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Old Dogs and New Tricks: §1202, New Tax Rules, and Entity Choice

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INTRODUCTION

Section 1202[1] was enacted in 1993 and generally provides non-corporate taxpayers with an exemption from federal income tax for eligible gains from the sale of qualified small business stock in subchapter C corporations held for more than five years.[2] As described in more detail below:

- The 1202 exemption generally is limited to the greater of $10 million per taxpayer or 10 times the taxpayer's original adjusted tax basis in the 1202 stock.
- Each partner in a partnership that sells shares of 1202 stock generally is entitled to a separate $10 million/10 times basis exemption with respect to each separate corporation that has issued 1202 stock sold by the partnership.
- The 1202 exemption only applies with respect to originally issued stock of the corporation and stock purchased from a prior holder does not qualify for the exemption.
- The corporation must not have more than $50 million in aggregate gross assets before and immediately after the issuance of the 1202 stock, and subsequent increases in corporate assets do not disqualify previously issued stock.
- The corporation must be engaged in the active conduct of a qualified trade or business.
- Other applicable requirements must be satisfied to qualify for the 1202 exemption.

The 2017 tax act[3] reduced the maximum federal income tax rate applicable to C corporations to 21%, and made other changes to U.S. tax law that will have profound effects on the taxation of businesses and individuals. When considered together with the new corporate tax rate and other applicable tax rules, the 1202 exemption might be sufficient to cause some taxpayers to choose C corporations for the acquisition or commencement of a new business.

This article presents a general overview of §1202 with respect to newly organized corporations and other major factors that may be relevant to entity choice decisions, and does not present an exhaustive discussion of all legal, tax, business, and other issues that may arise. U.S. international tax issues, employee benefits issues, issues relating to tax-exempt organizations, and issues applicable to other specialized entities or situations generally are not addressed herein. Moreover, this article generally addresses federal tax issues only, and tax rules under applicable state tax laws may differ. Taxpayers should consult with their personal tax advisers prior to making any decisions based upon statements made herein.

THE 1202 EXEMPTION

Scope of the 1202 Exemption, Partnerships, Carried Interests

Section 1202(a) provides that in the case of a taxpayer other than a corporation, taxable gross income

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[1] All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

[2] This exemption is referred to herein as the ''1202 exemption,'' and stock qualifying for the exemption is referred to as ''1202 stock.''

[3] Pub. L. No. 115-97.

shall not include any gain from the sale or exchange of qualified small business stock held for more than five years.[4] This exclusion from taxable income is subject to the dollar limits and other requirements described below, and results from application of a 100% exclusion percentage under the statute. The 100% exclusion percentage applies only with respect to stock of a qualifying U.S. corporation that was acquired after September 27, 2010.[5] Gains from the sale of qualified small business stock in excess of the dollar limitations described below are treated as long-term capital gains subject to federal income tax at a maximum rate of 20%.[6] The amount of the gain excluded pursuant to §1202 is not subject to the 3.8% Medicare tax,[7] and for 1202 stock acquired after September 27, 2010, is not subject to the alternative minimum tax.[8]

Qualifying gains earned by a pass-thru entity[9] such as a partnership (including a private equity fund classified as a partnership for tax purposes) generally are passed through to the partners.[10] To be eligible for the exclusion, a partner must have been a partner in the partnership on the date on which the partnership acquired the qualified small business stock and at all times thereafter before the disposition of the stock by the partnership.[11] The amount of gain that the partner can exclude from taxable income cannot exceed the amount of the gain exclusion determined by reference to the interest held by the partner in the partnership on the date the qualified small business stock was acquired.[12] This rule would prevent a partner from increasing his or her share of the 1202 exemption by acquiring additional interests in a partnership after the issuance of the 1202 stock in question.

It is not clear how the 1202 exemption would be applied to gains allocable to a profits interest or carried interest[13] in a partnership or private equity fund. The statutory text might be interpreted to allow application of the 1202 exemption to the extent that the gain is attributable to a profits interest or carried interest that was issued and outstanding as of the issuance date of the 1202 stock,[14] but it also could be interpreted differently. For example, regulations issued pursuant to §1045[15] provide that in the case of 1202 stock rollovers, the amount of gain that can be deferred by a partner is limited by reference to the partner's lowest percentage of capital in the partnership at the time of issuance of the 1202 stock.[16] When these regulations were promulgated, the Treasury indicated that it was following the limits of §1202.[17] If the approach taken in the §1045 regulations were applied to gains from sale of 1202 stock allocated to a profits interest or carried interest, then the 1202 exemption

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[4] §1202(a)(1), §1202(a)(4).

[5] For stock acquired on or prior to this date, the percentage of the covered gain that was excludable generally varied between 50% and 75%, depending on the acquisition date of the stock, and subject to other applicable conditions.

[6] The statutory language that provides for the 20% rate seems overly complicated, and requires navigation through (in suggested order) §1202(b), §1202(a), §1(h)(7), §1(h)(4), §1222(3), §1222(11), and §1(h)(3), and then through the six layers of computations in §1(h)(1)(A) through §1(h)(1)(F), most notably §1(h)(1)(D) and §1(h)(1)(F). When the §1202(a) exclusion percentage is 100%, the ''section 1202 gain'' defined in §1(h)(7), which is ultimately taxed at a 28% rate under §1(h)(1)(F), is zero. In cases where the §1202(a) exclusion percentage is less than 100%, the section 1202 gain under §1(h)(7) will essentially equal the product of (i) the applicable dollar limitation under §1202(b), multiplied by (ii) 100% minus the applicable exclusion percentage under §1202(a). Gains in excess of the dollar limitation of §1202(b) are subject to tax at a 20% rate under §1(h). This result is consistent with an example that appears in footnote 75 on page 49 of the Joint Committee on Taxation's General Explanation of Tax Legislation Enacted in 1997, dated December 17, 1997. The concept of section 1202 gain was inserted in §1(h) in 1997. The structure of §1(h) and the definition of section 1202 gain therein was subsequently changed in conforming amendments made pursuant to the Community Renewal Tax Relief Act of 2000 (Pub. L. No. 106-554) (which introduced a 60% exclusion percentage for certain empowerment zone businesses). The different versions of the statutory text have yielded the same result, with the regular long-term capital gain rate applying to gains on 1202 stock in excess of the §1202(b) limitation amount.

