Exploring Section 1202's Active Business Requirement

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Section 1202 provides an exclusion from capital gains when a stockholder sells qualified small business stock (**QSBS**), assuming all eligibility requirements are satisfied.[1] The One Big Beautiful Bill Act (**OBBBA**) further enhances Section 1202's benefits for QSBS issued after the July 4, 2025, date of enactment. Section 1045 provides for the tax-free rollover of gain from the sale of QSBS, where proceeds are rolled over into replacement QSBS, again assuming all eligibility requirements are satisfied. For articles discussing the benefits, requirements and planning aspects for Sections 1202 and 1045, see the QSBS library.

Congress enacted Section 1202 to incentivize investment in start-ups and small businesses that are satisfying Section 1202's "active business requirement," including engaging in the active conduct of qualified activities.[2] This article focuses the active business requirement.

The elements of Section 1202's "active business requirement"

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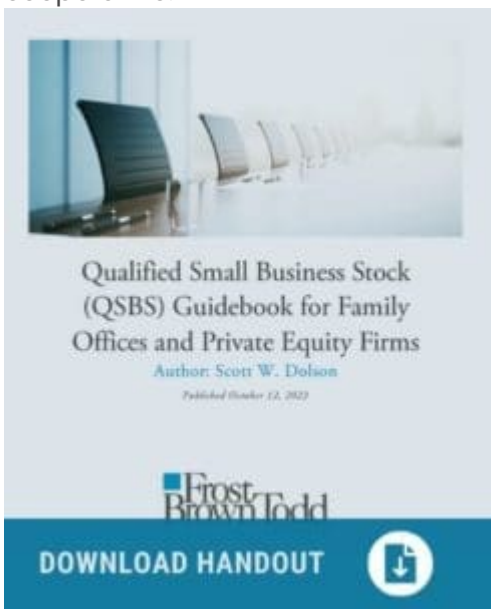
Section 1202(c)(2)(A). Section 1202(c)(2)(A) provides that stock does not qualify as qualified small business stock (**QSBS**) unless the corporation issuing the stock (**QSBS Issuer**) has met Section 1202(e)'s "active business requirement." A key element of the active business requirement is Section 1202(e)(1)(A), which provides that "*at least 80 percent (by value) of the assets of such corporation are used by such corporation in the active conduct of 1 or more qualified trades or businesses*." (the "**80% Test**"). The QSBS Issuer must also be a domestic (US) C corporation and must not be a domestic international sales corporation (DISC) or former DISC, a regulated investment company, real estate investment company or real estate mortgage investment conduit (REMIC) or a cooperative.



Section 1202(e)'s active business requirement must be met for "substantially all" of a taxpayer's QSBS holding period. "Substantially all" is not defined in Section 1202, but based on other tax authorities is likely to fall between 75% to 95% of a taxpayer's QSBS holding period. Under Section 1045(b)(4)(B), a provision generously permitting the tax-free rollover of QSBS sales proceeds into replacement QSBS, a taxpayer is required to satisfy the active business requirement for only substantially all of the first six months after issuance of replacement QSBS for purposes of qualifying for the Section 1045 election.

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See *Substantiating the Right to Claim QSBS Tax Benefits (Part 1)* and *Substantiating the Right to Claim QSBS Tax Benefits (Part 2)*.

Breaking down the 80% Test. Satisfying the 80% Test requires the following:

- At least 80% of the QSBS Issuer's assets (by value) must be used in one or more qualified business activities, which, as discussed below, can include start-up and research and development (**R&D**) activities intended to develop, if and when commercialized, into qualified business activities. The 80% Test allows a QSBS Issuer to hold assets not contributing towards satisfaction of the 80% Test in the following categories: assets used in excluded activities, investment assets (but see the separate limitation in Section 1202(e)(5)(B)), real estate activities (but see the separate limitation in Section 1202(e)(7)), cash (see Section 1202(e)(6)), and any other assets not used in undertaking qualified business activities.
- The QSBS Issuer must "**actively conduct**" its start-up, R&D and/or qualified business activities.

Some activities are excluded for purposes of the 80% Test. Sections 1202(e)(3) and (7) identify a number of activities that are excluded from the scope of Section 1202's qualified business activities (e.g., consulting, health, leasing, restaurants, real estate).[3] Assets used in excluded activities do not count toward satisfying Section 1202's 80% Test. Activities that are not listed in Sections 1202(e)(3) or (7) and are actively conducted should generally be treated as qualified activities whose assets count towards satisfying the 80% Test.

Assets used in connection with start-up and R&D activities count towards satisfying the 80% Test and its associated active conduct requirement if those activities are reasonably expected to result in commercialized qualified activities. Section 1202(e)(2) provides that assets used in start-up and R&D activities count towards satisfaction of the 80% Test, so long as it is reasonably anticipated that the start-up and R&D activities further the development of activities falling within the scope of qualified

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business activities: "*(A) start-up activities described in Section 195(c)(1)(A), (B) activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under Section 174, and (C) activities with respect to in-house research expenses described in Section 41(b)(4)*" are "***treated as used in the active conduct of a trade or business***." The provision also states that "*any determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination*." Section 1202(e)'s treatment of start-up and R&D activities as "active conduct" is addressed below.

Cash and cash management investment assets can qualify as "working capital" contributing towards satisfying the 80% Test and its associated active conduct requirement. Section 1202(e)(6) provides assets falling within the scope of working capital and associated cash management assets "***shall be treated as used in the active conduct of a trade or business***." This provision is addressed below.

Section 1202(e)(5)(A) provides for a look-through to the assets of a corporate subsidiary (and most likely a partnership). A QSBS Issuer that holds more than 50% by vote or value of a corporate subsidiary is treated as owning directly a ratable share of the assets of that subsidiary for purpose of the active business requirement. This means that a ratable portion of the assets (and the activities associated with those assets) of the subsidiary would be treated as being held directly by the QSBS Issuer for purposes of the 80% Test. Although Section 1202 is silent on the issue, the same look-thru should apply to lower-tier LLCs/LPs/joint ventures and partnerships (referred to in this article as "**Partnerships**"). See *Exploring the Role of Partnerships in Qualified Small Business Stock (QSBS) Planning*. If a QSBS Issuer holds 100% of a disregarded entity, the general treatment of disregarded entities for federal income tax purposes should result in the assets of the disregarded entity being treated as though they are owned directly by the QSBS Issuer.

The active business requirement is not satisfied for any period during which a QSBS Issuer has excessive minority stock

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investments or real property activities. Sections 1202(e)(5)(B) and (e)(6) provides that the "active business requirement" will not be satisfied during a period where more than 10% of the value of its assets in excess of its liabilities consists of stock or securities in other corporations which are not subsidiaries of the QSBS Issuer other than working capital assets;[4] or (2) more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified business (for this purpose, owning, dealing in, or renting real property is not considered to be the active conduct of a qualified business).[5]

Corporations qualifying as "specialized small business investment companies" are not required to satisfy the active business requirement. Section 1202(c)(2)(B) waives the active business requirement for "specialized small business investment companies." This provision is addressed below.

What does it mean to be "actively conducting" qualified business activities for purposes of the 80% Test?

The elements of Section 1202(e)'s active business requirement includes not only the 80% Test (i.e., that 80% by value of a QSBS Issuer's assets are used in engaging in one or more qualified activities) but also the requirement that the corporation "**actively conduct**" its qualified business activities. The 80% Test and its "active conduct" element apply throughout a taxpayer's QSBS holding period.

Tax authorities available to interpret what is meant by "active conduct" for purposes of Section 1202. Neither Section 1202 nor the Section 1202 Treasury Regulations provide guidance regarding what constitutes "active conduct." How taxpayers should interpret and apply the "active conduct" requirement must be determined based on the language of Section 1202, the Tax Court's *Owen* decision, and the other tax authorities addressed below.[6]

The active conduct requirement is also addressed in *Finding Suitable Replacement Qualified Small Business Stock – Advanced Section 1045 Issues* and *Substantiating the Right to Claim QSBS Tax*

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Benefits (Part 1).

How the Tax Court addressed the "active conduct" requirement in the *Owen* decision. The Tax Court's decision in *John P. Owen*, T.C. Memo 2012-21 (2012) is the only tax authority that addresses Section 1202's "active conduct" requirement. In *Owen*, the Tax Court considered whether John Owen was entitled to make an election to roll over proceeds tax-free from his original QSBS into replacement QSBS under Section 1045.

