To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)

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**This article is part of a series addressing entity decision and planning issues related to qualified small business stock (QSBS) and the workings of Sections 1202 and 1045. For additional resources, visit our QSBS & Tax Planning Services page.*

Since the finalization of the IRS's "check-the-box" entity-classification regulations nearly 30 years ago,[1] a state law LLC can elect to be taxed an association taxable as a corporation.[2] During the past month, we have heard that there are tax practitioners who take the position that a limited liability company that has elected to be classified as an association taxable as a corporation by filing IRS Form 8832 (Entity Classification Election) cannot issue qualified small business stock (QSBS) within the meaning of Section 1202(c). We are not 100% clear the reason for this position, but we presume that some practitioners believe that because an LLC's equity is a "membership interest" rather than "stock," the equity interest cannot be QSBS due to the fact that there are references to "stock" throughout Section 1202 or because of the references in Section 1202 to "domestic corporation."[3]

A limited liability company is a creature of state law. In Delaware, laws applicable to LLCs are found in the Delaware Limited Liability Company Act. Since 1993, all 50 states and the District of Columbia have enacted LLC statutes. QSBS is a creature of the Internal Revenue Code. Under Section 1202, a taxpayer may be entitled to an exclusion of gain arising out of the sale or exchange of QSBS. QSBS can only be issued by a domestic (US) C corporation. Section 1202(c)(1) provides that "*the term 'qualified small business stock' means any stock in a C corporation.*" When addressing federal income tax issues, the Internal Revenue Code, not state law, governs. Treasury Regulation Section 301.7701-1(a) provides that:

the Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not

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depend on whether the organization is recognized as an entity under local law.

Under the Internal Revenue Code, a single-member LLC or multi-member LLC is an "eligible entity" that can elect to be an association taxable as a corporation. Treasury Regulation Section 301.7701-3(a) provides that:

A business entity that is not classified as a corporation under §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under §301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Treasury Regulation Section 301.7701-2(b) provides that: *"For federal tax purposes, the term corporation means . . . (2)* ***An association (as determined under §301.7701-3)*** . . . . (emphasis added)." Section 7701(a) provides that the term "corporation" includes associations. Section 7701(a)(7) provides that the term "stock" includes shares in an association.

There are references in Section 1202 to "domestic corporation." Viewed in a vacuum, the reference to "domestic corporation" would seem to suggest that the phrase means a corporation organized as a corporation under state law. But Treasury Regulation Section 301.7701-5(a) provides that:

[a] business entity (including an entity that is disregarded as separate from its owner under §301.7701-2(c)) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated association, general partnership, limited partnership, and limited liability company) in the United States, or under the law of the United States or of any State. Accordingly, a business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity. A business entity

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(including an entity that is disregarded as separate from its owner under § 301.7701-2(c)) is foreign if it is not domestic. The determination of whether an entity is domestic or foreign is made independently from the determination of its corporate or non-corporate classification. See §§301.7701-2 and 301.7701-3 for the rules governing the classification of entities.

And, most importantly, Treasury Regulation Section 301.7701-5(b) includes the following example (1):

(i) Facts. Y is an entity that is created or organized under the laws of Country A as a public limited company. ***It is also an entity that is organized as a limited liability company (LLC) under the laws of State B. Y is classified as a corporation for Federal tax purposes under the rules of §§ 301.7701-2, and 301.7701-3.***

(ii) ***Result. Y is a domestic corporation because it is an entity that is classified as a corporation and it is organized as an entity under the laws of State B.*** (emphasis added)

This Treasury Regulation unambiguously confirms that the reference to a "domestic corporation" under the Internal Revenue Code (which includes Section 1202) includes an LLC classified as an association taxable as a corporation under Treasury Regulation Sectio 301.7701-3 (i.e., under the check-the-box classification regime).

Section 7701 and the Treasury Regulations addressed above appear to unequivocally confirm that an LLC, regardless of the number of members, can elect to be classified as an association taxable as a C corporation. Further, Section 7701(a)(7) provides that "stock" includes shares in an association. If those apparently unambiguous references don't seem to sufficiently connect the dots, then hopefully the following discussion will leave no room for doubt with respect to the issue.