[7] Section 1411(c)(1)(A)(iii) only applies to net gain that is taken into account in computing taxable income. Reg. §1.1411-4(d)(3) *Ex.* 3, presents an analogous situation and supports this conclusion by stating that gain exempt under another Code provision (§121) is not subject to the Medicare tax.

[8] §1202(a)(4)(C).

[9] Section 1202(g) uses the term ''pass-thru entity'' when referring to S corporations and partnerships. This term is also used in this article in reference to disregarded entities.

[10] §1202(g)(1)(B).

[11] §1202(g)(2)(B).

[12] §1202(g)(3).

[13] A profits interest generally is an interest in a partnership that does not have a liquidation value upon issuance and otherwise complies with Rev. Proc. 93-27 and Rev. Proc. 2001-43. A profits interest only participates in profits and gains that arise after the date on which it is issued. Carried interests issued in the fund context are generally structured to comply with the aforementioned rules.

[14] Section 1202(g)(3) defines the relevant limitation as follows: ''Paragraph (1) shall not apply to any amount to the extent such amount exceeds the amount to which paragraph (1) would have applied if such amount were determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired.''

[15] Reg. §1.1045-1. This regulation provides rules relating to the application of gain deferral under §1045 in cases where a partnership disposes of 1202 stock and reinvests the proceeds in other 1202 stock. Section 1045 provides for deferral of gain from the sale of 1202 stock held for more than 60 days if the sale proceeds are reinvested in other 1202 stock and other conditions are met. *See below*.

[16] Reg. §1.1045-1(d).

[17] T.D. 9353, 72 Fed. Reg. 45,346 (Aug. 14, 2007).

ISSN 0148-8295

would not be available with respect to the gains if the interest did not have any capital value at the time the 1202 stock was issued.[18]

$10 million or 10 × Basis Limit

The maximum amount that a taxpayer may exclude from taxable income with respect to 1202 stock is the greater of the following two amounts:

- $10 million per issuing corporation, reduced by the aggregate amount of eligible gain taken into account by the taxpayer for prior years attributable to dispositions of stock issued by such corporation (in the case of a married taxpayer filing separately, this limit is $5 million);[19] or
- 10 times the taxpayer's aggregate adjusted bases of qualified small business stock issued by the corporation and disposed of by the taxpayer during the taxable year.[20] For purposes of this 10 times limit, the adjusted basis of any stock is determined without regard to any addition to basis after the date on which such stock was originally issued.

If capital contributions are to be made to an eligible corporation after the date of the original stock issuance, the contributing shareholder should consider making the subsequent contributions in exchange for additional shares of 1202 stock of the corporation, because additions to the basis of the original stock are not counted for purposes of applying the 10 times limit described above. If separate shares of 1202 stock are issued in connection with a subsequent contribution, the basis of the additional shares sold in the year of sale presumably should be taken into account for purposes of determining the 10 times limit.[21]

The $10 million and 10 times basis limits apply separately to every corporation that has issued 1202 stock to a taxpayer. Hence, an individual taxpayer can apply the 1202 exemption to the extent of said limits with respect to each separate issuer of 1202 stock owned by the taxpayer.

For purposes of applying the 10 times limit to a partner in a partnership that disposes of 1202 stock, the partner is treated as having an adjusted basis in the 1202 stock equal to the partner's proportionate share of the partnership's adjusted basis in the 1202 stock,[22] and each eligible partner can separately apply the 1202 exemption up to the $10 million/10 times basis limit.

Original Issuance Requirement and Permitted Transferees

The 1202 exemption generally applies only with respect to stock that was acquired by the taxpayer at its original issue (directly or through an underwriter).[23] Stock that is purchased from a prior holder of the stock therefore is not eligible for the 1202 exemption in the hands of the buyer. The original issuance requirement does not prevent shares issued by the corporation after its first issuance of shares from qualifying. A corporation may issue 1202 stock on multiple occasions subsequent to the first issuance of stock by the corporation, so long as each subsequent issuance meets the applicable requirements at the time of issuance.

In certain limited circumstances, a transferee is allowed the benefits of the 1202 exemption if all applicable requirements are satisfied. Permitted transferees are persons who receive the 1202 stock pursuant to a transfer made as a result of a gift, the death of the transferor, or a distribution from a partnership.[24] Such transferees generally are entitled to count the holding period of the transferor for purposes of applying the five-year holding period requirement.[25] Although a partner may receive 1202 stock as a distribution from a partnership, the converse is not true and a contribution of stock to a partnership will disqualify the contributed stock from application of §1202.[26]

Issued for Money, Property or Services Requirement; Holding Period and Basis

To qualify as 1202 stock, the stock generally must be issued by the corporation in exchange for money, property (not including stock of another corporation),

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[18] A helpful discussion of this issue appears in David F. Levy and Nickolas P. Gianou, *2011: A Boom Year for the Qualified Small Business?* Corporate Business Taxation Monthly (CCH), Apr. 2011, 41, 43. *See also* Janet Andolina & Kelsey Lemaster, *Candy Land or Sorry: Thoughts on Qualified Small Business Stock*, 158 Tax Notes (TA) 205, 221 (Jan. 8, 2018).

[19] §1202(b)(1)(A), §1202(b)(3)(A).

[20] §1202(b)(1)(B).

[21] The exclusion of subsequent basis additions to previously issued 1202 stock prevents (among other things) increases of the 10 times amount through capital contributions after the corporation has exceeded the $50 million asset limit and is no longer eligible to issue new 1202 stock. No authorities specifically address whether tax basis should be ignored if it is attributable to a subsequent stock issuance that is economically meaningless, but increasing the 10 times amount in these cases does not seem to contradict the apparent purpose of the anti-basis addition rule.