John Owen sold his original QSBS investment and rolled over $1,916,827.07 into J&L Gems pursuant to a Section 1045 election. Owen testified that J&L Gems' business activity was the operation of a retail jewelry store. The Tax Court focused on the fact that during the two-year period after incorporating J&L Gems, only 8% ($147,026.50) of the corporation's money was invested in jewelry inventory:

at trial Mr. Owen attempted to justify his lack of inventory by explaining that he did not believe it was prudent to purchase more inventory without first learning the business. However, it is clear from the record that Mr. Owen simply did not follow the advice of his accountant and appears to have been unaware of or misunderstood the 80 percent active business requirement. Mr. Owen testified that 'My view of active business is just that. I went out and I purchased. I took the stock of this company and put it into the stock of this other company. I put the money from the sale of the company within the 60-day period he told me to put it in, and I started buying up gems. So in my opinion, I thought I was doing everything correctly.' It is apparent that J&L Gems was never an active business within the meaning of section 1202(e). We note that as of August 1, 2004 (about 2 years after the initial deposit), J&L Gems had 16 pieces of jewelry. Although Mr. Owen explained at trial that his goal was to develop the business and indicated that it took time for a jewelry business to become established, 2 years after the money was injected, J&L Gems was still not using it.

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The Tax Court also focused on the nature of the activities and John Owen's lack of credibility, and in particular his explanation of why only limited funds were invested into the jewelry business during the two-year period.[7] The Tax Court held that John Owen was not entitled to the benefits of the Section 1045 election based on his failure to provide credible evidence that J&L Gems was actively pursuing the retail jewelry business.

The *Owen* decision is noteworthy for its focus on the "active conduct" requirement, Owen's lack of credibility, and on the limited expenditure of funds as evidence of lack of "active conduct." Equally noteworthy is the apparent failure by both parties and the Tax Court to restrict their focus to the six-month period after issuance of the replacement QSBS, as dictated by the requirements of Section 1045, and by Owen's failure to argue that the activities during the first six months after issuance of the replacement QSBS consisted of start-up and R&D activities that might not have required a substantial expenditure of the corporation's funds. So, while the corporation's failure to spend more than 8% of its funds over a two-year period might well be an indication of lack of "active conduct," that same failure during only the first six months of operations might have been reasonable – we will never know. Certainly the *Owen* decision strongly suggests that taxpayers should operate pursuant to a credible budget and business plan when acquiring replacement QSBS under Section 1045, be fully prepared to defend that budget and business plan, and further be further prepared to explain, if applicable, why the actual expenditure of funds materially deviated from the business plan and budget. Taxpayers who do not have credible explanations for what was planned and what occurred are likely to end up in John Owen's position.

How "active conduct" is addressed in the *Medchem* decision. While the *Medchem (P.R.) Inc. v. Commissioner*[8] decision is not a Section 1202 case (the case addresses Puerto Rico possession tax credits which requires engaging in activities that meet an active conduct requirement), the decision does provide useful insight into how the Tax Court might approach a QSBS case. Section 936 is another statute that fails to define what active conduct means.

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After noting that there were no cases dealing with defining the scope of "active conduct" for purposes of Section 936, the Tax Court commented that the determination of whether a taxpayer activity conducted a trade or business "*is a highly fact intensive issue as to which petitioners (taxpayer) has the burden of proof*" and that it was appropriate to construe the phrase by reference to its use elsewhere in the Internal Revenue Code, keeping in mind the intent of Congress in enacting the applicable statute, as indicated in legislative history. The Tax Court then noted that taxpayers are generally considered to be actively conducting a business if they meaningfully participate in the management or operations, as contrasted to passive investors who are not involved in management or operations. The court focused on Section 355 and other Internal Revenue Code provisions that use similar "active conduct" language. After conducting the survey of other tax provisions, the Tax Court considered whether the taxpayer "***participated regularly, continually, extensively, and actively in the management and operation***" of the manufacturing activity during the applicable 36-month period. The First Circuit concluded upon review of the Tax Court's *Medchem* decision that "active conduct" for purposes of the Puerto Rico tax credits did not extend to products manufactured by third parties and merely sold by the corporation claiming the credits – i.e., being a mere retailer of third-party manufactured products was not "regular and extensive participation" (i.e., active conduct) as contemplated when Congress enacted the Puerto Rico possession tax credits.[9] *Medchem* suggests that in order to satisfy an "active conduct" requirement, the Tax Court is likely to require evidence of a significant level of activity.

How "active conduct" is addressed in the United States Supreme Court's *Groetzinger* decision. In *Commissioner v. Groetzinger*,[10] the United States Supreme Court considered whether a gambler was engaged in a "trade or business" within the meaning of Sections 162(a) and 62(1): *"we accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion*

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does not qualify" and that the resolution of the issue of whether a taxpayer is engaged in a trade or business "*requires an examination of the facts in each case*."[11] The *Groetzinger* decision provides further support for the expectation that to substantiate "active conduct," a taxpayer must prove that there was a relatively high level of activity. Exactly what that level of activity must be will be a facts and circumstances analysis of the activities undertaken by the corporation.

How "active conduct" is defined for purposes of Section 355. Section 355 addresses tax-free divisions of corporations, and requires that in order to divide a corporation's activities into two corporations on a tax-free basis, there must be two activities, each of which was actively conducted for at least five years before the division. Proposed Regulation Section 1.355-3(b)(2)(iii) further develops the "active conduct" requirement set forth in the current Section 355 regulation:

*[T]he determination of whether a trade or business is actively conducted will be made from all of the facts and circumstances. **Generally, the corporation is required itself to perform active and substantial management and operational functions**. Activities performed by a corporation include activities performed by employees of an affiliate (as defined in paragraph (c)(1) of this section), and in certain cases by shareholders of a closely held corporation, if such activities are performed for the corporation. For example, activities performed by a corporation include activities performed for the corporation by its sole shareholder. However, the activities of employees of affiliates (or, in certain cases, shareholders) are only taken into account during the period such corporations are affiliates (or persons are shareholders) of the corporation. A corporation will not be treated as engaged in the active conduct of a trade or business unless it (or its SAG, or a partnership from which the trade or business assets and activities are attributed) is the principal owner of the goodwill and significant assets of the trade or business for Federal income tax purposes. Activities performed by a corporation generally do not include activities*

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performed by persons outside the corporation, including independent contractors, unless those activities are performed by employees of an affiliate (or, in certain cases, by shareholders). However, a corporation may satisfy the requirements of this paragraph (b)(2)(iii) through the activities that it performs itself, even though some of its activities are performed by persons that are not its employees, or employees of an affiliate (or, in certain cases, shareholders) (emphasis added).

The reference to "*active and substantial management and operational functions*" appears consistent with the relatively high bar set by the Tax Court in the *Medchem* decision.[12] In *Rafferty v. Commissioner*,[13] the First Circuit Court of Appeals stated that

it is our view that in order to be an active trade or business under § 355 a corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations.

"Active conduct" defined for purposes of Section 179 activities. Section 179, which addresses the election to expense certain otherwise depreciable business expenses, defines "Section 179 property" to include property "*which is acquired for use in the active conduct of a trade or business.*" Treasury Regulation Section 1.179-2(c)(6) addresses "active conduct" as follows:

the determination of whether a trade or business is actively conducted by the taxpayer is to be made from all the facts and circumstances and is to be applied in light of the purpose of the active conduct requirement of section 179(b)(3)(A). In the context of section 179, the purpose of the active conduct requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income derived from that trade or business. Consistent with this purpose, a taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or

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operations of the trade or business. Generally, a partner is considered to actively conduct a trade or business of the partnership if the partner meaningfully participates in the management or operations of the trade or business. A mere passive investor in a trade or business does not actively conduct the trade or business.

The Section 179 regulations are useful because they direct taxpayers and the Government to look at legislative history to determine the purpose of including the active conduct requirement in connection with defining the phrase's use in the statute. Similarly, the Tax Court and First Circuit Court of Appeals in *Medchem* looked at the policy reasons for enactment of the Puerto Rico possession tax credits.[16] The courts' focus on the policy reasons for the enactment of a statute in connection with interpreting the meaning of "active conduct" has particular relevance in connection with comparing purposes behind the inclusion of the phrase "active conduct" in Section 355 versus Section 1202.

Other tax authorities addressing the meaning of "active conduct." In the course of addressing Section 1202 issues not expressly addressed in the language of the statute, IRS Private Letter Ruling (PLR) 202114002, focused on the "popular dictionary" definitions to define the scope of an excluded activity for Section 1202 purposes and both the IRS and courts have also focused on how a term or phrase is used elsewhere in the Internal Revenue Code.[14] The on-line Merriam-Webster dictionary defines "actively" to mean "in a *manner involving great or constant activity, as in diligently*." Synonyms and similar words listed in the dictionary include "*diligently, assiduously, industriously, vigorously, energetically, tirelessly, busily, laboriously and indefatigably*." "Conduct" is defined to mean "*to look after and make decisions about*." Synonyms include "*supervise, manage, handle, oversee, regulate, govern, operate, control and run*." The dictionary does not address the meaning of the phrases "active conduct" or "actively conduct." These dictionary references suggest that "active conduct" and "actively conduct" would entail a meaningful level of direct involvement or management of an activity.[15] The focus on managing and supervising suggests that a meaningful level of

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activities of a taxpayer-stockholder in connection with managing and supervising the activities of others, including employees, employees of affiliated entities or independent contractors working on behalf of the QSBS Issuer, should be imputed to the QSBS Issuer for purpose of the "active conduct" requirement. The dictionary definitions of "actively" and "conduct" suggest that passive activities would certainly not satisfy the "active conduct" requirement. However, beyond confirming that "managing and supervising" can be considered engaging in active conduct, the dictionary definitions do not provide useful guidance regarding whether there is any distinction between efforts of employees, stockholders, employees of affiliates or independent contractors.