There is no language in Section 1202 providing that QSBS can only be issued by a state-law corporation. Section 1202(c)(1) provides that QSBS is "stock in a C corporation" (not "state-law"

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corporation). Section 1202(e)(2) again merely references that stock in a corporation is not QSBS unless such corporation is a C corporation. Section 1202(d)(1) provides that a "qualified small business" "*means any domestic corporation which is a C corporation*." Section 1202(e)(4) also refers to "*domestic corporation*." Again, there are no references to "state-law corporation," just "domestic corporation," which under Section 7701(a)(7) can include an "association," with "association" defined to include both single and multi-member LLCs under under Treasury Regulation Sections 301-7701-3(a) and 301-7701-5(a).

The treatment of an LLC interest as "stock" for federal income tax purposes is illustrated in Treasury Regulation Section 301.7701-3(g)(1), which addresses the election to change an entity taxed as a partnership to an entity taxed as a corporation: "*[i]f an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association* ***in exchange for stock in the association****, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners*." (emphasis added). A multi-member LLC defaults to partnership status under Section 7701. Note the Treasury Regulation's reference to "stock" as the equity deemed to be received upon conversion of the partnership (e.g., multi-member LLC) via a "check-the-box" election.

Treasury Regulation Section 301-7701-3(g)(1) provides clear guidance that the when a check-the-box election is made by a multi-member LLC to be a corporation for tax purposes, the LLC is deemed to have contributed assets and liabilities to the corporation in exchange for stock, which is then deemed to be distributed to the LLC's members (who are actually holding on to their state-law LLC units). Section 1202(h)(2)(C) confirms that the QSBS status of the stock that is deemed to be distributed by the LLC to the LLC's members is preserved in the hands of the members. Also, Section 1202 provides that the LLC is deemed to have a tax basis for QSBS and the "10X gain exclusion cap" purposes equal to the fair market value of the contributed assets. So, when the LLC checks-the-box (i.e., files Form 8832), the LLC members'

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units are deemed to be stock (QSBS if the eligibility requirements are otherwise met). For further guidance, see "Guide to Converting Partnership (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1."

Treasury Regulation Section 301-7701-3(g)(2)(i) provides that if the LLC filing the check-the-box election to be a corporation is a single-member LLC, the owner of the LLC is deemed to have contributed assets and liabilities to the newly-organized corporation in consideration of the issuance of stock (QSBS, if applicable). Like the multi-member check-the-box election, the deemed contribution would be treated as a Section 351 nonrecognition exchange.

When either a multi-member LLC (taxed as a partnership) or a single-member LLC (treated as a disregarded entity) files a check-the-box election to be taxed as a corporation and there is a deemed issuance of "stock" (QSBS), the running of Section 1202's holding period for the QSBS commences on the effective date of the Form 8832 election. With either a single or multi-member LLC, the deemed asset contribution to the association (corporation) in exchange for stock is subject to Section 1202(i)(1) which provides:

Stock exchanged for property. *In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation— (A) FTC such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and (B) 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.*

A good example of where the terms "stock" and "corporation" are used in the Internal Revenue Code is Section 368, which acts as the traffic cop for the treatment of tax-free reorganizations involving corporations and stockholders. Like Section 1202, Section 368 refers to "corporations" and "stock" but does not reference "state-law corporations." There has never been any question among tax practitioners regarding the eligibility of LLCs that have "checked the box" to be treated as a corporation to also be eligible parties to tax-free reorganizations under Section 368.