[22] §1202(g)(1)(B).

[23] §1202(c)(1)(B).

[24] §1202(h)(1), §1202(h)(2).

[25] §1202(h)(1)(B).

[26] H.R. Conf. Rep. No. 103-213, at 525 (1993).

ISSN 0148-8295

or as compensation for services provided to the corporation (other than services performed as an underwriter of such stock).[27]

If property (other than money or stock) is transferred to a corporation in exchange for its stock, for purposes of §1202, the stock received is treated as having been acquired by the taxpayer on the date of the exchange, and the basis of the stock received is treated as not less than the fair market value of the property exchanged.[28] These rules override tax rules that may otherwise provide for the tacking of holding periods[29] and carryover of tax basis.[30] Hence, for purposes of §1202, the five-year holding period begins on the exchange date, and the 1202 exemption can apply only to gains that accrue after the transfer.[31]

Stock and Debt Conversions; Exercise of Options and Warrants

If any stock in a corporation is acquired solely through the conversion of other stock in the same corporation that is 1202 stock, then the acquired stock is treated as 1202 stock with a holding period that includes the holding period of the original stock.[32]

The legislative history of §1202 indicates that stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue. The determination of whether the gross assets test is met (described below) is made at the time of exercise or conversion, and the holding period of such stock is treated as beginning at that time. Stock received in connection with the performance of services is treated as issued by the corporation and acquired by the taxpayer when included in the taxpayer's gross income in accordance with the rules of §83.[33]

$50 Million Limit on Corporate Assets

In order to qualify for the 1202 exemption, the corporation issuing the 1202 stock must be a qualified small business, which requires that at all times prior to issuance of the 1202 stock and immediately after such issuance, the aggregate gross assets of the corporation not exceed $50 million.[34] Because this requirement relates to gross assets, there is no reduction for liabilities of the corporation.

When determining if the $50 million limit is exceeded, the aggregate gross assets of the corporation generally means the amount of cash and the aggregate adjusted bases of other property held by the corporation, except that the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution.[35]

Aggregation rules apply, and all corporations that are members of the same parent-subsidiary controlled group shall be treated as a single corporation for purposes of applying the $50 million gross asset limit.[36] Subject to some detailed rules, a parent-subsidiary controlled group generally consists of one or more chains of corporations with a common parent corporation, where the corporations are connected to each other by stock ownership that exceeds 50% by vote or value.[37]

Active Business Requirement

In order to qualify for the 1202 exemption, during substantially all of the taxpayer's holding period for such stock, the issuing corporation generally must meet applicable active business requirements.[38] This requires that at least 80% of the corporation's assets (determined by value) are used in the active conduct of one or more qualified trades or businesses.[39] A qualified trade or business means any trade or business other than certain prohibited businesses described below.[40]

For purposes of applying the foregoing 80% active trade or business assets rule, stock and debt of a more-than-50% owned corporate subsidiary of the corporation are ignored and the parent corporation is deemed to own and conduct its ratable share of the subsidiary's assets and activities.[41] The Code does not address the issue of conducting a trade or business through a subsidiary entity that is classified as a partnership. Arguments can be made that investments in and activities conducted through partnerships by a corporation should also satisfy active trade or busi-

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[27] §1202(c).
[28] §1202(i).
[29] §1223.
[30] §358.
[31] H.R. Conf. Rep. No. 103-213, at 526 (1993).
[32] §1202(f).
[33] H.R. Conf. Rep. No. 103-213, at 526 (1993).
[34] §1202(d)(1).
[35] §1202(d)(2).
[36] §1202(d)(3)(A).
[37] §1202(d)(3)(B), §1563(a)(1).
[38] §1202(c)(2)(A).
[39] §1202(e)(1)(A).
[40] §1202(e)(3).
[41] §1202(e)(5)(A), §1202(e)(5)(C).

ISSN 0148-8295

ness requirements,[42] but this will remain an uncertain point until specific guidance on the topic is issued.

Special rules apply with respect to specialized small business investment companies, working capital, startup activities, and assets used or to be used in certain R&D activities.[43]

Prohibited Businesses and Limits on Securities and Real Estate

The following businesses are not qualified trades or businesses, and do not qualify for the 1202 exemption:

- 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 one or more of its employees;
- any banking, insurance, financing, leasing, investing, or similar business;
- any farming business (including the business of raising or harvesting trees);
- any business involving production or extraction activities that qualify for certain depletion deductions, such as mining and oil and gas activities; and
- any business of operating a hotel, motel, restaurant, or similar business.[44]

Authorities interpreting the scope of ineligible businesses are limited. The IRS has issued two PLRs relating to businesses operating in the healthcare industry and their eligibility for the 1202 exemption. In the first ruling, issued in 2014, the IRS stated that a business was not an ineligible healthcare business where it used its physical and intangible property to provide products and services to the pharmaceutical industry consisting of research, development, testing, manufacture, and commercialization of drugs.[45] In the second ruling, issued in 2017, the IRS stated that a business was not an ineligible healthcare business where its activity generally was limited to providing testing services and preparation of lab reports at the request of physicians.[46] The business was not otherwise involved in the diagnosis or treatment of patients and none of its revenue was earned in connection with patient medical care. The business generally would deal directly with patients only on billing issues, except for rare instances in which it would provide a copy of a report to a patient and refer the patient to the healthcare provider to answer any questions. With the exception of the lab director who acted in a quality control role, lab personnel were not subject to licensing requirements or classified as healthcare professionals by applicable governmental authorities. The 2014 and 2017 PLRs indicate that the IRS views prohibited healthcare services somewhat narrowly.

As mentioned above, §1202 provides that businesses where the principal asset is the reputation or skill of one or more employees do not qualify for the exemption.[47] In a 2012 memorandum decision, the Tax Court found that a corporation's principal asset was its training and organizational structure, and this was sufficient for it to conclude that the corporation's business activities satisfied the active business requirement, even though it stated that the success of the business was attributable to the individual shareholders.[48] In light of the statutory text and the available authorities, a business seeking to qualify for the 1202 exemption should be prepared to establish that it has significant tangible assets and/or intangible assets other than assets based on the reputation or skill of employees.

