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PROPOSED REVENUE PROCEDURE TO STANDARDIZE THE INFORMATION CORPORATIONS GIVE SHAREHOLDERS TO SHOW THAT STOCK IS QSBS

This proposal was prepared by Andrew Gradman.[1] The author thanks reviewers Matthew E. Rappaport and Christopher A. Karachale for their helpful comments.[2]

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[1] The comments contained in this paper are the individual views of Andrew L. Gradman, and do not represent the position of the California Lawyers Association, its Taxation Section, or of the paper's reviewers.
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EXECUTIVE SUMMARY

As a solo tax lawyer, I often represent shareholders who want help showing that their shares constitute Qualified Small Business Stock (QSBS) under IRC Section 1202. In these cases, I am struck by how unprepared both shareholders and the corporation are to answer this question. Even more striking, when it's unclear whether the shares qualify, the shareholder often claims these tax benefits, without really knowing whether entitled to them.

The source of the problem is misaligned incentives. For an investor to show that his stock is QSBS, he must rely on information provided by a corporation. But the corporation may not wish to spend resources answering the shareholder's questions, confess failure or ignorance, or make representations which will be relied upon by the IRS. Under IRC Section 1202(d)(1)(C), the Treasury Department has the power to address this imbalance by imposing reporting new requirements on the corporations, but to date it has not done so.

This paper proposes one example of a reporting requirement which Treasury or the IRS might adopt, in the form of a new revenue procedure. Compliance with this revenue procedure would be entirely optional for taxpayers. It would set forth a certificate, to be signed by a representative of the corporation, disclosing compliance with certain elements of the QSBS rules, which taxpayers claiming QSBS can attach to their returns.

The remaining details of this revenue procedure will depend on how the IRS chooses to answer the following three questions.

1. First, how detailed should these statements be?
2. Second, should concessions be extended to shareholders who obtain the certificate, and/or to corporations which supply it?
3. Third, should burdens be imposed on shareholders who obtain the certificate, and/or to corporations which supply it?

The main beneficiary of this proposal would be the IRS, in that widespread adoption of this certificate will incentivize corporations to maintain records on an ongoing basis and to respond candidly to shareholder inquiries. Conversely, if a corporation cannot submit a perfect certificate, this puts the shareholder on notice that he should not claim QSBS benefits. The IRS can then treat a shareholder's failure to attach a complete certificate as grounds for prioritizing an audit.

Part I of this paper summarizes the relevant law. In Part II, describes what I understand to be the "correct" way to advise a shareholder and a corporation, in light of these rules. Part III explains why shareholders, corporations, and their advisors rarely meet this standard in practice. Part IV describes an optional certificate which could improve these practices.

DISCUSSION

I. SUMMARY OF RELEVANT LAW

A. Definition of Qualified Small Business Stock

To be QSBS, stock must meet the following requirements:

1. Under IRC Section 1202(c)(1), it must be
    a. stock in a C corporation (today, and when issued);
    b. issued after August 10, 1993;
    c. issued to the taxpayer **<u>at original issue;</u>**
    d. issued for cash, services, or other property (**<u>but not for stock</u>**);
    e. issued while the corporation was a "**<u>Qualified Small Business</u>**."

2. Under IRC Section 1202(c)(2), during **<u>substantially all</u>** of the taxpayer's holding period, the corporation
    a. must have been a C corporation, and
    b. must have met the **<u>active business requirements</u>**.

3. Under IRC Section 1202(c)(3), the corporation
    a. must not have issued the stock within 2 years before or after buying its own stock from that taxpayer **<u>or a related party</u>**; and
    b. must not have issued the stock within 1 year before or after buying an amount of its own stock **<u>exceeding 5% of the value of all its stock</u>** in the year before issuance.

The seven **<u>bold-and-underline</u>** requirements are discussed in the seven sections that follow.

1. Section 1202(c)(1) – QSBS Must Be Original Issue

The "original issue" rule in IRC Section 1202(c)(1) has some exceptions.

First: For a distribution from a pass-through entity, a gift, or a testamentary transfer, treat the transferee as having acquired the stock in the same way as the transferor. IRC Section 1202(h)(1), (h)(2). If the pass-through entity sells the stock, the "original issue" rule is not applied to the partner/shareholder. IRC Section 1202(g). However, stock ceases to be QSBS if it is contributed to a partnership. Treas. Reg. §1.1045–1(f).

Second: If the taxpayer held original issue stock, and exchanged it for stock in an E or F reorganization, the new stock will be deemed held at original issue. IRC Section 1202(h)(3).

