the percentage gain exclusion applicable to QSBS issued in connection with a Partnership conversion.

When Section 1202 was enacted in 1993, the percentage gain exclusion was 50%, with the balance of the gain taxed at a 28% rate. The percentage gain exclusion was increased to 75% for QSBS issued beginning on or after February 18, 2010 (with the balance taxed at 28%), and further increased to 100% for QSBS issued beginning on or after September 27, 2010.[9]

If QSBS is issued after September 27, 2010, for cash or services, the holder will be able to claim a 100% gain exclusion if Section 1202's eligibility requirements are met. If QSBS is issued after September 27, 2010, for property, and that property has a holding period in the hands of the contributor that commenced after September 27, 2010, the holder will be able to claim a 100% gain exclusion if Section 1202's eligibility requirements are met. But if QSBS is issued after September 27, 2010, for property, and that property has a holding period in the hands of the contributor that commenced prior to September 27, 2010, there is the issue of whether the holding period for the QSBS issued in exchange for the property has a holding period for purposes of the percentage gain exclusion that commenced when the QSBS was issued or when the holding period for the contributed property commenced. Further, the 100% gain exclusion is clearly applicable if QSBS issued after September 27, 2010, is exchanged for replacement QSBS under Sections 1045, 351 or 368. But what percentage gain exclusion applies if QSBS issued before September 27, 2010, is replaced with QSBS under Sections 1045, 351 or 368 or non-QSBS under Sections 351 or 368? Does the historic percentage gain exclusion apply or does the issue date of the replacement QSBS govern?

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Section 1202 provides in flush unnumbered language in Sections 1202(a)(3) and (4) that with respect to QSBS issued during the period when either the 75% or 100% gain exclusion was in effect, the acquisition date for purposes of the 75% or 100% test is "*the first date the QSBS was held by the taxpayer determined after the application of Section 1223.*"[10]

The only tax authority addressing the intent of the drafters of the flush language in Sections 1202(a)(3) and (4) is the 112th Congress' General Explanation of Tax Legislation prepared by the Committee on Taxation (the "General Explanation").[11] The General Explanation provides that "*the provision clarifies that in the case of any qualified small business stock acquired (determined without regard to the tacked-holding period) after February 17, 2009, and before January 1, 2014, the date of acquisition for purposes of determining the exclusion percentage is the date of the holding period for the stock begins. Thus, for example, if an individual (i) acquires qualified small business stock at its original issue for $1 million on July 1, 2006, (ii) sells the stock on March 1, 2012, for $2 million in a transaction in which gain is not recognized by reason of section 1045, (iii) acquires qualified replacement stock at its original issue on March 15, 2012, for $2 million, and (iv) sells the replacement stock for $3 million, 50 percent (and not 100 percent) of the $2 million gain on the sale of the replacement stock is excluded from gross income.*"[12]

The General Explanation is clear authority for the conclusion that if QSBS acquired by a stockholder when the percentage gain exclusion was less than 100% is exchanged for stock in a nonrecognition transaction where Section 1223 is applicable, such as Sections 1045, 351 or 368, the stock (whether QSBS or non-QSBS) received in exchange retains the original percentage exclusion. So if a stockholder's original QSBS eligible for the 50% gain exclusion is sold and the proceeds rolled over into replacement QSBS, the replacement QSBS will only be eligible for the 50% gain exclusion when sold.

What percentage gain exclusion applies when QSBS is issued in exchange for contributed property in a nonrecognition transaction? The 100% gain exclusion is clearly applicable if (i) QSBS is issued

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after September 27, 2010, in exchange for property contributed to the corporation in a Section 351 nonrecognition transaction, and (ii) the contributor's holding period for the contributed property began after September 27, 2010. But because of the flush unnumbered language in Sections 1202(a)(3) and (4) discussed above, it is not entirely clear what percentage gain exclusion is applicable if (i) QSBS is issued after September 27, 2010, and (ii) the contributor's holding period for the contributed property began prior to September 28, 2010.