Section 1202 also provides special rules that can disqualify a business if it has excessive stock, securities, or real estate. The active conduct of a qualified trade or business requirement will not be satisfied if either one of the following conditions applies:

- more than 10% of the value of the corporation's assets (in excess of liabilities) consists of stock or securities in other corporations if the corporation does not own more than 50% of the stock of such other corporations, by vote or value (except that assets held for working capital purposes generally are not prohibited, subject to compliance with additional rules);[49] or

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[42] Arguments for satisfaction of the active business requirements through partnerships are set forth in Andolina & Lemaster, n.18, at 218–219, above.

[43] §1202(c)(2)(B), §1202(e)(2), §1202(e)(6).

[44] §1202(e)(3)(A)–§1202(e)(3)(E).

[45] PLR 201436001.

[46] PLR 201717010.

[47] §1202(e)(3)(A).

[48] *Owen v. Comissioner*, T.C. Memo 2012-21. In *Owen*, the corporation in question was engaged in the sale of prepaid legal services, life insurance products, and estate planning services, and had about 150 employees and 350 independent sales agents. The court considered §1202 active business requirements to determine if §1045 applied to a reinvestment of proceeds from sale of 1202 stock. The Tax Court decided in favor of the government on other grounds.

[49] §1202(e)(5)(B), §1202(e)(5)(C) and §1202(e)(6).

ISSN 0148-8295

- more than 10% of the value of the corporation's assets[50] consists of real property that is not used in the active conduct of a qualified trade or business (and dealing in or renting real property is not an active qualified trade or business for this purpose).[51]

Notwithstanding any of the foregoing, rights to computer software that produce certain active business computer software royalties are treated as assets used in the active conduct of a trade or business.[52]

Limits on Redemptions

Certain purchases by the corporation of its own stock can disqualify stock from the 1202 exemption. These rules are intended to prevent circumvention of the original issuance requirement described above.[53] In the following circumstances, the 1202 exemption becomes unavailable.

- Stock acquired by a taxpayer will not qualify as 1202 stock if the issuing corporation directly or indirectly purchased its own stock from the taxpayer or certain persons related to the taxpayer within two years before or two years after the issuance of the stock in question.
- Stock issued by a corporation will not qualify as 1202 stock if the issuing corporation purchased stock with an aggregate value exceeding 5% of the aggregate value of all of its stock within one year before or one year after the issuance of the stock in question. For this purpose, the value of the stock purchases is determined as of the time of the respective purchases, and the value of all of the corporation's stock is determined as of one year before the issuance of the stock in question.
- For purposes of the foregoing rules, acquisitions of the corporation's stock by certain other related corporations that are otherwise treated for tax purposes as redemptions are also treated as purchases by the issuing corporation of its own stock.[54]

Exchanges of 1202 Stock in Reorganizations, Certain §351 Transfers and §1045 Rollovers

In the case of a reorganization described in §368 or a qualifying §351 transfer, if 1202 stock is exchanged for stock of another corporation that would not otherwise qualify as 1202 stock, the stock of the other corporation received in the exchange is treated as 1202 stock acquired on the date on which the original 1202 stock was acquired.[55] In such case, subsequent gain from the sale of the newly received 1202 stock is subject to §1202 only to the extent of the gain which would have been recognized at the time of the reorganization or qualifying §351 transaction if said transaction had been a taxable transaction; however, this limitation on subsequent gains does not apply if the corporation issuing the newly received stock is a qualified small business that satisfies the requirements of §1202.[56] These rules generally can be reapplied to successive transfers, subject to special rules relating to the built-in gain on the 1202 stock at the time of the first exchange.[57]

As a result of the foregoing rules, a corporation issuing 1202 stock can be acquired by a publicly traded corporation in a tax-free reorganization transaction, and gains on the subsequent sale of the public corporation stock would be eligible for the 1202 exemption to the extent of the unrecognized built-in gain on the original 1202 stock at the time of the transaction, subject to the limits otherwise applicable under §1202.

Finally, §1045 generally allows for deferral of taxable gain from the sale of 1202 stock in cases where the 1202 stock has been held for more than six months, the proceeds are reinvested in new 1202 stock issued by another corporation within 60 days, and other applicable requirements are satisfied.

Excluded Corporations, Short Positions, Record-Keeping, and Anti-Abuse Rules

The following corporations are not eligible for the 1202 exemption: DISCs or former DISCs, corporations (including subsidiaries) that have a §936 election in effect (relating to tax credits for activities in Puerto Rico or other U.S. possessions), regulated investment companies, REITs, REMICs, cooperatives, S corporations, and foreign corporations.[58] Certain short positions can make the 1202 exemption unavailable unless applicable requirements are satisfied.[59] To be eligible for the 1202 exemption as a qualified small business, the corporation must also agree to submit

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[50] Unlike the stock or securities rule above, the reference in this real property rule to assets does not also refer to liabilities.

[51] §1202(e)(7).

[52] §1202(e)(8), §543(d)(1).

[53] H.R. Conf. Rep. No. 103-213, at 523 (1993).

[54] §1202(c)(3).

[55] §1202(h)(4)(A). For this purpose, §1202(h)(4)(D) provides that a §351 transfer will qualify only if the transferee corporation has control of the original qualified small business corporation within the meaning of §368(c) immediately after the transaction.

[56] §1202(h)(4)(B).

[57] §1202(h)(4)(C).

[58] §1202(e)(4), §1202(d)(1), §1361(a)(2), §7701(a)(4).

[59] §1202(j).

ISSN 0148-8295

such reports as may be required by the Treasury,[60] which has not yet imposed specific reporting requirements. The Treasury is also authorized to issue regulations to prevent avoidance of the purposes of §1202,[61] but no regulations have been issued.