How start-up and R&D activities are treated for purposes of the 80% Test and the "active conduct" requirement. For many newly-organized corporations, and in particular those corporation issuing replacement QSBS under Section 1045, Section 1202(e)(2)'s reference to start-up and R&D activities might play a critical role in determining whether the corporation has satisfied Section 1202's "active conduct" requirement.

Section 1202 does not limit the **active conduct** of a business to the stage of development where a corporation has commercialized and profitable products and services. Section 1202(e)(2) provides that assets used in either start up or R&D activities are deemed to be used in the active conduct of a business (presumably so long as it can be substantiated that the start-up and R&D activities are reasonably anticipated to culminate in profitable commercialized products and services) and count towards meeting the 80% Test. As discussed below, Section 1202(e)(2) does not expressly require a particular level of activities for start-up and/or R&D activities to qualify under Section 1202(e)(2).

With respect to what constitute "start-up activities," Section 1202(e)(2)(A) cross references Section 195(c)(1)(A), which focuses on the tax treatment of activities associated with investigating the creation or acquisition of an active trade or business, creating an active trade or business, or any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an

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active trade or business. With respect to what constitutes R&D activities, Sections 1202(e)(2)(B) and (C) reference "*activities resulting in the payment or incurring of expenditures which may be treated as research and development expenditures under section 174 or domestic research and experimental expenditures under section 174A*" or "*activities with respect to in-house research expenses described in section 41(b)(4).*" Treasury Regulation Section 1.174-2 includes within the scope of Section 174, experimental or laboratory research and development activities. Treasury Regulation Section 1.174-2(a)(1) provides that

> *expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.*[17]

The cross references in Section 1202(e)(2) to Sections 195, 174, 174A and 41 do not work cleanly as those statutes exist to establish the treatment of expenditures, while Section 1202 focuses on the scope of what activities constitute start-up and R&D activities for purposes of the 80% Test and the "active conduct" requirement. A survey of Section 195 tax authorities confirms that "start-up" activities are considered to be those activities that might be reasonably expected to lead to the commencement of an active trade or business. In discussing the concept of "start-up" expenses

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for purposes of Section 195, the legislative history provided that *"[u]nder the provision [Section 195], eligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or enter that business. These costs include expenses incurred for the analysis or survey or potential markets, products, labor supply, transportation facilities, etc."*[18] Revenue Ruling 99-23, 1999-1 CB 998, provided that Section 195's scope included "investigatory expenses," which are "*costs incurred in seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business*," as distinguished from the situation where the corporation is engaged in acquiring a particular business, which would require capitalization of the expenses.[19] If the Section 195 tax authorities, which address the treatment of expenditures, are instead applied to defining the scope of start-up activities, then based those authorities, a corporation's start-up activities appears to encompass those activities occurring before a business reaches the stage where it commercializes its products and services. If and when the corporation reaches the commercialization stage, presumably the issue of whether the corporation is actively conducting its business activities should no longer be an issue.

Sections 1202(e)(2)(B) and (C) confirm that assets used in connection with R&D activities also count towards meeting Section 1202's 80% Test and its "active conduct" requirement. The language of Section 1202(e)(2) provides that if a corporation is engaging in start-up or R&D activities, any assets deemed to be used in those activities are deemed to satisfy the active conduct requirement. The tax authorities discussed above address what activities should be considered to fall within the scope of start-up and/or R&D activities, but the question still remains whether there is a certain level of those activities that must be undertaken before Section 1202(e)(2) applies. A reasonable melding of Section 1202(e)(2)'s language with the active conduct authorities addressed above suggests that the Tax Court would expect to see evidence of a reasonable and customary level of start-up and/or R&D activities undertaken by the QSBS Issuer for purposes of satisfying the "active conduct" requirement, and additional evidence identifying the assets were either used or earmarked for use in those activities

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for purposes of counting those assets towards meeting the 80% Test.

How working capital and associated cash management assets are treated for purposes of the 80% Test and the "active conduct" requirement

Section 1202(e)(6) provides that

any asset which — (A) are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or (B) FTC are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business, ***shall be treated as used in the active conduct of a qualified trade or business****. For periods after the corporation has been in existence for at least 2 years, in no event may more than 50 percent of the assets of the corporation qualify as used in the active conduct of a qualified trade or business by reason of this paragraph* (emphasis added).

So, with certain limitations, assets of a QSBS Issuer that fall within the scope of working capital and associated cash management assets (i.e., invested working capital) are counted towards meeting the 80% Test and are deemed to be used in the active conduct of the corporation's activities, assuming those activities, either prospective or actual, are qualified activities. If the language of Section 1202(e)(6) is taken literally, a corporation whose assets consist entirely of money and cash management assets (e.g., a newco-corporation that recently issued replacement QSBS) could be deemed to satisfy the 80% Test and the "active conduct" requirement. The taxpayer, of course, must be prepared to substantiate that the corporation's cash and cash management assets qualify as assets reasonably required for current and future working capital needs in qualified activities. Although Section 1202

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is silent regarding what falls within the scope of "working capital," it seems reasonable to assume that for purposes of Section 1202, the scope should include not only money/cash management assets required for current and future operating expenses but also a corporation's current and future capital requirements (e.g., funds earmarked for purchasing the assets or equity of a business engaged in qualified activities).[20]

After a QSBS Issuer has been in existence for two years, Section 1202(e)(6)'s places a limit on the amount of cash and investment assets (invested working capital) that qualifies as a good assets for purposes of the 80% Test (no more than 50% of the fair market value of all of the QSBS Issuer's assets), which means in practical terms that a corporation engaged in the activity of searching for an acquisition target must deploy its funds within that two-year period, and a QSBS Issuer that is a created start-up must compare the amount of cash and investment assets to the aggregate value of all assets (including goodwill not on the balance sheet).

Liquidating and reinvesting proceeds under Section 1045 in a new corporation has been suggested as a way to start a new two-year clock for purposes of Section 1202(e)(6). However, this strategy risks the possibility that the IRS and Tax Court would invoke the liquidation-reincorporation doctrine to treat the newco-QSBS Issuer as a continuation of liquidated QSBS Issuer, which would defeat the goal of attempting to start a new two-year "working capital" clock.

For a newco-QSBS Issuer, Section 1202(e)(6)'s treatment of money and cash investment assets could play a critical role in satisfying the 80% Test and the "active conduct" requirement. A Section 1045 election usually involves the rollover of significant funds into the newco-QSBS Issuer. It seems likely that, whether that newco-QSBS Issuer thereafter engages in creating a start-up (e.g., software development activities) or undertakes an effort to search for an acquisition target, the corporation's assets will initially consist of almost entirely of the initial cash investment and recently acquired investment assets. Applying the language of Section 1202(e)(6), a corporation engaged in start-up and/or R&D activities whose assets consist primarily of working capital and cash management assets

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should satisfy both the 80% Test and the active conduct requirement. Section 1202(e)(6) speaks in terms of a corporation's current and future working capital needs, and itself does not establish any minimum level of current activities during the pre-commercialization stage in order for the working capital/cash management assets to qualify as counting towards the 80% Test and deemed to be used in the active conduct of the corporation's activities. However, a reasonable melding of the language of Sections 1202(e)(2) and (6) with the active conduct authorities addressed above suggests that the Tax Court would expect to see evidence of a reasonable and customary level of start-up and/or R&D activities undertaken by the QSBS Issuer for purposes of meeting the "active conduct" requirement, and additional evidence establishing that the corporation's money and cash management assets met the requirements of Section 1202(e)(6) for purposes of counting towards satisfying the 80% Test.

Summary of how the "active conduct" requirement functions for purposes of Section 1202

The Tax Court's *Owen* decision suggests that whether a taxpayer can substantiate that a QSBS Issuer engaged in the "active conduct" of its business activities will be a critical aspect of satisfying Section 1202's 80% Test, particularly in circumstances where a newco-corporation issues replacement QSBS under Section 1045.