Section 1202 provides in flush unnumbered language in Sections 1202(a)(3) and (4) that with respect to QSBS issued during the period when either the 75% or 100% gain exclusion was in effect, the acquisition date for purposes of the 75% or 100% test is the first date the QSBS was held by the taxpayer determined after the application of Section 1223. Section 1223(1) provides that the holding period for capital assets and Section 1231 assets contributed to a corporation in a Section 351 exchange includes the contributor's holding period. A literal reading of the flush unnumbered language in Sections 1202(a)(3) and (4) suggests that the provision could be read to provide that if property is contributed in a nonrecognition transaction under Sections 351, and the contributor's holding period for the property began prior to the effective date for the 100% gain exclusion, the percentage gain exclusion for the QSBS issued in exchange for the property would not qualify for the 100% gain exclusion, even if the QSBS was issued after September 27, 2010.

As discussed above, the only tax authority addressing the intent of the drafters of the flush language in Sections 1202(a)(3) and (4) is the General Explanation. The General Explanation at footnote 490 provides that the flush unnumbered language at Section 1202(a)(3) and (4) "*is not intended to change the acquisition date under section 1202(i)(1)(A) for certain stock exchanged for property*." Section 1202(i)(1)(A) provides that "*in the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation—(A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange. . .*" Footnote 490 in the General Explanation has two possible readings:

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- Alternative 1: The provision could be merely confirming that while the pre-contribution holding period for contributed property can affect the applicable percentage gain exclusion, it doesn't affect the holding period of the QSBS issued in exchange for the property for purposes of a stockholder's starting date for holding QSBS for purposes of Section 1202's five year holding period requirement. If this is the correct reading, then footnote 490 wouldn't shed light on the reach of the flush unnumbered language in Sections 1202(a)(3) and (4), because those provisions address the applicable percentage gain exclusion, not the holding period for the QSBS.
- Alternative 2: An alternative reading of footnote 490 is that it is intended to confirm that the purpose of the flush unnumbered language in Sections 1202(a)(3) and (4) was to establish that, in conjunction with Section 1202(i)(1)(A), the holding period for QSBS commences on the date it is first issued to a stockholder, and in a situation where the stock is exchanged for other stock in a nonrecognition transaction where Section 1223 applies (e.g., an exchange of original QSBS proceeds for replacement QSBS under Section 1045, or an exchange of QSBS for QSBS or non-QSBS under Sections 351 or 368), the original percentage gain exclusion remains applicable. This reading gains support from the example in the General Explanation that focuses on how the flush unnumbered language in Sections 1202(a)(3) and (4) functions when a stockholder sells his original QSBS acquired before the 100% gain exclusion became effective and acquires replacement QSBS under Section 1045. The example confirms that the replacement QSBS acquired with Section 1045 proceeds retains the pre-100% percentage gain exclusion applicable to the original QSBS. It appears to be significant that the example focuses entirely on the holding period for QSBS when it is exchanged for replacement QSBS in a transaction where Section 1223 is applicable and doesn't mention the contribution of appreciated property in exchange for QSBS.

There doesn't appear to be a good reason why Congress would direct that the percentage gain exclusion is affected by a

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stockholder's pre-contribution holding period for contributed property. On the other hand, it does make sense that if a stockholder is holding QSBS that is subject to the 50% gain exclusion, the stockholder should not be able to exchange that QSBS in a nonrecognition transaction (under Section 1045 or otherwise) for replacement stock and increase the percentage exclusion to 100%.