Major Factors to Consider in Entity Choice Decisions

In addition to the 1202 exemption, there are many factors that should be considered for purposes of deciding whether to structure a new business entity as a C corporation or a pass-thru. For purposes of this discussion, it is assumed that the new business entity is owned by a U.S. private equity fund or other entity classified as a U.S. partnership for federal tax purposes. Accordingly, the only pass-thru entities considered herein are either disregarded entities or partnerships, and S corporations are not considered because they are not permitted to have partnership shareholders. Major factors are listed below, along with brief summaries. This list does not cover all differences and there may be additional factors that may be relevant in certain cases. Taxpayers should consult their tax advisers with respect to their particular situations.

Major Factors Favoring C Corporations

1202 Exemption. Sale of shares of a C corporation might qualify for the benefit of the 1202 exemption if applicable requirements are satisfied. This benefit generally does not apply with respect to the disposition of a pass-thru entity.

21% Federal Corporate Tax Rate. The federal corporate income tax rate was reduced to 21% by the 2017 tax act.[62] This tax rate is not subject to a sunset provision and is permanent.[63] This rate applies to undistributed income.[64] Additional tax may be incurred at the shareholder level upon distribution of the income. See below regarding the single level of tax applicable to pass-thru entities.

The 2017 tax act reduced the maximum federal income tax rate applicable to individuals to 37% with respect to income allocated to them by pass-thru entities.[65] This tax rate is subject to a sunset provision and reverts back to prior law in 2026.[66] In addition, an effective rate of as low as 29.6% may apply to individuals with respect to such income if the income qualifies for the new 20% deduction applicable to certain pass-thru income.[67] The 20% deduction is also scheduled to sunset and ceases to apply in 2026. Investors may also be subject to the 3.8% Medicare tax or the self-employment tax on their share of pass-thru income allocated to them.[68]

The lower corporate tax rate can result in better cash flow for the business to the extent that it is less than the amount of tax distributions that otherwise might be made to investors to cover their tax liabilities arising from income of a pass-thru that is allocated to them.

No AMT. The 2017 tax act repealed the alternative minimum tax (AMT) for corporations,[69] but not for individuals.[70] Some tax items allocated to individuals by a pass-thru entity could be subject to the alternative minimum tax. This would have the effect of increasing the effective rate of tax on income from pass-thru entities as compared to income earned in a corporation.

No Limit on State Tax Deductions. The 2017 tax act limited the ability of individuals to take deductions on their federal returns for state income taxes prior to 2026.[71] The deduction is limited to $10,000 for state and local income taxes and for property taxes not incurred in a trade or business.[72] State and local income taxes attributable to the share of income allocated to an individual by a pass-thru entity are subject to this limit. Corporate taxpayers are not subject to this deduction limitation, effectively lowering their effective tax rate in comparison to pass-thru entities.

Blocker for Federal and State Tax; No Phantom Income. The corporate format does not require the allocation of current income earned by the business to investors for federal or state tax purposes. This simplifies tax compliance for the business and the investors.

In contrast, income earned by a pass-thru entity is allocated to the equity owners, subjecting the equity owners to tax on the income, at the federal and (when applicable) state levels, even if no amounts are distributed to them, possibly exposing them to phantom

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[60] §1202(d)(1)(C).

[61] §1202(k).

[62] §11(b), as amended by the 2017 tax act, §13001(a).

[63] Modification of this tax rate would require new legislation.

[64] The accumulated earnings tax and personal holding company tax can also result in additional corporate taxes under certain circumstances. §531, §541.

[65] §1, as amended by the 2017 tax act, §11011(a).

[66] The maximum individual income tax rate is therefore scheduled to rise to 39.6% in 2026.

[67] §199A, as added by the 2017 tax act, §11011.

[68] §1401–§1403, §1411.

[69] §55(a).

[70] The 2017 tax act did increase the AMT exemption amount for individuals for years prior to 2026. §55(d)(4).

[71] §164(b)(6).

[72] §164(b)(6)(B).

ISSN 0148-8295

income[73] and to additional filing requirements in states to which they otherwise have no connection.

In the case of foreign and tax-exempt investors, the allocation of income to them by a pass-thru entity could expose them to U.S. tax in cases where they otherwise might not have any U.S. tax.[74] In the case of foreign investors in a partnership, the partnership must comply with withholding requirements that apply to U.S. effectively connected income allocated to the foreign investors.[75]

No U.S. Tax for Foreign and Tax-Exempt Investors on Most Stock Sales. This factor is closely related to the blocker effect described above. Foreign investors generally may be exempt from U.S. tax on sales of stock of U.S. corporations, so long as the stock is not classified as a U.S. real property interest[76] and the gain is not otherwise effectively connected with the conduct of a U.S. trade or business.[77] To the extent that the gain generates effectively connected taxable income allocable to a foreign investor, the selling fund or partnership may be required to withhold taxes and remit them to the IRS.[78] This withholding obligation would apply in cases where the stock is classified as a U.S. real property interest, but generally would not otherwise apply. If the entity is a pass-thru entity engaged in a U.S. trade or business, sale of the equity of the entity or of the underlying assets generally will result in U.S. taxation of the foreign investors and the triggering of withholding obligations.

Subject to certain exceptions, tax-exempt organizations generally are exempt from tax on capital gains income.[79] Exceptions include situations where the asset sold is subject to special rules relating to debt-financed property, or to the extent gains are otherwise classified as certain types of ordinary income.[80] Tax-exempt organizations therefore generally are not subject to tax on capital gains arising from the sale of corporate stock. Tax-exempt organizations also generally are exempt from tax on the sale of partnership interests, but special ''look-through'' rules applicable to partnerships can operate to create taxable income for a tax-exempt organization with respect to the sale of a partnership interest.[81]

No Ordinary Income on Corporate Stock Sales. Assuming that the stock of the corporation is a capital asset that has been held for more than one year, individual investors generally can report all of the gains on the sale of corporate stock as a long-term capital gain.[82] A sale of a disregarded entity or a partnership interest can generate ordinary income to the extent the gain is attributable to non-capital or ''hot'' assets.[83]

Reorganizations. Corporations generally can be parties to tax-free reorganizations,[84] and partnerships and disregarded entities generally cannot. Hence, the corporate form generally allows for a target entity to be acquired by a corporate acquirer in a tax-free reorganization, and the shareholders of the target can receive acquiring corporation stock on a tax-deferred basis.[85] Non-corporate entities might be able to convert into corporate form prior to a reorganization transaction, but this will require some advance planning and could be taxable under certain circumstances.[86] Non-corporate entities might be able to enter into other types of tax-deferred transactions with corporate buyers,[87] but such transactions may be incompatible with business, legal, and structural objectives.