2. Section 1202(c)(1) – QSBS Cannot Be Acquired for Stock

The not-for-stock rule in IRC Section 1202(c)(1) also has some exceptions. These are for stock acquired by conversion of other stock that was QSBS, and for stock acquired by relinquishing QSBS in an exchange under IRC Section 351 (transfer to controlled corporation) or Section 368 (reorganization). IRC Section 1202(f), (h)(4).

After an IRC Section 351 exchange, the issuing corporation must control the corporation whose QSBS stock is contributed. If the stock in the issuing corporation is not QSBS after the IRC Section 351 or Section 368 exchange, the QSBS exclusion will only apply to the built-in gain in the contributed stock.

3. Section 1202(c)(1) – Issued while the Corporation was a Qualified Small Business

Stock was issued by a Qualified Small Business, as required in IRC Section 1202(c)(1), if it was issued by a domestic (U.S.) corporation whose "aggregate gross assets" did not exceed $50 million at any time

> (i) before the issuance of the stock, and
> (ii) immediately after the issuance, taking into account any assets contributed by the shareholder in exchange for the stock.
> IRC Section 1202(d)(1).

For this purpose, "aggregate gross assets" are valued as: cash plus adjusted basis of noncash property. IRC Section 1202(d)(2)(A). However, for property acquired by contribution, treat its basis immediately after contribution as equal to its fair market value at such time. IRC Section 1202(d)(2)(B). Also, for this purpose, treat as one corporation: all members of the same 50% parent-child controlled group. IRC Section 1202(d)(3).

Finally, to be a Qualified Small Business, the company must agree "to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section." IRC Section1202(d)(1)(C). Treasury has not yet articulated any such requirements. Nevertheless, even absent such requirements, this language requires that the company document its agreement to submit reports which Treasury "may" require in the future. Many companies do not have such a formal agreement in their books at the time they issue the stock. It is unclear whether the IRS would accept an agreement entered into around the time the stock was sold (the statute does not rule this out), or whether the IRS even seeks to enforce this provision.

4. Section 1202(c)(2) – Substantially All—Definition

"Substantially all" in IRC Section 1202(c)(2) is not defined. Many practitioners treat 4 out of 5 years as sufficient. See, e.g., Lee, Comeau, Kwon & Syida, Qualified Small Business Stock: Quest for Quantum Exclusions, 168 Tax Notes Fed 15 (July 6, 2020).

5. Section 1202(c)(2) – Active Business Requirements—Definition

To meet the “Active Business” requirement in IRC Section1202(c)(2), there are two requirements.

First, the corporation must be an “eligible corporation.” This means any domestic corporation that is not a Domestic International Sales Corporation (DISC) or former DISC, a Regulated Investment Company (RIC)/Real Estate Investment Trust (REIT)/Real Estate Mortgage Investment Conduit (REMIC), or a cooperative. IRC Section1202(e)(4). Also, neither it nor any subsidiary may have an IRC Section936 election in place.

Second, of its assets (measured by value; looking through subsidiaries owned greater than 50% by vote or value),

- It must use 80% or more in the active conduct of “qualified trades or businesses” (QTBs); *and*
- Not more than 10% can be real property used in the active conduct of QTBs; *and*
- Not more than 10% can be corporate stock or securities, other than subsidiaries owned greater than 50% by vote or value; this test is applied to assets net of liabilities.

IRC Section 1202(e)(1)(B), (5)(B), (7).

The Active Business requirement is also met by any Specialized Small Business Investment Company, but no new SSBICs have been licensed since 1996. See https://sgp.fas.org/crs/misc/R41456.pdf.

i Qualified Trade or Business

“Qualified Trade or Business” (QTB) means any trade or business, other than if:

- Its principal asset is the reputation or skill of employee(s);
- It involves services in health, law, accounting, actuarial services, engineering, architecture, consulting, finance/brokerage, sports, or performing arts;
- It is a banking, insurance selling, financing, leasing, investing, or similar business;
- It is a farming business;
- It produces or extracts oil, gas, or similar items in IRC Sections 613 or 613A;
- It operates a hotel, motel, restaurant, or similar business; or
- (for the 10% limit on real property) it owns, deals in, or rents real property.

ii. Active Conduct

The phrase “active conduct” is not defined. Complicating this further, the phrase has different meanings throughout the Code. However, IRC Section 1202 does provide a few safe harbors. Assets will qualify if

- In connection with a future QTB, the corporation is engaged in (or uses assets in) activities involving start-up expenditures in IRC Section 195(c)(1)(A), research and experimentation in IRC Section 174, or in-house research in IRC Section 41(b)(4), regardless whether these activities earned income. IRC Section 1202(e)(2).
- The assets are rights to computer software that produces active business computer software royalties. IRC Section 1202(e)(8).
- The assets are held as part of the reasonably required working capital needs of a QTB, or are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in, or increases in the working capital needs of, a QTB. After the corporation has been in existence for 2 years, no more than 50% of its assets may qualify for these working capital exceptions. IRC Section 1202(e)(6).