Section 1202 provides that with respect to QSBS issued during the period either the 75% or 100% gain exclusion was (is) in effect, the acquisition date for purposes of the 75% or 100% test would be the first date the QSBS was held by the taxpayer determined after the application of Section 1223. This language can be read to provide that if assets contributed to a corporation in a Section 351 exchange were acquired by the contributor prior to September 28, 2010, then the QSBS issued in exchange for certain assets would not qualify for the 100% gain exclusion.[13] Section 1223(1) provides that the holding period for stock received in a Section 351 exchange includes the contributor's holding period for the contributed property, if that contributed property is a capital asset or Section 1231 property. A like reading would apply with respect to the 75% gain exclusion for assets acquired by a contributor prior to February 18, 2009. This reading of Sections 1202(a)(3) and (4) could result several different applicable gain exclusion percentages due to the fact that Partnership assets and equity interests (capital assets) contributed in connection with a Partnership incorporation often have different holding periods and certain contributed assets won't be capital assets, which means those assets would have an applicable gain exclusion percentage based on the date the QSBS was issued.

If the interpretation in the preceding sentence of how Section 1202's percentage gain exclusions apply when property is contributed in a Section 351 nonrecognition exchange, then the form of a Partnership conversion could have an impact what percentage exclusion is applicable. If the conversion is accomplished through an "assets over" method, then the partnership might have a variety of holding periods for its capital assets and might also have non-capital assets which wouldn't fall

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within the scope of Section 1223.[14] The result would be that each share of QSBS could have a variety of different holding periods. Under Revenue Ruling 85-164, where property is contributed to a corporation in a Section 351 nonrecognition transaction, the stock issued in exchange is treated as having a split basis (splitting the shares in fractions), for purposes of Section 1223, which means that for purposes of determining the applicable Section 1202 percentage gain exclusion, each share of QSBS would be split along the same lines if some of the contributed property has a holding period that dates back before September 27, 2010.[15]

VI.G. Other Section 1202 eligibility requirements to consider when converting a Partnership.

A critical part of the decision-making process when considering whether to convert to a C corporation in hopes of later claiming Section 1202's gain exclusion is confirming that the business will satisfy the several issuing corporation eligibility requirements. In particular, attention should be paid to the nature of the Partnership's business activities and the post-conversion mix of assets (i.e., whether it is expected that the corporation will not accumulate assets not used in its active trade or business, non-working capital cash, investment securities or non-operating real property investments).[16] For a more detailed discussion of these issues, see the article "*Dissecting Section 1202's Active Business and Qualified Trade or Business Qualification Requirements*."

Section 1202 eligibility requirements that should be considered include: (i) whether the activities of the Partnership are excluded or qualified activities under Section 1202; (ii) whether the Partnership owns minority corporate stock or securities positions that could adversely affect Section 1202 eligibility; (iii) whether the Partnership owns real property or engages in real property related activities that could adversely affect Section 1202 eligibility; and (iv) whether the Partnership owns interests in other entities taxed as partnerships.

There may be an opportunity to undertake pre-conversion planning if the Partnership has business activities, portfolio stock and securities, investment assets or real property investments that will

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cause it to fail Section 1202's eligibility requirements. Unwanted or ineligible assets or activities can be distributed out of the Partnership prior to conversion or otherwise withheld from contribution into the corporation issuing QSBS.

The typical conversion of a Partnership into a C corporation involves a deemed or actual contribution of assets or Partnership interests to the C corporation in exchange for common or preferred stock. Either Partnership interests or assets should qualify as "property" for purposes of Section 1202. Section 1202 doesn't specify whether the contribution must be taxable or tax-free, but most Partnership incorporations will be structured as tax-free Section 351 contributions of property to a corporation in exchange for stock. See the discussion in Part 1 of this Article and Section VI.F. above regarding Section 351 and Revenue Ruling 84-111.[17]

In order for the stock issued in a Section 351 nonrecognition transaction to qualify as QSBS, partnership property or interests must be exchanged for stock issued by a domestic (US) C corporation. The corporation should remain a domestic (US) C corporation throughout period during which the stockholders hold QSBS and when the stockholders' QSBS is sold or exchanged.

VI.H. Effect of a conversion on the gifting of QSBS or transfers of Partnership equity.