Major Factors Favoring Pass-Thru Entities

Single Level of Tax. Income earned through a pass-thru entity generally is subject to a single level of taxation. Partners are subject to tax on the income even if it is not distributed. The maximum federal tax rates for individuals on ordinary pass-thru income range from 40.8%[88] to as low as 33.4%. If income is earned by a corporation and then distributed to individual U.S. shareholders, the income is first generally subject to a federal corporate tax of 21%, and then generally subject to an additional combined federal tax of 23.8% at the shareholder level. This results in a combined federal tax rate of about 39.8%,[89] which is higher than the 33.4% pass-thru rate if the 20%

[73] Phantom income includes, among all other types of income, a partner's share of income from discharge of indebtedness incurred by a partnership. The applicability of exclusions from discharge of indebtedness income generally is determined at the partner level and not at the level of the partnership. §108(e)(6). This can result in taxable income to the partners in cases where they do not qualify for the exclusions (which is often the case). In contrast, debt cancellation income incurred by a C corporation is not allocated to its shareholders.

[74] §871(b), §882, §875, §511–§514.

[75] §1446.

[76] §897.

[77] §871, §881, §882.

[78] §1446.

[79] §512(b)(5).

[80] *See, for example,* §514, §512(b)(5)(A), §512(b)(5)(B); Reg. §1.1245-6(b).

[81] *See* TAM 9651001.

[82] §1221, §1222.

[83] *See, for example,* §1221, §1245, §751.

[84] §368.

[85] §354, §356.

[86] *See, for example,* Rev. Rul. 70-140.

[87] *See* §351, §721.

[88] This percentage represents the sum of the 3.8% Medicare tax plus the maximum individual income tax rate of 37%.

[89] For example, assume a corporation earns $1 million, pays

ISSN 0148-8295

pass-thru deduction described in further detail below is fully applicable, but slightly lower than the combined federal rate of 40.8% on pass-thru income if the 20% pass-deduction is not available. This does not include the effects of state taxes, which vary by state.

Whether the single level of tax applicable to pass-thru entities provides a net benefit when compared to the double-tax regime applicable to corporations will depend on the extent to which the 20% pass-thru deduction is available (discussed in further detail below), and upon the applicability and extent of state-level income taxes.

20% Deduction for Qualifying Businesses. The 2017 tax act introduced §199A, which generally provides that non-corporate taxpayers may claim a tax deduction of up to 20% of the qualified business income allocated to them with respect to a qualified trade or business, subject to satisfaction of applicable requirements. Qualified business income eligible for the deduction generally consists of ordinary income and does not include capital gains, dividends, and interest.[90] This deduction is not available for corporate taxpayers. The 20% deduction only applies for years beginning prior to 2026. For the 20% deduction to apply with respect to a business operated by a pass-thru entity, the business generally must be a qualified trade or business. A qualified trade or business generally does not include any of the following:

- any trade or business involving the performance of services in the fields of health, law, 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 one or more of its employees or owners;[91] or
- that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.[92]

The 20% deduction cannot exceed the greater of (i) 50% of the taxpayer's share of W-2 wages with respect to the qualified trade or business, or (ii) the sum of 25% of the taxpayer's share of W-2 wages with respect to the qualified trade or business, plus 2.5% of the taxpayer's share of the unadjusted basis immediately after acquisition of all qualified property of the business.[93] The 20% tax deduction does not apply with respect to income in the form of reasonable compensation or guaranteed payments for services received by the taxpayer.[94] Taxpayers with taxable incomes below certain thresholds are not subject to the W-2 and basis limits and prohibitions against the first group of service businesses described above.[95] Other limitations apply for purposes of computing the applicable deduction for all taxpayers.

If the full 20% deduction applies with respect to an investment in a pass-thru entity, the maximum individual federal income tax rate applicable to the activity is 29.6%.[96] When the Medicare tax rate is added, the maximum combined federal rate applicable to the qualifying pass-thru income is 33.4%.[97]

Tax-Free Distributions and Divisions. Corporations generally cannot distribute assets to their shareholders on a tax-free basis unless the distribution transactions can qualify under §355. This requires satisfaction of criteria that may be difficult or impossible to satisfy, depending on the circumstances. On the other hand, disregarded entities and partnerships generally can transfer assets to their equity owners without triggering tax on the distribution.[98] Consequently, pass-thru entities provide greater flexibility than corporations in cases where there is a need to distribute assets to the equity owners. One example would be where the entity must distribute some of its assets to its equity owners prior to a sale of the entity to a buyer that is not interested in purchasing the distributed assets. In the case of a pass-thru entity, the distribution of the unwanted assets generally can be accomplished without triggering tax on the distribution of said assets.

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corporate tax on the income and distributes the remainder to the shareholders. The corporate level tax at a 21% rate is $210,000, leaving $790,000 for distribution. This dividend distribution is then subject to shareholder level tax at a 23.8% rate, resulting in $188,020 in tax. The combined taxes are $398,020, or about 39.8% of the income earned by the corporation.

[90] §199A(c)(3)(B). Interest allocable to a trade or business, however, is eligible for the deduction, as well as ordinary income dividends paid by REITs. §199A(c)(3)(B)(iii), §199A(e)(3).