6. Section 1202(c)(3)(A) – Redemptions from Related Parties

Under IRC Section 1202(c)(3)(A), a share "X" is not QSBS, if, within two years before and two years after X's issuance date, the corporation "purchased (directly or indirectly)" even one share of stock from X's holder, or from persons related to him per the table below.[3]

For this purpose, disregard certain purchases by the corporation of stock that is (see TR 1.1202-2):

- de minimis in amount (which is not defined, but which cannot be satisfied if the corporation pays more than $10k to acquire more than 2% (using values at date of purchase, and for multiple purchases adding percentages) of the stock held by a taxpayer and his related parties);
- paid by a shareholder to an employee or independent shareholder for services;
- paid to employees or directors, in connection with a bona fide termination of services;
- held by a shareholder's estate/heirs/etc, within 3 years and 9 months from his death; or
- purchased incident to the selling shareholder's disability, mental incompetency, or divorce.

[3] For stock which is "substantially nonvested" under TR 1.83-3(b) (i.e., nontransferable and subject to substantial risk of forfeiture) and for which an 83(b) election has been made, it is unclear whether forfeiture counts as a "purchase". On the one hand, TR 1.83-1(a)(1) specifies that unvested stock remains "owned" by the company, and IRC 83(f) specifies that the holding period does not begin while shares are substantially nonvested. However, TR 1.83-4 states that, if in 83(b) election is made, the holding period begins at transfer. See Portfolio 384 Restricted Stock - Section 83 at FN 136 (discussing the "fail[ure] to offer a complete analysis of the tax consequences that flow ... from being deemed the owner of the property during the restricted period.")

The following persons are related:		Additional Conditions	Citation
An individual	Another individual	If they are "family," meaning siblings, half-siblings, spouses, or lineal ancestors/descendants.	267(b)(1)
An individual	A corporation	If the individual owns more than 50% of the value of the corporation's stock.	267(b)(2)
A corporation	Another corporation	If they are in the same controlled group under IRC §1563(a).	267(b)(3)
A corporation	A partnership	If 50% of the corporation's stock, and 50% of the partnership's capital or profits interests, is owned by the set of people who own interests in both entities.	267(b)(10)
A corporation	An S corporation	If 50% of both corporations' stock is owned by the set of people who own interests in both entities.	267(b)(11), (12)
A trust	Its grantor		267(b)(4)
A trust	Another trust	If they have the same grantor.	267(b)(5)
A trust	Beneficiary	A beneficiary of a trust is related to that trust, and to any other trust with the same grantor.	267(b)(6), (7)
A trust	A corporation	If the trust, or a grantor of the trust, owns more than 50% of the value of the corporation's stock.	267(b)(8)
An estate	Beneficiary of that estate	Except for a sale or exchange in satisfaction of a pecuniary bequest	267(b)(13)
Any person	A §501-exempt org	If he, or members of his "family," control the organization.	267(b)(9)
Any person	A partnership	If the person owns more than 50% of the partnership's capital or profits interests.	707(b)(1)(A)
A partnership	Another partnership	If 50% of both partnerships' capital or profits interests are owned by the set of people who own interests in both entities.	707(b)(1)(B)

7. Section 1202(c)(3)(B) – Significant Redemptions

Under IRC Section 1202(c)(3)(B), a share "Y" is not QSBS, if [the value of all the company's shares one year before Y's issuance date] exceeds 0.5 * [the value when purchased of all shares purchased by the company during the period one year before and one year after Y's issuance date].

For this purpose, disregard the purchases by the corporation described in the previous section (except, for the definition of purchases which are not de minimis, use "2% of all outstanding stock" instead of "2% of the stock held by a taxpayer and his related parties").

B. QSBS Eligible for Tax-Free Rollover Into Other QSBS or Tax-Free Sale

When QSBS is sold, it is possible to roll the gain into other QSBS. This is analogous to an IRC Section 1031 like-kind exchange of real property. To be eligible, the seller cannot be a C corporation and must have held the relinquished QSBS for at least 6 months. Within 60 days of selling that QSBS, the seller must buy the replacement QSBS, in a transaction that would otherwise have generated a cost basis. IRC Section 1045; Treas. Reg §1.1045–1.

One benefit of this election is that the replacement stock will inherit the holding period of the previous stock. IRC Sections 1202(a)(4), 1223(13). In addition, if the shareholder reinvests 100% of their proceeds, they will recognize no gain. On the other hand, if the shareholder reinvests less than 100% of their proceeds, the remainder will be taxed like "boot" in a Section 1031 exchange. That is: All the shareholder's gain will be recognized, except to the extent the amount rolled over exceeds the shareholder's basis.