Tax authorities confirm that the determination of whether a corporation is actively conducting its activities generally requires a facts and circumstances analysis. The Tax Court's *Medchem* decision and the Section 355 proposed regulations suggest that in order for taxpayers to substantiate eligibility to claim the benefits of QSBS ownership, they must be prepared to provide credible and compelling evidence that the corporation met the "active conduct" requirement, and that there will be a relatively high bar set by the Tax Court (think in terms of "*regularly, continually, extensively, actively, substantially*"). Precisely what level of conduct is required before a corporation would be considered as actively conducting

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its business activities will differ among QSBS Issuers. Assuming that the Tax Court considers both the tax authorities addressing what "active conduct" means (e.g., *Owen*) and the express language of Sections 1202(e)(2) and (e)(6), a likely result would be a focus on the level of start-up and R&D activities undertaken by a newco-QSBS Issuer. The Tax Court would likely ask whether those start-up and R&D activities were consistent with those of a corporation owned by taxpayers not seeking QSBS tax benefits. For some start-ups, there will likely be less focus than in *Owen* on the level of cash expenditures, given the fact that many software and AI startups rely initially more on the activity and results achieved by a few key software developers, rather than engaging in activities that rely on large cash expenditures (of course, this is not always the case as some QSBS Issuers quickly ramp up activities). A taxpayer who can successfully substantiate that his corporation's activities, whether consisting of start-up, R&D and/or commercialized activities, were undertaken "*regularly, continually, extensively, actively, and substantially*" should be in a strong position if challenged by the IRS.

Beyond the general question of what is meant by "active conduct," there are the additional issues addressed below regarding (i) whose activities (i.e., those of employees, stockholders, employees of affiliate and/or independent contractors?) count towards meeting a QSBS Issuer's active conduct requirement, and (ii) whether there is a look-thru to activities of affiliated companies

Whose activities (e.g., those of employees, stockholders, employees of affiliated companies or independent contractors?) count towards satisfying the "active conduct" requirement?

Neither Sections 1202 nor 1045, nor tax authorities interpreting those statutes address whose efforts (i.e., those of employees, stockholders, employees of affiliates and/or independent contractors?) count towards determining whether a QSBS Issuer has actively conducted its business activities. In the absence of express tax authorities providing guidance, there is a reasonable argument that the efforts of any or all of employees, stockholders,

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employees of affiliate and/or independent contractors should be permitted to contribute towards a QSBS Issuer actively conducting its business activities.

Sections 1202 and 355 each have an "active conduct" requirement. Based on a review of tax authorities, there should be no doubt that the activities of employees are imputed to the corporation for purposes of the "active conduct" requirement, and there is no reason to doubt the same result should apply under Sections 1202 and 1045.[21] Likewise, the activities of the issuing corporation's stockholders are generally imputed to the corporation for purposes of the Section 355's "active conduct" requirement, and it seems reasonable that the same result should apply under Sections 1202 and 1045.[22] Section 355's regulations and related tax authorities further acknowledge that there are situations where the efforts of employees of affiliated entities should be considered as contributing towards the satisfaction of the "active conduct requirement," and again it seems reasonable that the same result should apply under Section 1202 and 1045. Section 355's regulations suggest a corporation will not satisfy the active conduct requirement if the activities of the corporation are undertaken exclusively through the use of independent contractors.[23] Proposed Regulation Section 1.355-3(b)(2)(iii) includes the following discussion of "active conduct":

Generally, the corporation is required itself to perform active and substantial management and operational functio*ns. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others*[24]

and

activities performed by a corporation include activities performed by employees of an affiliate (as defined in paragraph (c)(1) of this section), and in certain cases by shareholders of a closely held corporation, if such activities

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are performed for the corporation. ***For example, activities performed by a corporation include activities performed for the corporation by its sole shareholder****. However, the activities of employees of affiliates (or, in certain cases, shareholders) are only taken into account during the period such corporations are affiliates (or persons are shareholders) of the corporation. A corporation will not be treated as engaged in the active conduct of a trade or business unless it (or its SAG, or a partnership from which the trade or business assets and activities are attributed) is the principal owner of the goodwill and significant assets of the trade or business for Federal income tax purposes.* ***Activities performed by a corporation generally do not include activities performed by persons outside the corporation, including independent contractors, unless those activities are performed by employees of an affiliate (or, in certain cases, by shareholders)****. However, a corporation may satisfy the requirements of this paragraph (b)(2)(iii) through the activities that it performs itself, even though some of its activities are performed by persons that are not its employees, or employees of an affiliate (or, in certain cases, shareholders) (emphasis added).*[25]

Section 355's legislative history and tax authorities interpreting the statute confirm that the underlying concern that resulted in the inclusion of the active conduct requirement is that taxpayers would use the ability to divide corporations on a tax-free basis as a means of distributing out passive investment assets. Hence the statement at the beginning of the proposed regulation to the effect that: "*Generally, the corporation is required itself to perform active and substantial management and operational functions*," evidences an intent to distinguish between active and passive business activities. For purposes of Section 355, one potential earmark of a passive activity is the undertaking of the corporation's activities by outside independent contractors rather than employees, stockholders or employees of affiliated companies.

A series of Revenue Ruling explored the use of independent contractors in the Section 355 context. In Revenue Ruling 73-234,

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1973-1 CB 180, the IRS concluded that Section 355's "active conduct" requirement was satisfied where a corporation performed substantial management and operational functions in conducting the farm activities, in spite of the fact that the business involved the heavy involvement of tenant farmers acting as independent contractors. In Revenue Ruling 73-237, 1973-1 CB 184, the IRS also held that Section 355's "active conduct" requirement was satisfied where a general construction contractor's direct performance of substantial management and operational activities, apart from those activities performed by subcontractors acting as independent contractors. The IRS noted that

the activities of X corporation, performed by several salaried employees, consist of submitting bids on prospective jobs; negotiating and entering into contracts with principals and with subcontractors, acting as independent contractors; purchasing or leasing equipment or supplies, depending on the particular job; and supervising work of subcontractors to determine if it conforms to contract specifications. X has the primary responsibility for the completion of each job.

In Revenue Ruling 86-125, 1986-2 CB 57, the IRS held that Section 355's active business requirement was not met with regard to a rental office building where the building was managed by an unrelated real estate management company acting as an independent contractor. The IRS noted that

to meet the requirements of section 355(b) of the Code, each corporation must, as stated in Rafferty v. Commissioner, 452 F.2d 767, 772 (1st Cir. 1971), cert. denied, 408 U.S. 922 (1972), 'engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations.' Such objective indicia are found in active and substantial managerial and operational activities of the corporation. In addition, this business activity has to be activity of the corporation itself (through its officers and employees) and not the activity of independent contractors. Rev. Ruls. 80-181, 1980-2 C.B. 121,

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79-394, 1979-2 C.B. 141, and 73-234, 1973-1 C.B. 180.

The IRS took a close look at the activities of the parent corporation's personnel versus the activities of the independent contractor property management company:

A, the president and principal stockholder of P and an officer of S, devotes some time to the operation of the office building. A visits the building to insure that the cleaning and maintenance done by Z's employees are done properly. In addition, A approves the leases negotiated by Z's employees and the contracts entered into for repair of the building. A attends to all matters concerning zoning, building permits, and other local laws and ordinances affecting the building. No other officers or employees of P or S attend to the operation of the office building. P's outside accountant audits monthly the itemized list of income and expenses collected and paid by Z and reports the results to S.

X, an unrelated corporation, operates a larger insurance brokerage business. X desired to acquire the insurance brokerage business of P solely in exchange for X voting common stock. X, however, would not acquire P if P continued to hold the S stock. The management of P believed the association of its business with X would ensure the future growth and profitability of P. Accordingly, P distributed the stock of S pro rata to the P shareholders. Since the distribution, S has continued to use the services of Z as it had prior to the transaction.

The IRS concluded that the activities of the parent corporation's personnel did not extend beyond the activities of those of a mere investor:

In Rev. Rul. 73-237, the activity of X, carried on through its own employees, constituted active and substantial managerial and operational activity in the general contracting business. This activity of X contrasts with the activity carried on by S (through its officer) in the present situation. Here, the operational and management activity of the office building

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rental business is largely performed either by Z through Z's employees, or by independent contractors hired by Z. Clearly, S is not engaged in active and substantial operational and managerial activity with regard to the office building rental business. Although some of S's activities could be considered to be either managerial or operational, these activities are not different from those a prudent investor would be expected to undertake, and are not enough to "qualitatively distinguish its operations from mere investments." Thus, Rev. Rul. 73-237 is distinguishable from the present situation.