If a conversion structure is selected that results in direct ownership of QSBS by the Partnership's equity owners, the conversion won't impact planning relating to the timing of gifts of equity by those owners. The owners could make gifts of partnership interests prior to conversion or direct gifts of QSBS after the conversion and neither will adversely affect the QSBS status of the gifted stock. But if the conversion method results in a Partnership's ownership of QSBS, the gifting of equity interests in the Partnership after the conversion could adversely affect the owner's ability to claim Section 1202's gain exclusion.

Section 1202 provides that the sharing of Section 1202's gain exclusion by partners in a "pass-thru" entity (including Partnerships) is based on the smallest "interest" of a partner in the

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pass-thru entity during the period the pass-thru entity owns the applicable QSBS. Likewise, Section 1045 provides that the sharing of the right to make a Section 1045 election by a partner in a pass-thru entity with respect to the rollover of original QSBS proceeds is limited to the smallest "capital interest" held by the partner in the pass-thru entity while the pass-thru entity owned the applicable QSBS. The IRS could argue that a recipient of a gift of an equity interest in a pass-thru entity didn't have any "interest" in the QSBS prior to receipt of the gift, and that Section 1202 doesn't address the carryover of rights with respect to QSBS when a partnership interest is gifted. So, while arguments can be made that the gifting of a partnership interest should result in a transfer of transferring partner's right to share in Section 1202 gain exclusion or rollover proceeds under Section 1045, if the conversion transaction results in the Partnership owning the QSBS, the prudent course of action would be to either undertake any gifting prior to the conversion transaction. Another workaround that solves the grey area associated with transferring interests in Partnerships holding QSBS is to have the Partnership distribute out a pro rata share of QSBS to the partner(s) desiring to make gifts, which is expressly permitted under Section 1202, and have them gift the shares of QSBS directly. [18] But once the QSBS is in the hands of a partner, the QSBS cannot be recontributed to a Partnership without terminating the stock's QSBS status.[19]

VI.I. Dealing with restricted stock in a Partnership conversion; using preferred stock to reduce the value of common stock issued in the conversion.

Part I of this article addresses various tax consequences under Section 83 associated with converting restricted Partnership equity to restricted corporate stock or converting restricted Partnership equity to unrestricted corporate stock. From the standpoint of maximizing the benefits of Section 1202, it is important to get the clock running on Section 1202's five year+ holding period requirement, which generally means making a Section 83(b) election if stockholders are being issued restricted stock.

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If the tax cost of such election is significant or the tax cost of being issued unrestricted stock is significant (i.e., converting from restricted Partnership capital interests or profits interests to unrestricted corporate stock triggers substantial compensation income), consideration should be given to structuring the corporation's equity so that preferred stock is issued to investors and others with vested stock and common stock issued to stockholders who would otherwise incur a substantial compensation income hit in the conversion or as a result of the Section 83(b) election. By capitalizing the corporation with preferred and common stock, it is likely that a valuation of the common stock will be reduced given the overhang created by the preferred stock with its liquidation preference, particularly if the appraiser values the common stock on a liquidation basis. Prudence would dictate that the value of the common stock should not be pushed down to zero and that there should be business reasons for adopting the multiple equity class structure beyond any perceived tax benefits. Also, the interests of any current or future investors would need to be considered, which might result in the creation of multiple classes of preferred stock with different liquidation priorities and preferences. The IRS might argue this capitalization arrangement results in stock that should be treated as an option under Treasury Regulation Section 1.83-3(a), but there are no tax authorities directly supporting this argument. An arrangement that results in creating a desirable and acceptable incentive for employees may provide a compelling bona-fide business purpose for adoption of the multiple equity class structure.

VI.J. Converting a Partnership in conjunction with bringing in new investors or owners.