[91] §199A(d)(2)(A), §1202(e)(3)(A). This generally is the same as the first group of ineligible businesses for §1202 purposes, except that it does not include engineering or architecture businesses.

[92] §199A(d)(2)(B). Securities and commodities are defined in §475.

[93] §199A(b)(2)(B). For this purpose qualified property generally means depreciable tangible property until the depreciation period for the property ends or 10 years after the acquisition date, whichever is later. §199A(b)(6)(B).

[94] §199A(c)(4).

[95] §199A(b)(3), §199A(d)(3). Thresholds generally are $157,500, or $315,000 in the case of a joint return, adjusted for inflation, and the low-income exceptions are rapidly phased out and eliminated as income exceeds the applicable threshold.

[96] This is 37% minus the product of 37% multiplied by the 20% deduction percentage.

[97] The 20% deduction does not apply for purposes of calculating the 3.8% Medicare tax or the self-employment tax. §199A(f)(3).

[98] §731. Some exceptions apply, such as §731(a)(1), §737, and §704(c)(1)(B).

ISSN 0148-8295

Greater Flexibility for Issuance of Equity Interests. Appreciated assets generally can be transferred as capital contributions to a partnership in exchange for partnership interests without triggering taxable income to the transferor.[99] In addition, service providers generally can receive interests in partnerships in consideration of services rendered to the partnership without incurring tax upon receipt of the partnership interest if the partnership interests qualify as ''profits interests'' with no current liquidation value under IRS revenue procedures.[100] Requirements applicable to these types of transactions tend to be easier to comply with than corresponding corporate arrangements.

Appreciated assets generally can be transferred to a corporation in exchange for corporate stock without triggering taxable income to the transferor if the transaction qualifies as a §351 transaction or as a reorganization under §368. Although these provisions are commonly used to effect tax-free asset transfers, their application requires satisfaction of conditions that sometimes cannot be met. For example, a §351 transaction requires that the transferor be part of a controlling group of shareholders that is contributing money or property as part of the same contribution transaction,[101] and an acquisitive reorganization under §368 requires a corporate target and satisfaction of other applicable requirements.[102]

Service providers are subject to tax on the fair market value of corporate stock received as compensation for services pursuant to §83.[103] In some instances, a corporation may issue a separate class of stock to the service provider that is subordinate to other classes of stock issued by the corporation and that has no value if the corporation were to be liquidated immediately. The value of such stock must be determined for purposes of calculating the amount of taxable income incurred by the recipient, and even though the current liquidation value may be zero, the stock might still have a positive fair market value that will be taxed to the recipient. In contrast, a qualifying profits interest in a partnership with a current liquidation value of zero generally is automatically treated as having a zero value for purposes of determining taxable income of the recipient, if applicable conditions are satisfied.[104]

Although the partnership form generally is viewed as being more favorable with respect to the issuance of equity interests to service providers, it should be noted that the 2017 tax act added a new provision to the Code that imposes a three-year holding period requirement in order to obtain long-term capital gains treatment with respect to profits interests (carried interests) issued to providers of investment banking-type services.[105] This provision does not apply with respect to corporate stock issued to such service providers, which remains subject to §83 rules described above. In some cases the issuance of equity in a corporation as opposed to equity in a partnership might be preferable with respect to this issue.

Step-up in Asset Basis for Buyers. A buyer of equity of a disregarded entity or a partnership can obtain a step-up in tax basis in the underlying assets of the entity as part of the equity purchase. This step-up applies in cases where the entity is a disregarded entity after the transaction. The step-up also applies in cases where the entity is a partnership and remains a partnership after the transaction and a §754 election is made.[106] The step-up in basis can benefit the buyer after the transaction through increased amortization deductions and other offsets against taxable income.

In the case of a corporate entity that is owned by a fund or other partnership, a buyer of corporate stock generally cannot obtain a step-up in basis in the entity's underlying assets.[107] A step-up in asset basis can be achieved if the corporation were to sell its assets to the buyer, but this would trigger a corporate level tax in the target corporation, and then a second level of tax generally would be incurred by the shareholders of the corporation upon distribution of the net proceeds to them. Hence, an exit from an investment structured as a C corporation is usually structured as a stock sale with no basis step-up for the buyer.

The lack of a step-up may result in a lower purchase price in the transaction than what would otherwise have been paid if the target had been structured as a pass-thru. In theory, a step-up in basis should have a value equal to the projected amount of tax savings attributable to the increased amortization deductions and other income set-offs realized by the buyer over time, discounted to present value using an appropriate discount rate. The effects upon later disposition of a lower basis arising from increased deductions

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[99] §721. Some exceptions apply such as §721(b).

[100] *See* Rev. Proc. 93-27, Rev. Proc. 2001-43.

[101] §351(a).

[102] §368(a)(1)(A)–§368(a)(1)(D).

[103] Taxation generally arises when the stock becomes fully vested, and the taxable amount generally is determined at the time of vesting. If the service provider pays some amount for the stock, the amount so paid reduces the amount of taxable income incurred. §83(a). If an election is made under §83(b), the tax is imposed upon grant of the stock and the taxable amount is the value of the stock at the time of grant.

[104] Rev. Proc. 93-27, Rev. Proc. 2001-43.

[105] §1061.

[106] §743, §754.

[107] If available, an election under §338 can result in a corporate basis step-up, but such an election usually would trigger taxable income in the target corporation equal to the basis step-up.

ISSN 0148-8295

should also be factored into any such value. Recent reductions in tax rates will lower the value of basis step-ups because the tax savings from step-ups will be diminished.