The Section 355 regulations and related Revenue Rulings provide several suggestions regarding how the Tax Court would address performance of the "active conduct" requirement for purposes of Section 1202. First, the authorities confirm that the activities of a corporation's employees are clearly imputed to the corporation, and generally, the activities of stockholders and employees of affiliates are also imputed to the activities of the corporation, subject to a facts and circumstances analysis. But where the activities of a corporation are undertaken solely through independent contractors, the IRS is likely to take the position that the corporation's activities are passive for purposes of Section 355. Where a corporation's activities are undertaken by a mixture of employees and/or stockholders providing managerial oversight and involvement, and independent contractors contributing to the operation of the businesses, the issue of whether the corporation would be considered to actively conduct its business depends on a facts and circumstances analysis, looking in particular at whether the use of independent contractors is customary given the nature of the business activity.

The Section 355's tax authorities discussed above suggests that a QSBS Issuer who relies heavily on independent contractors should be considered to be actively conducting its business activities, if reliance on independent contractors is customary given the activity (e.g., a software/AI start-up relying on independent domestic and/or foreign software developers or a newco-QSBS Issuer engages in a business search process and relies heavily on outside resources such as finders, brokers, attorneys, accountants and

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other financial professions whose role is to assist in the business search and acquisition process.[26]), so long as stockholders or other management personnel have meaningful involvement in the corporation's management and direction. In contrast, an example of a passive investment activity might be the ownership of rental properties where all of the activities are outsourced to independent contractor property management companies. Two further items of note are (1) Section 1202 is silent regarding whether it makes a difference if an action is performed by an employee or independent contractors, and (2) there are no other tax authorities interpreting Sections 1202 or 1045 suggesting that actions taken by independent contractors should be viewed differently than those undertaken by employees.

A separate consideration is whether the treatment of independent contractors under Section 355 is relevant to Section 1202 given the different policy reasons for use of the active conduct requirement in the two statutes. The application of the active conduct requirement under Section 355 and the associated treatment of independent contractors arises out of the concern that the statute might be used as a device to distribute earning and profits on a tax-free basis rather than subject those distributions to the C corporation double taxation regime. Hence the focus on the potential abuse of Section 355 and Type D reorganizations as a vehicle to distribute passive assets to stockholders. Here the policy objectives of Section 355 differs from those of Section 1202. Section 1202's legislative history speaks in terms of providing "*targeted relief for investors who risk their funds in new ventures [and] small businesses*" and to "*encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing*." Presumably, the "active conduct" requirement was included as a Section 1202 requirements to ensure that investors were not incentivized to seek the benefits of QSBS ownership in connection the ownership of corporations holding passive investment assets. But Section 1202's policy objectives are in no way impaired where an AI software startup uses independent contractors to undertake software development activities or a corporation engaged in a business acquisition search uses service providers traditionally employed to assist in the search and

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acquisition process. So long as a QSBS Issuer's activities are directed at ultimately operating an economically successful business engaged in qualified activities, the fact that the QSBS Issuer has employed independent contractors to assist the corporation in achieving those goals should not generally result in the conclusion that the corporation is not actively conducting its business activities. The activities of a software startup that relies heavily on independent contractors appears to be indistinguishable from another startup whose software developers are W-2 employees.

While Section 355 and other Internal Revenue Code provisions using the phrase "active conduct" should be considered for their relevance, it is important to consider whether the policy reasons behind use of the phrase "active conduct" aligns among the statutes. There are some circumstances where the heavy use of independent contractors might, in fact, be evidence that the corporation is engaged in passive investment activities. But as noted above, there are also common examples of corporations that are actively conducting their business operations while at the same time relying to some degree on the services of independent contractors.

Can a parent corporation engage in "active conduct" through its disregarded entities, corporate subsidiaries and/or Partnerships (joint ventures/LLCs/LPs)?

Disregarded entities. Under the Section 7701 "check-the-box" regulations and related tax authorities, a single-member LLC is treated as disregarded for federal income tax purposes, unless it has checked the box to be taxed as a corporation. Based on the check-the-box regulations and associated tax authorities, there is no reason to doubt that a parent corporation (the QSBS Issuer) is deemed to engage in the active conduct of a business through its disregarded subsidiaries, as the assets of those disregarded entities are treated as being held directly by the corporate parent for federal income tax purposes.

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Corporate subsidiaries. A parent corporation (the QSBS Issuer) can engage in active conduct of trade or business activities through one or more corporate subsidiaries. Section 1202(e)(5) provides that a corporation that owns a "subsidiary" is deemed to conduct its ratable share of the subsidiary's activities. A parent corporation is considered to own a "subsidiary" if the parent corporation "*owns more than 50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent in value of all outstanding stock*" of the corporation. Section 1202(e)(5) does not state that the corporate subsidiary must be a domestic (US) corporation, and there are no tax authorities that provide any guidance regarding whether the IRS would be inclined to argue that the requirement that the QSBS Issuer be a domestic (US) C corporation should apply at the subsidiary level.

Partnerships (joint ventures/LLCs/LPs). Sections 1202 and 1045 (including Treasury Regulation Section 1.1045-1) are silent regarding whether the active conduct of a pass-through entity can be imputed to a corporation that holds an equity interest in Partnerships. In spite of this silence, engaging in business activities through lower-tier Partnerships is a common occurrence. This fact increases the planning stakes involved for taxpayers who anticipate taking advantage of Section 1202's gain exclusion but hold stock in corporations that operate through lower-tier Partnerships. If the assets included in the Partnership are less than 20% of the value of the corporation's overall assets, the corporation might be able to satisfy the 80% Test without digging too deeply into the issue of whether the Partnership's assets should qualify. But some corporations hold a greater percentage of their assets through Partnerships.

Legislative history and policy considerations. Section 1202's legislative history notes that Section 1202 was designed to provide "*targeted relief for investors who risk their funds in new ventures [and] small businesses*." The potential for a substantial gain exclusion was intended to "*encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing*." In connection with increasing the gain exclusion to 100% in 2010, the legislative history noted that the "*increased exclusion and the elimination of the minimum tax preference for small*

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business stock will encourage and reward investment in qualified small business stock." There is nothing in Section 1202's legislative history suggesting that Congress would not want to incentivize the flow of capital to a corporation engaging in activities through a lower-tier Partnerships, at least to the same extent as permitted where there is a corporate subsidiary. Should Section 1202's silence on the issue of operating through Partnerships, in contrast to the express handling of corporate subsidiaries, be interpreted to mean that there isn't a comparable look-through to the active conduct and qualified activities of the Partnership? Or should the fact that Section 1202 is silent on the issue simply mean that taxpayers should look to other tax authorities addressing the look-through issue for guidance?

Past consideration of the Partnership look-through issue in tax literature. The issue of whether there is a Partnership look-through under Section 1202 has existed for a long time with little additional guidance and no definitive resolution. The following discussion was included in a "Shop Talk" column in the October, 2000 Journal of Taxation,[27]

Todd D. Golub, an attorney with Katten Muchin Zavis in Chicago and author of a recent article on Section 1045 rollovers entitled 'Tax-Free Rollover of Qualified Small Business Stock', 1 Mergers and Acquisitions, No. 4, page 15 (August 2000), provides Shop Talk with these observations:

The General Explanation of Tax Legislation engaged in 1997 by the staff of the Joint Committee on Taxation (the 1997 Blue Book) states at page 58 that Congress enacted Section 1045 with the hope that the deferral would encourage investors to reinvest funds in qualified small businesses, making more capital available to new, small businesses that are important to the long-term growth of the economy. There is no indication of why Congress limited the deferral benefit to investors that provide funds to small businesses that operate only in corporate form. So long as Congress intended to provide such a benefit to parent-subsidiary corporate relationship, Congress actually may have limited the funding

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that otherwise might be available to businesses that choose not to incorporate.

Accordingly, it would seem that a look-through rule should apply to corporations that have an interest in LLCs or other entities taxed as partnerships that are engaged in a qualified business. It also would seem fitting that this rule should extend only to parent corporations that invest directly in the LLC as opposed to corporations that purchase the interests of existing members. In a case of first impression, it might be easier to establish attribution of the LLC's active business to its corporate member if the latter is the sole manager-member of the LLC.

Congress, however, did not go so far as to specifically provide for a look-through rule when a corporation invests directly in an LLC or partnership. So, if one looks solely to the statute, the business of the LLC arguably may not be attributable to the corporate member. One can only hope that future guidance will clarify that the deferral benefit of Section 1045 should apply to the shareholders of corporations that invest directly in qualified businesses regardless of the form of entity that engages in the qualified business.

Mr. Golub suggested that silence in Sections 1202 and 1045 on the issue of active conduct through Partnerships supported the position that there is no look-through from the corporate parent to the Partnership subsidiary. But should Section 1202's failure to expressly address the issue be interpreted negatively as Mr. Golub suggests?

Should the active conduct of a Partnership be imputed to its corporate parent? There are a number of tax authorities supporting the conclusion that a corporate parent should be able to look-through to the active conduct of a Partnership, provided that the corporate parent's interest in the Partnership is either "meaningful" or "substantial."