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Private Letter Ruling (PLR) 200534005 (8/26/2005) addresses the tax consequences of a divisive reorganization under Section 368(a)(1)(D) (a Type D reorganization). Type D reorganizations typically involve a corporation with two business activities forming a subsidiary and spinning out the subsidiary to the corporation's stockholders. The corporation in the PLR was operating the second business activity in a disregarded LLC. In order to accomplish the formation of the subsidiary in anticipation of the spin-off, a check-the-box election was filed for the subsidiary, converting it into a corporation for federal income tax purposes. The equity of the now corporate subsidiary was then distributed out to the corporation's stockholders, completing the Type D reorganization. Based on those steps, the IRS concluded that the distribution qualified as a Type D reorganization, and referred to the membership interests of "Controlled" distributed to "Distributing" stockholders as "stock" received in the spin-off. Given how commonplace the use of check-the-box corporations has become in the world of corporate transactions, the PLR simply takes for granted without comment the treatment of the LLC as a corporation for purposes of involvement in tax-free reorganizations under Section 368.

Finally, in PLR 201603011 (1/15/16), the IRS concluded that the status of stock as QSBS was unaffected by the conversion of the issuing corporation into an LLC for state-law purposes. This PLR is directly on point, confirming an LLC that has checked the box under the Section 7701 Treasury Regulations is eligible to issue QSBS and its equity owners eligible to claim Section 1202's gain exclusion.

Hopefully, this article has successfully driven the proverbial wooden stake through the heart of any uncertainty over whether membership interests in an LLC can qualify as QSBS under Section 1202. If you still disagree with the conclusions in this article, tell us why.

A fair question after slogging through this article is why not just use a state-law corporation, thereby altogether avoiding the issue of whether LLC equity qualifies as QSBS. We certainly agree that a newly created qualified small business should strongly consider using a state-law corporation. Probably the situation where we see LLCs taxed as C corporations with QSBS outstanding is where a

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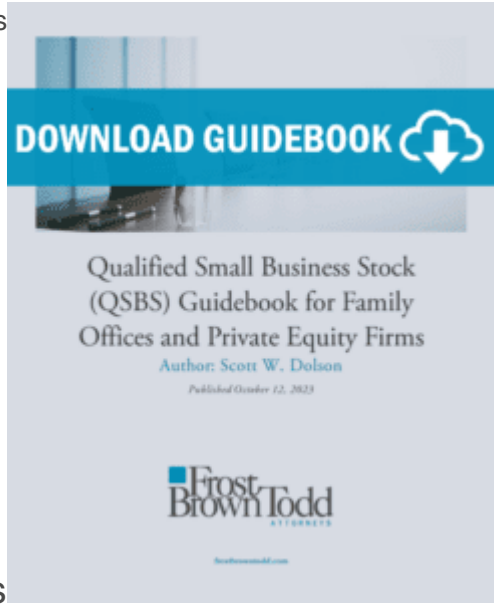
partnership has converted to a C corporation by filing a check-the-box election. The conversion is treated as a Section 351 nonrecognition exchange of assets for stock (see Revenue Ruling 84-111 where electing on Form 8832 to be taxed as an association is treated as a Situation 1 "assets over" incorporation).[4]

Sometimes a check-the-box election is chosen over a state-law conversion from LLC to corporation or a merger into a newly-organized corporation because it only requires the filing of the Form 8832 and as such, represents the simplest means available to convert to a corporation for tax purposes. In other cases, the check-the-box election route is chosen because the owners prefer the governance flexibility afforded LLCs over corporations or the pre-conversion LLC had a complicated distribution waterfall that the parties desired to kept intact through retention of the LLC's limited liability company agreement as the instrument governing the owner's economic and governance structure.

Please 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 for more QSBS-related analysis curated by topic, from the choice of entity decision and Section 1202's gain exclus transactions.

More QSBS Resources



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- Advanced Section 1202 (QSBS) Planning for S Corporations
- Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 2
- 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
- A SPAC Merger Primer for Holders of Qualified Small Business Stock
- 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

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- 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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[1] Treasury Regulation Sections 301.7701-1 to -3. The Treasury Department published the "check-the-box" regulations on December 18, 1996 (T.D. 8697), with an effective date of January 1, 1997.

[2] Treasury Regulation Section 301.7701-3(a).

[3] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended.

[4] Revenue Ruling 84-111, 1984-2 C.B. 88.

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