The conversion of a Partnership into a C corporation happens frequently in conjunction with bringing in new investors. There are several reasons why investors would want to own C corporation stock. Some investors don't want to receive Schedule K-1s and be obligated to file US tax returns and/or deal with the pass through of ordinary operating income. Many investors want to be positioned to claim Section 1202's gain exclusion and want to immediately start

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working towards meeting the five-year holding period requirement. Typically, the new money investors are brought on board when the Partnership converts as part of a global Section 351 nonrecognition exchange. For a further discussion of global Section 351 transactions, see Section III.C.4 (Part 1 of this article). If the investors are not brought in as part of the initial Section 351 exchange, then the tax consequences of adding the investors post-incorporation will need to be reviewed to confirm whether the issuance of stock to the investors will cause the previous conversion to fail Section 351's 80% control requirement.

A global Section 351 transaction works when the investors' funds remain in the corporation. But what about structuring issues if the transaction involves the exit of some or all of the Partnership's owners? If the transaction involves the sale of 100% of the equity or assets of the Partnership, then buyers interested in pursuing Section 1202's benefits can organize a newco-acquisition corporation to purchase the assets or Partnership equity interests. As discussed in Section VI.E. above, the $50 Million Test could be an issue. One aspect of the $50 Million Test is that once QSBS is issued before while the corporation has less than $50 million in "aggregate gross assets," the later increase of "aggregate gross assets" beyond $50 million doesn't adversely affect already issued QSBS. So, if the value of the target assets are expected to exceed $50 million, it might be possible to form a newco-corporation and capitalize it by issuing less than $50 million of QSBS. After newco-corporation is organized and QSBS issued, then corporation could undertake a search and later acquire a $200 million target company (for example), using third-party debt and/or seller financing, or additional capital obtained through the issuance of the non-QSBS. There are no tax authorities that specifically address these planning issues. The IRS might argue that the $50 Million Test should include the value of the acquired target assets and/or the separating the newco-corporation's initial formation and issuance of QSBS and the acquisition of the target company assets or equity has not bona-fide business purpose. But Section 1202(e)(2) provides that the active conduct of a qualified business activity includes start-up activities described in section 195(c)(1)(A) which includes "*investigating the creation or acquisition of an active trade or*

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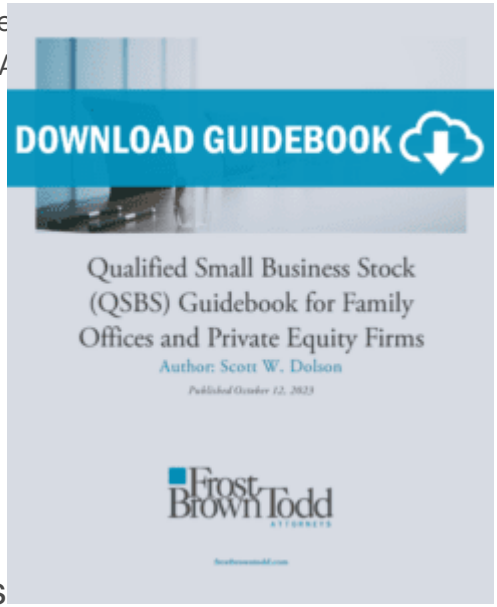
business," which suggests that it is possible to form a corporation that undertakes the search for and deferred acquisition of a target company engaged in qualified business activities.

If some but not all of the Partnership's equity owners are selling, then one approach would involve the buyers first acquiring Partnership equity or assets and then participating in the conversion to a C corporation. This method works well if the buyer isn't adverse to owning Partnership equity or assets for a brief period, and the value of the Partnership's assets and any capital infused into the business aggregates less than $50 million. If the transaction would result in a failure of the $50 Million Test, then the blueprint outlined above for the 100% purchase should also work for the partial acquisition. But if the Section 351 transaction is decoupled from the later partial purchase, the 80% control requirement might well interfere with the target Partnership or equity owners contributed assets or Partnership equity to the newco-corporation on a tax-free basis. One possible approach would be for the newco-corporation to own an interest in a joint venture, with the rollover interest of the target owners taking the form of a continuing interest in the joint venture (i.e., the operating business owned by the newco-corporation). Finding the right solution often requires experie
planning and transaction (M&A