In Revenue Ruling 92-17, 1992-1 C.B. 142, the IRS considered whether D, a corporate general partner in a limited partnership, engaged in the active conduct of a trade or business within the meaning of

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Section 355(b). The IRS noted that for more than 5 years, D owned a 20 percent interest in LP, a limited partnership that owned several commercial office buildings leased to unrelated third parties. D's officers performed active and substantial management functions with respect to LP, including the significant business decision-making of the partnership, and regularly participated in the overall supervision, direction, and control of LP's employees in operating LP's rental business. The Ruling concluded that D was engaged in the active conduct of trade or business within the meaning of Section 355(b):

[i]f officers of a corporation that is a general partner in a limited partnership perform active and substantial management functions for the partnership, including the decision-making regarding significant business decisions of the partnership and regular participation in the overall supervision, direction and control of the employees of the partnership in operating the partnership's rental business, the corporation is engaged in the active conduct of a trade or business within the meaning of section 355(b) of the Code. Accordingly, because all the other requirements of section 355 of the Code are met, the distribution of the stock of C by D to D's shareholders is tax-free to the D shareholders under section 355.

Both the reasoning and conclusion in Revenue Ruling 92-17 are important as relevant authority for purposes of QSBS planning. Like Sections 1202 and 1045, Section 355 references "active conduct" but is silent on whether a corporation can engage in "active conduct" through a Partnership. Nevertheless, the IRS concluded in Revenue Ruling 92-17, **based on the Tax Court's interpretation of Section 355**, that a corporation could engage in active conduct of a business through a Partnership. In other words, the IRS reached its conclusion based on the authority of Section 355(b), in spite of the fact that Section 355 was itself silent, as in Section 1202, regarding whether there is look-through to the activities of a subsidiary Partnership. A similar approach was subsequently adopted by Proposed Regulation Section 1.355-3(b)(v):[28]

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Partner attributed the trade or business assets and activities of a partnership.

(A) In general. For purposes of section 355(b), a partner in a partnership will be attributed the trade or business assets and activities of that partnership during the period that such partner satisfies the requirements of paragraph (b)(2)(v)(B) or (b)(2)(v)(C) of this section. However, for purposes of this paragraph (b)(2)(v), the stock of a corporation owned by the partnership is not attributed to a partner. For purposes of determining the activities that are conducted by the partnership that may be attributed to the partner under this paragraph (b)(2)(v), the activities of independent contractors, and partners that are not affiliates (or, in certain cases, shareholders) of the partner, are not taken into account. For this purpose, the activities of partners that are affiliates (or, in certain cases, shareholders) of the partner are only taken into account during the period that such partners are affiliates (or, in certain cases, shareholders) of the partner.

(B) Significant interest. The trade or business assets and activities of a partnership will be attributed to a partner if the partner (or its SAG) directly (or indirectly through one or more other partnerships) owns a significant interest in the partnership.

(C) Meaningful interest. The trade or business assets and activities of a partnership will be attributed to a partner if the partner or affiliates (or, in certain cases, shareholders) of the partner performs active and substantial management functions for the partnership with respect to the trade or business assets and activities (for example, makes decisions regarding significant business issues of the partnership and regularly participates in the overall supervision, direction, and control of the employees performing the operational functions for the partnership), and the partner (or its SAG) directly (or indirectly through one or more other partnerships) owns a meaningful interest in the partnership. Whether such active and substantial management functions are performed with respect to the trade or business assets

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and activities of the partnership will be determined from all of the facts and circumstances. The number of partners providing management functions will not be determinative.

(D) Other factors. In deciding whether the requirements of paragraph (b)(2)(v)(B) or (b)(2)(v)(C) of this section are satisfied, the formal description of the partnership interest (for example, general or limited) will not be determinative and the extent to which the partner is responsible for liabilities of the partnership will not be relevant.

Proposed Regulation Section 1.355-3 is an "interpretive regulation" which means its role is to interpret, explain and apply Section 355. The Tax Court has stated that "*an interpretive regulation is a reasonable implementation of the congressional mandate if it harmonizes with the plain language of the statute, its origin, and its purpose.*"[29] Given that the term "active conduct" is used by both Sections 355 and 1202, where the IRS and the Treasury Department have interpreted the plain language of Section 355 to mean that a corporation can actively conduct business through a Partnership, it certainly seems reasonable that the same conclusion should apply when determining the scope of "active conduct" for purposes of Section 1202.

Other tax authorities support the position that there should generally be a look-through with the activities of a Partnership considered to be the activities of the partners. Revenue Ruling 2007-42, 2007-2 CB 44 concludes that active conduct can be imputed from a partnership to a partner if the partner holds a 33.33% membership interest, even if the corporation doesn't perform active and substantial management functions. In *Butler v. Commissioner*, 36 T.C. 1097 (1961), *acq*. 1962-2 C.B. 4, the Tax Court examined the relationship between a partner and a partnership for purposes of determining whether the partner was entitled to a business bad debt deduction for a loan he had made to the partnership that it could not repay. In holding that the partner was entitled to the bad debt deduction, the Tax Court noted that *"[b]y reason of being a partner in a business, petitioner was individually engaged in business*." In Revenue Ruling 98-15, 1998-1 CB 718, the IRS noted that

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For federal income tax purposes, the activities of a partnership are often considered to be the activities of the partners. . . Thus, the activities of an LLC treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of section 501(c)(3).

The IRS also concluded in TAM 9728002 (7/11/1997) that there should be imputation of a limited partnership's trade or business activity to partners, but limited the scope of the imputation to general partners. The TAM referred to Section 1402(a)(13) as evidence that Congress recognized that a limited partner is not generally considered to be engaged in the trade or business of his partnership. The distinction drawn in TAM 9728002 between general and limited partners is captured in part in the proposed Section 355 regulations' focus on having a "meaningful" interest that includes participation in management.

Finally, Treasury Regulation Section 1.179-2(c)(6) addresses "active conduct" as follows:

the determination of whether a trade or business is actively conducted by the taxpayer is to be made from all the facts and circumstances and is to be applied in light of the purpose of the active conduct requirement of section 179(b)(3)(A). In the context of section 179, the purpose of the active conduct requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income derived from that trade or business. Consistent with this purpose, a taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business. Generally, a partner is considered to actively conduct a trade or business of the partnership if the partner meaningfully participates in the management or operations of the trade or business. A mere passive investor in a trade or business does not actively conduct the trade or business.

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This regulation suggests that a QSBS Issuer's active participation in the management of a Partnership might be considered a important consideration if the Tax Court looked at the issue in the QSBS context.

The tax authorities discussed above provide significant support for the position that where a corporation has a "meaningful" or "significant" interest in a Partnership and some meaningful level of management participation, there should be a look-through for purposes of imputing active conduct. Given Section 1202's requirement that the look-through applies to majority-owned corporate subsidiaries, a prudent approach if a QSBS Issuer intends to assert that the "active conduct" requirement is satisfied through ownership of one or more Partnership interests would be to hold a majority interest in the equity of the Partnership by vote and/or value (ideally both), coupled with "active and substantial" participation in management functions. See *Exploring the Role of Partnerships in Qualified Small Business Stock (QSBS) Planning*.

Engaging in active software development and licensing business activities

Section 1202(e)(8) provides that for purposes of the active business requirement, "*rights to computer software which produce active business computer software royalties (within the meaning of section 543(d)(1)) shall be treated as an asset used in the active conduct of a trade or business*." The 80% Test would be satisfied where at least 80% of the QSBS Issuer's assets consist of active computer software and associated assets used in the production of "active business computer software royalties." Several requirements must be satisfied under Section 543(d) for software royalties to qualify as "active business computer software royalties." The bottom line is that the activities of very few corporations are likely to fit comfortably within the requirements of Section 543(d)(1), and if those activities did fit within the statute, there would be significant concern that the corporation would be treated as a personal holding company.

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A. The royalties must be received by a corporation actively engaged in a computer software business. This requirement has two parts:

- first, the corporation receiving the royalties must be engaged in the active conduct of a trade or business of developing, manufacturing, or producing computer software.
- second, the computer software producing the royalties must either have been developed, manufactured, or produced by the corporation (or a predecessor) as part of the active conduct of its business activities described in (i) above, or the computer software must be directly related to the trade or business activity being conducted by the corporation.

This requirement appears to be satisfied only if a corporation is engaged in activities that extend beyond merely licensing computer software. A corporation that merely licenses software and receives royalties won't satisfy either this Section A or Section C below which requires that there be significant ordinary and necessary business expenses arising out of the corporation's operations.

B. The computer software royalties must constitute at least 50% of the corporation's income. This requirement must be satisfied each taxable year and is satisfied if the royalties constitute at least 50% of the ordinary gross income of the corporation.