Losses Allocated to Equity Owners; Ordinary Losses on Asset Sales. Losses incurred by a pass-thru entity are allocated to its equity owners, and may reduce their taxable income to the extent they can use losses under applicable rules. In the case of a disposition of the business by means of an entity-level asset sale, ordinary losses on sale retain their ordinary character when allocated to the investors.[108] Ordinary characterization on exit generally requires an entity-level asset disposition, because a loss on sale of a partnership interest is usually treated as a capital loss.[109]

Losses flowing through to partners are subject to various limitations, including basis limitations,[110] at-risk limitations,[111] passive loss limitations,[112] and the new limitations on excess business losses introduced by the 2017 tax act for years prior to 2026.[113] These limitations may reduce or eliminate the benefit of flow-through of losses. The tax benefits of losses of a partnership generally are recaptured in whole or in part upon sale of the investment as a result of reductions in the basis of the entity's assets and/or the outside basis of the partners in their partnership interests and application of ordinary income recapture rules.[114]

In contrast, losses incurred by a C corporation are not allocated to the owners of the entity. Accordingly losses from operations do not flow through to the shareholders, and, similarly, an ordinary loss incurred by a C corporation upon a disposition of its assets does not flow through to the shareholders. A loss incurred by the shareholders upon disposition of their shares generally is a capital loss.[115]

Basis Increases for Reinvested Pass-Thru Income. Taxable income earned and reinvested by a disregarded entity or a partnership in business assets has the effect of increasing the entity's basis in its assets and, in the case of a partnership, the basis of the partners in their partnership interests.[116] Hence, if a pass-thru entity has taxable income and pays out distributions to its owners in amounts sufficient to cover their tax liabilities, there is a net basis increase equal to the amount of the income minus the tax distribution. Upon a subsequent sale of the entity or its assets, the taxable gain on the sale of partnership interests or entity assets attributable to reinvested earnings is offset by the net basis increases from the reinvested earnings.[117]

In contrast, a C corporation that has taxable earnings, pays its taxes, and then reinvests the earnings in the assets of the business will experience an increase in the basis of its assets, but the shareholders do not adjust their bases in stock of the corporation for the reinvested earnings. Hence, when the shares are subsequently disposed of, there is no reduction in taxable gain attributable to the reinvested earnings.

The effects of basis adjustments for income tends to favor the use of pass-thru entities, and should be incorporated in models that may be used to compare projected cash flows arising from pass-thru and C corporation structures.

Greater Flexibility for Changing Tax Classification. Finally, if a pass-thru entity is used initially but a C corporation is subsequently determined to be preferable, transition of the pass-thru to a corporate structure generally can be achieved on a tax-free basis under §351,[118] either by means of an actual contribution of the entity's equity interests or its assets to a newly formed corporation, or by filing of a check-the-box election for the entity to classify it as a corporation for federal tax purposes.[119] Consequently, taxpayers may not be boxed in if they initially choose to use pass-thru entities. If a 1202 exemption might otherwise be available, however, a delay in converting to the corporate form could be costly in the sense that pre-conversion appreciation in the assets of the business would not be eligible for the 1202 exemption, and the required five-year holding period would not start until the conversion date. Pre-conversion asset appreciation would be treated as tax basis for purposes of §1202 and the 10 times basis limitation, but the appreciation

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[108] §702(b).

[109] §741. In narrow circumstances, an abandonment of a partnership interest may qualify for ordinary loss treatment. *See* Mckee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners*, ¶16.06.

[110] §704(d), as amended by the 2017 tax act, §13503(a).

[111] §465.

[112] §469.

[113] §461(l), as added by the 2017 tax act, §11012(a).

[114] §705(a)(2)(A), §1245, §751.

[115] Corporate stock generally is a capital asset under §1221. Individuals may claim ordinary treatment with respect to limited amounts of losses (up to $100,000 for a married couple filing a joint return) upon sale of C corporation stock to the extent the losses qualify under §1244. Qualification under §1244 requires that the corporation not have more than $1 million in equity at the time of the stock issuance and satisfaction of other conditions.

[116] §705(a)(1)(A).

[117] If net retained earnings are used to pay liabilities, the respective asset and partnership interest bases decline by the liability payment (*see* §752), but the amount realized on a subsequent disposition attributable to assumed debt is reduced by the reduction in debt, yielding an equivalent reduction in taxable gain upon sale.

[118] The incorporation is subject to tax if liabilities exceed tax basis pursuant to §357.

[119] Reg. §301.7701-3(c).

ISSN 0148-8295

could prevent the entity from qualifying under §1202 if it is enough to cause the assets of the entity to exceed $50 million.[120]

In contrast, the conversion of a C corporation owned by a partnership or other non-corporate taxpayer into a pass-thru entity generally results in a taxable gain at the corporate level equal to the excess of the fair market value of the assets of the corporation over their adjusted bases,[121] and an additional taxable gain at the shareholder level equal to the excess of the net fair market value of the equity in the entity over the adjusted basis of the shareholder in the corporate stock.[122] The corporate level gain would be subject to federal tax at a 21% rate and the domestic noncorporate investors generally would be subject to federal tax at a combined rate of 23.8% if the gain is a long-term capital gain,[123] or 40.8% if it is a short-term capital gain. State taxes would be additional.

[120] *See* above.

[121] §336.

[122] §331.

[123] If §1202 applies, which requires a holding period over five years, some or all of the gain may be tax exempt.

CONCLUSION

Prior to the 2017 tax act, many investments in portfolio companies by private equity funds already were structured as C corporations, primarily due to the blocker effect of using a C corporation, and despite the higher combined tax rates on distributed income and other factors. The availability of the 1202 exemption represented an added benefit in cases of qualifying investments.

The 2017 tax act reduced individual tax rates and added a new 20% tax deduction for noncorporate taxpayers with interests in qualifying pass-thru entities. This new 20% tax deduction favors investment through pass-thru entities in cases where it is available, but the 2017 tax act counterbalanced the entity choice decision by reducing the federal corporate income tax rate to 21%, repealing the corporate AMT, and preserving the state and local income tax deduction for corporate taxpayers. When the new aspects of the corporate tax law are considered in conjunction with the 1202 exemption, investors may find that the relevant factors favor the corporate form overall. Qualification for tax exemptions and deductions requires compliance with a multitude of conditions, and all aspects of an investment and its disposition should be considered when choosing the form of organization.

ISSN 0148-8295