More QSBS Resources

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- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1
- Structuring the Ownership of Qualified Small Business Stock (QSBS) – Is There a Role for Roth IRAs?
- Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide
- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations
- Can Stockholders of Employee Leasing or Staffing Companies Claim Section 1202's Gain Exclusion?
- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion
- Determining the Applicable Section 1202 Exclusion Percentage When Selling Qualified Small Business Stock
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- 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
- Dissecting 1202's Active Business and Qualified Trade or Business Qualification Requirements
- Recapitalizations Involving Qualified Small Business Stock
- The 21% Corporate Rate Breathes New Life into IRC § 1202

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Contact Scott Dolson if you want to discuss any Section 1202 or Section 1045 issues by video or telephone conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. LLCs and LPs taxed as partnerships for federal income tax purposes are referred to together in this article as "Partnerships." LLCs owned by a single member default to disregarded entity status unless a "check-the-box" election is made on Form 8832 for the entity to be taxed as a corporation for federal income tax purposes.

[2] *See* Frost Brown Todd's **QSBS & Tax Planning Services page**.

[3] Although this article focuses on converting Partnerships into C corporations, a number of the tax issues would also be relevant in connection with converting sole proprietorships to C corporations.

[4] A sale can include a redemption of stock or a complete liquidation of the corporation.

[5] Exceptions to the general rule include gifted QSBS, QSBS transferred at death, and QSBS distributed by a partnership to its partners.

[6] See Section 1223(1) and Part 1 of this article for further discussion of holding period and basis issues.

[7] See Section 1202(d)(2)(B).

[8] An alternative interpretation of how Section 1202(d)(2)(B) has been suggested based on the wording of the parenthetical in that section which refers to the basis of contributed property "immediately after such contribution." The parenthetical is read to mean that Section 1202(d)(2)(B)'s FMV rule applies with respect to specific contributed property only "immediately after such contribution," the result being that if the $50 Million Test is run at a later date with respect to a subsequent issuance of stock, the previously contributed property would revert to its historic adjusted tax basis at the time of contribution for purposes of placing the assets on the "Section 1202 balance sheet."

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[9] See Endnote 1 above.

[10] The flush language in Sections 1202(a)(3) and (4) provides that "*[i]n the case of any stock which would be described in the preceding sentence (but for this sentence), the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223.*"

[11] General Explanations of tax legislation prepared by the Joint Committee on Taxation are referenced in Treasury Regulation Section 1.6662-4(d)(3)(iii) as authority for purposes of determining whether there is substantial authority for the tax treatment of an item.

[12] The General Explanation of Tax Legislation Enacted in the 112th Congress at footnotes 490 and 401. The reference to 2014 is no longer applicable due to the permanent extension of the 100% gain exclusion.

[13] The 50% gain exclusion applies to QSBS issued during the period commencing August 11, 1993, through February 17, 2009. The 75% gain exclusion applies to QSBS issued during the period commencing February 18, 2009, through September 27, 2010. The 100% gain exclusion applies to QSBS issued after September 27, 2010.

[14] See Revenue Ruling 84-111, 1984-2 C.B. 8.

[15] Revenue Ruling 85-164, 1985-2 C.B. 117.

[16] Section 1202 requires that at least 80% by value of the corporation's assets be used in one or more active trade or business activities that are not excluded activities. There are separate limitations relating to working capital, investment in real property assets and portfolio stock and securities.

[17] Revenue Ruling 84-111, 1984-2 C.B. 8. Transfers to foreign corporations generally do not qualify for tax-free treatment under Section 351 and are generally taxable under Section 367.

[18] Section 1202(h)(2)(C) permits a distribution of QSBS from a partnership to a partner, based on the applicable partner's

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"interest" in the partnership.

[19] See Treasury Regulation Section 1.1045-1.

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