C. Allowable deductible expenses must be at least 25% of ordinary gross income. For each taxable year, the corporation's deductible expenses under Sections 162, 174 and 195 must aggregate at least 25% of the corporation's ordinary gross income. Alternatively, the corporation's average annual deductible expenses (either for the preceding five years or if less, for the period of existence) must meet the 25% test. Compensation for personal services rendered by the corporation's five largest stockholders is excluded; provided, however, compensation paid to a less than 5% stockholder is allowable. Deductions under Section 162 are excluded if they are specifically allowable under another Internal Revenue Code section.

Compensation, start-up, research and development expenses and miscellaneous operating expenses would need to be incurred in the

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operation of the active business activities. This provision is consistent with Section A in that it appears to be focused on limiting the active computer software except to companies that are engaged in an active business rather than passively generated software royalties.

D. For each taxable year, the corporation's dividends must equal or exceed an amount equal to (A) the excess of the corporation's personal holding company income, over (B) 10% of the corporation's ordinary gross income. This requirement is satisfied for a taxable year if the corporation's aggregate dividends are at least the amount, if any, by which the personal holding company income for the taxable year exceeds 10% of the ordinary gross income of the corporation for that taxable year. During the start-up period, interest income is generally excluded, but rents, dividends, mineral and oil and gas royalties are included. If a corporation's royalties fit within this active software activities exception and there is no other personal holding company income, then this Section D would appear to be satisfied.

Unfortunately, a negative but reasonable inference that can be drawn from Section 1202(e)(8) is that assets attributable to software licensing activities would not count positively towards satisfying the active conduct requirement unless each of Section 1202(e)(8)'s requirements are met. It might be possible to satisfy the active conduct requirement where the principal revenue producer was software royalties, if the taxpayer could substantiate that at least 80% of the corporation's assets were used for activities outside of the licensing function (e.g., research and development activities, other activities associated with a software development business). To make that argument, a taxpayer would need to convince the court that the corporation was engaged in the active conduct of a software development business. Because royalty income is passive, any corporation falling into this category of activities would be potentially exposed to the personal holding company surtax.

Waiver of the active business requirement for "specialized small business investment

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companies"

Section 1202(c)(2)(B) provides that that the active business requirement is waived if the QSBS Issuer is a "specialized small business investment company" (SSBIC) which is defined as "*any eligible corporation (as defined in subsection (e)(4)) which is licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).*" In order to fall within the scope of this provision, a corporation must have been issued its SSBIC license by the Small Business Administration before September 30, 1996. As of 2014, there were only 10 SSBICs that were still licensed and our understanding is that few, if any, exist today. SSBICs are no longer included in the Small Business Administration's Annual Performance Report.

When is the IRS likely to focus on the "active conduct" requirement?

The question of whether a corporation has engaged in the "active conduct" of its business activities is likely to be less of a concern if the corporation's QSBS is sold for a substantial profit. The IRS might explore the "active conduct" issue even under those circumstances if the QSBS Issuer engaged in its business activities through lower-tier Partnerships, or engaged in activities through independent contractors. Both of the issues are discussed above. Whether a corporation "actively conducted" its business activities seems more likely to be a focus of attention if a taxpayer claims Section 1202's gain exclusion in connection with the complete liquidation of an issuer of replacement QSBS under Section 1045.[30] Taxpayers will have the burden of proof to substantiate satisfaction of the active conduct requirement.[31]

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 exclusion to Section 1045 rollover transactions.

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More QSBS Resources

- Substantiating the Right to Claim QSBS Tax Benefits | Part 1
- Substantiating the Right to Claim QSBS Tax Benefits | Part 2
- One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors
- To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)
- 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 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

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- 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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[1] There are a number of articles on the Frost Brown Todd website addressing the benefits of Section 1202's gain exclusion and the various eligibility requirements and planning issues associated with seeking and obtaining Section 1202's benefits. The website also includes several articles focused on Section 1045's tax-free rollover or original QSBS sales proceeds into replacement QSBS. See *Frost Brown Todd's QSBS library*. This Article has been updated to reflect changes to Section 1202 made by the One Big Beautiful Bill Act (OBBBA). For additional discussion of OBBBA, see the *One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors*.

Section 1202 has gain exclusion caps that generally functions to limit a stockholder gain exclusion from a single issuer of QSBS to the greater of $10 million or 10 times the stockholder's aggregate basis in QSBS sold during the taxable year for stock issued prior to July 5, 2025, and $15 million or 10 times the stockholder's aggregate basis in QSBS sold during the taxable year for stock issued after July 4, 2025.

This Article focuses on federal income taxes. Many, but not all, states follow the federal treatment of QSBS. Notably, California and New Jersey (until 2026) do not have a corresponding gain exclusion.

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[2] Section 1202's legislative history states that it was designed to provide "*targeted relief for investors who risk their funds in new ventures [and] small businesses*." The potential for a substantial gain exclusion was intended to "*encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing*." References to "Section" are to sections of the Internal Revenue Code of 1986, as amended.

[3] Section 1202(e)(3) provides that the term "qualified trade or business" means any trade or business other than –

> (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,
>
> (B) any banking, insurance, financing, leasing, investing, or similar business,
>
> (C) any farming business (including the business of raising or harvesting trees),
>
> (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and
>
> (E) any business of operating a hotel, motel, restaurant, or similar business.

Also, Section 1202(e)(7) provides that the "ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business."

[4] See Section 1202(e)(5).

[5] See Section 1202(e)(7).

[6] *John P. Owen v. Commissioner*, T.C. Memo 2012-21 (2012).

[7] The Tax Court noted that:

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At trial Mr. Owen attempted to justify his lack of inventory by explaining that he did not believe it was prudent to purchase more inventory without first learning the business. However, it is clear from the record that Mr. Owen simply did not follow the advice of his accountant and appears to have been unaware of or misunderstood the 80 percent active business requirement.

My view of active business is just that. I went out and I purchased. I took the stock of this company and put it into the stock of this other company. I put the money from the sale of the company within the 60-day period he told me to put it in, and I started buying up gems. So in my opinion, I thought I was doing everything correctly.

It is apparent that J&L Gems was never an active business within the meaning of section 1202(e). We note that as of August 1, 2004 (about 2 years after the initial deposit), J&L Gems had 16 pieces of jewelry. Although Mr. Owen explained at trial that his goal was to develop the business and indicated that it took time for a jewelry business to become established, 2 years after the money was injected, J&L Gems was still not using it.

[8] 116 T.C. 308 (2001), *affd.* 295 F3d 118 (1st Cir. 2002).

[9] *Medchem Inc. v. Commissioner*, 295, F3d 118 (1st Cir. 2002).

[10] 480 U.S. 23 (1987).

[11] See also, *Higgins v. Commissioner*, 312 U.S. 212 (1941).

[12] Treasury Regulation Section 355-3(b)(2)(iii) addresses "active conduct" as follows:

[T]he determination whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A

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corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others.

[13] 452 F.2d 767 (1st Cir. 1971).

[14] In PLR 202114002, the IRS noted that "*words in a statute generally are presumed to bear their ordinary, contemporary, common meaning. Walters v. Metro. Educ. Enters., Inc., 519 U.S. 202, 207 (1997). To ascertain the plain meaning of terms, courts have consulted the definitions of those terms in popular dictionaries. Metro One Telecommunications, Inc. v. Commissioner, 704 F.3d 1057, 1061 [110 AFTR 2d 2012-7087] (9th Cir. 2012).*"

[15] In *Medchem Inc. v. Commissioner*, 295 F3d 118 (1st Cir. 2002), the First Circuit Court of Appeals had the following to say with respect to "active conduct":

The Oxford English Dictionary's first definition of the noun 'conduct' is '[t]he action of conducting or leading,' and, as the term relates to a business, it is defined as '[t]he action or manner of conducting, directing, managing, or carrying on (any business … etc.).' Oxford English Dictionary (2d ed. 1989), http://dictionary.oed.com. Similarly, Webster's defines the noun "conduct" as 'the act, manner, or process of carrying out … or carrying forward (as a business, government, or war).' Webster's Third New International Dictionary of the English Language Unabridged 473 (P.B. Gove et al. eds. 1993). 'Active,' in turn, is generally defined as '[c]haracterized by action' and is defined in terms such as '[o]riginating or communicating action,' 'practical,' 'working, effective, having practical operation or results.' Oxford English Dictionary, supra; see also Webster's Third New International Dictionary of the English Language Unabridged, supra, at 22 (defining 'active' as 'characterized by action rather than by contemplation or speculation').

[16] *Medchem Inc. v. Commissioner*, 116 T,C, 308, *affd*. 295 F3d 118 (1st Cir. 2002).

[17] The WG&L Tax Dictionary defines "qualified research" as follows:

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a research and experiment activity, as defined in § 174, that is conducted within the United States, fundamentally of a technological nature, and intended to be useful in the development of a new or improved trade or business already being carried on by the taxpayer. § 41(d)(1). The trade or business requirement can also be met if in-house research expenses, when incurred, have the principal purpose of making use of the research in the active conduct of a future business of the taxpayer or certain related taxpayers. § 41(b)(4). Research activities must also constitute elements of a process of experimentation for a fundamental purpose, which requires more than one alternative designed to achieve an unproven result. Only research involving a new or improved function, performance, reliability, or quality is considered to have fulfilled a functional purpose, whereas research relating to style, taste, cosmetic, or seasonal design factors is not. § 41(d)(3). Each business component must satisfy these requirements independently. § 41(d)(2). In cases of entire marketable products, the requirements apply to the most significant subset of elements, until they have been met, or the most basic components have been reached. A plant process, machinery, or a technique for commercial production of a business component is considered a separate component that will not be available for the credit unless the definition of qualified research is met separately, without taking into account research relating to development of the product. See HR Conf. Rep. No. 841, 99th Cong., 2d Sess. II-73 (1986). Computer software developed primarily for internal use qualifies if it is used in qualified research undertaken by the taxpayer or in a production process. § 41(d)(4)(E). Regulations may also require all software to be innovative, to involve significant economic risk, and not to be commercially available for use by the taxpayer. No credit is allowed to the taxpayer when research is funded by another entity, including the government. § 41(d)(4)(H). See § 41(a)(1)(A).

[18] H.R. Rep. No. 1278 Cong., 2d Sess. 10-11 (1980); S. Rep. No. 1036, 96th Cong., 2d Sess. 11-12 (1980).

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[19] See also *Kellett v. Commissioner*, T.C. Memo 2022-62 (2015).

[20] Treasury Regulation Section 1.537-2(b) provides that the accumulation of earnings and profits is reasonable if it is to provide for (1) a bona fide expansion of business or replacement of plant, or (2) to acquire a business enterprise through purchasing stock or assets.

[21] Various private letter rulings addressing the issue of whether a particular corporation is engaged in qualified or excluded activities generally refer to the activities of the corporation's employees. See, for example, PLRs 20248001, 20352009 and 202242014.

[22] See Proposed Regulation Section 1.355-3(b)(2)(iii).

[23] The IRS concluded in Revenue Ruling 86-125, 1986-2 C.B. 57, that a corporation was not considered to be engaging in the active conduct of a trade or business within the meaning of Section 355(b) and Treasury Regulation Section 1.355-1(c) where an unrelated real estate management company acting as an independent contractor managed the applicable property. The IRS cited Revenue Ruling 73-237, 1973-1 C.B. 184, where the activities of a corporation, carried on through its own employees, constituted active and substantial managerial and operations activity a general contracting business. The IRS concluded that active conduct could not be imputed where substantial operational and managerial activities were outsourced. This result contrasts with the result in Revenue Ruling 79-394, 1979-2 C.B. 141, where the IRS concluded that a corporation's active conduct could be imputed from activities undertaken by employees of affiliated corporations.

[24] Treasury Regulation Section 1.355-3.

[25] Treasury Regulation Section 1.355-3(b)(2)(iii) provides the following:

For purposes of section 355(b), the determination whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by

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persons outside the corporation, including independent contractors. A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others.

[26] In particular where a corporation is engaged in a search activity primarily through third-party independent contractors such as accountants, attorneys, broker and other commercial search services, the goal of Congress when it referenced start-up activities falling within the scope of Section 195 would be further through the successful completion of the search activity culminating in the acquisition of a qualified business. Further, reliance for "operations" during the search period of the corporation's existence would likely be coupled with active participation by the corporation's management and owners in direction and decision-making which would more closely align the corporation's activities with the requirements for actively conducting business activities for purposes of Section 355 (i.e., as outlined in the series of Revenue Ruling discussed in the body of this article).

[27] 93 Journal of Taxation 254.

[28] The Preamble to the Proposed Regulations (5/8/2007), Federal Register, Volume 72, No. 88, p. 26012, included the following background and explanation of the proposed regulation addressing the JV/LLC look-through:

Activities Conducted by a Partnership

Revenue Ruling 92-17 (1992-1 CB 142) and Rev. Rul. 2002-49 (2002-2 CB 288) address in a number of fact situations whether a corporation that is a partner in a partnership can satisfy the active trade or business requirement by reason of its ownership of the partnership interest where the partnership conducts a trade or business. Those rulings illustrate that a corporation owning a 20-percent interest in a state law partnership or limited liability company (LLC) that is classified as a partnership for Federal income tax purposes can be treated as engaged in the active conduct of the trade

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or business of the partnership if the corporation performs active and substantial management functions for the partnership's business. In addition, Rev. Rul. 2002-49 concludes that such a corporation can be treated as engaged in the active conduct of a partnership's trade or business, even if another partner also performs active and substantial management functions for the partnership's trade or business.

Consistent with the principles set forth in Rev. Rul. 92-17 and Rev. Rul. 2002-49 regarding satisfying the active trade or business requirement through an interest in a partnership, these proposed regulations provide that for purposes of section 355(b) a partner will be attributed the trade or business assets and activities of a partnership if the partner (1) Performs active and substantial management functions for the partnership with respect to the trade or business assets or activities (for example, makes decisions regarding significant business issues of the partnership and regularly participates in the overall supervision, direction, and control of the employees performing the operational functions for the partnership), and (2) owns a meaningful interest in the partnership. Further, because a partnership might only conduct a portion of a trade or business, the IRS and Treasury Department believe that a partner that satisfies these requirements can be attributed the portions of a trade or business (or assets and activities) that are conducted by a partnership. Under these circumstances the IRS and Treasury Department believe that it is appropriate to aggregate the partnership's trade or business assets and activities with those of the partner for purposes of determining whether the partner satisfies the active trade or business requirement. However, the stock of a corporation held by the partnership is not attributed to a partner.

The IRS and Treasury Department understand that the facts presented in Rev. Rul. 92-17 and Rev. Rul. 2002-49 do not necessarily reflect the exclusive methods by which corporations engage in a trade or business through a

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partnership. In particular, the IRS and Treasury Department understand that both the management and operational activities of an LLC are often conducted by the LLC itself, rather than by its members, to protect its members from liability for the LLC's activities. In these cases, Rev. Rul. 92-17 and Rev. Rul. 2002-49 do not explicitly support the conclusion that a corporation may rely on the trade or business assets and activities of an LLC to satisfy the active trade or business requirement, since no activities are performed by the corporate partner.

The IRS and Treasury Department believe that, in certain cases, a partner that owns a significant interest in an entity that is treated as a partnership for Federal income tax purposes should be attributed the trade or business assets and activities of a partnership, even if the partner does not directly conduct any activities relating to the business of the partnership. By comparison, the IRS and Treasury Department have promulgated regulations regarding the treatment of acquired assets held by a partnership for purposes of satisfying the continuity of business enterprise requirement applicable to reorganizations. Those regulations provide that a partner will be treated as owning the acquired target business assets used in the business of a partnership in satisfaction of the continuity of business enterprise requirement if the members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business. See §1.368-1(d)(4)(iii)(B)(1). Those regulations include an example concluding that the continuity of business enterprise requirement is satisfied where a partner owns a one-third interest in a partnership that continues the business of the target corporation, even though the partner performs no management or operational functions for that business. See §1.368-1(d)(5) Example 9.

These proposed regulations yield results similar to the continuity of business enterprise rule in determining whether the active trade or business requirement is satisfied when a

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corporation conducts a trade or business or portions of a trade or business through a partnership but does not participate in the partnership's activities. Specifically, these proposed regulations provide that for purposes of section 355(b) a partner will be attributed the trade or business assets and activities of a partnership provided the partner owns a significant interest in the partnership. The IRS and Treasury Department intend that the term "significant interest" requires an ownership interest that is greater than that suggested by the term "meaningful interest," which is the level of ownership required for a partner to be attributed the trade or business assets and activities of a partnership in cases where the partner performs active and substantial management functions for the partnership.

However, a partner will be attributed the trade or business assets and activities of a partnership only during the period it owns a significant interest or alternatively owns a meaningful interest and performs active and substantial management functions.

[29] *Tate & Lyle, Inc. v. Commissioner*, 103 T.C. 656 (1994).

[30] Section 1202 permits a taxpayer whose combined holding period for original QSBS and replacement QSBS exceeds five years to claim Section 1202's gain exclusion not only in connection with a taxable sale but also in connection with a taxable exchange (which includes a complete liquidation).

[31] The IRS agent might also focus attention on the possible application of the bona-fide business purpose and economic substance doctrines that are discussed in *Substantiating the Right to Claim QSBS Tax Benefits (Part 2)*.

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