Alternatively, when the non-C-corporation taxpayer sells QSBS, they may be able to exclude some of the gain (eligible gain). Eligible gain is a gain from a sale or exchange of QSBS that the taxpayer held for more than 5 years. IRC Section 1202(b). This holding period "tacks" in some cases. See IRC Section 1202(a)(4) (QSBS rollover), Section 1202(f) (conversion of stock), Section 1202(h)(1) (acquisition by gift, at death, or from a partnership), Section 1202(h)(3) (E or F reorganization).

The total exclusion is limited to the greater of [$10mm] or [ten times [cash contributed plus FMV of assets contributed]]. IRC 1202(b)(1)(B). The latter term is helpful where the taxpayer acquired the QSBS for a contribution property worth more than $1mm. However, in those cases, the taxpayer cannot avoid being taxed on any built-in gain in that property. This is thanks to IRC Section 1202(i), which provides that, for calculating gain excluded, the basis of QSBS reflects the FMV of the contributed property (in contrast to the normal rule, under IRC Section 358, that the basis of stock reflects the basis of the contributed property). (Notice that in this calculation, having a higher basis leads to higher taxes.) For this reason it is common to say that IRC 1202 only applies to exclude "1202 gain," which is calculated using "1202 basis."

If the taxpayer acquired the stock before September 28, 2010 (the dated of enactment of the Creating Small Business Jobs Act of 2010), the alternative minimum tax (AMT) applies, and the savings are less generous. Specifically, the savings are as follows:

Citation	Date acquired	Exclusion
1202(a)(4)	After 09/28/2010[4]	100% (and don't apply AMT)

[4] Enactment of Creating Small Business Jobs Act of 2010.

1202(a)(3)	Between 02/17/2009[5] and 09/28/2010	75%
1202(a)(1)	Before 02/17/2009	50%
1202(a)(2), (4)	Between 12/21/2000[6] and 09/28/2010, for certain Enterprise Zone entities in 1397C(b)	60% (but not to post-2018 gain)

Finally, the exclusion does not apply if the value of the stock is protected by an "offsetting short position." IRC Section 1202(j)(2). If the shareholders are allowed to "put" their stock, either to other shareholders or to the company, in case of certain disputes or significant events, planners have differing opinions whether this is an "offsetting short position." Compare Rappaport & Friedman, Section 1202: A Big Deal for Small Business, 37 ABA Tax Times 28 (Aug. 2, 2018) (disqualifying), with Andolina & LeMaster, Candy Land or Sorry: Thoughts on Qualified Small Business Stock, 158 Tax Notes 205 (Jan. 8, 2018) (not disqualifying).

C. Reporting and Penalties

Corporations have no reporting obligations; Treasury has not exercised its power under IRC Section 1202(d)(1)(C) to impose these requirements.

For an IRC Section 1045 QSBS rollover, the shareholder must make this election by the due date (including extensions) for filing the income tax return for the year in which the QSBS was sold. The election is made on IRS Form 8949 and Schedule D. Rev Proc 98-48. For a Section 1202 QSBS exclusion, the exclusion is reported on IRS Form 8949, and (if required for AMT) IRS Form 6521. See Instructions to IRS Schedule D (Form 1040) at "How to Report," and Instructions to IRS Form 8949. See also IRS Publication 550, Investment Income and Expenses (Including Capital Gains and Losses) (2020).

If the IRS later disputes these claimed benefits, it can impose the tax, interest, underpayment penalties, and accuracy-related penalties ranging from 20% to 40%. It can also extend the statute of limitations from 3 to 6 years, or longer for fraud. The taxpayer may be able to defeat certain penalties by demonstrating that he had "reasonable cause" for the position (even if that position was still substantively wrong). Presumably, one avenue to reasonable cause would be to show reasonable reliance on documents provided by the corporation. If that documentation later proved to be erroneous, the availability of penalties might depend on the specific facts and circumstances.

During the course of the investigation, the corporation could also come into the IRS's crosshairs. If the shareholder is audited on the QSBS issue, the IRS has the right to test that claim by demanding records from the *corporation*. IRC Section 7602. Depending on what it finds, the IRS might also impose the "aiding and abetting understatement" penalty on the corporation under IRC Section 6701. Finally, while there is no basis for transferring the shareholder's substantive liability for taxes, penalties, and interest onto the corporation, one could imagine an enterprising

[5] Enactment of Pub. L. 111–5.
[6] Enactment of Pub. L. 106–554.

tort lawyer who attempts to recover these for the shareholder as damages in a suit for negligent misrepresentation.

II. WHEN EVERYTHING GOES RIGHT

With QSBS, the tax liability of the taxpayer (the shareholder) depends on records potentially going back many years. Most of these are in the possession of another person (the corporation).

Neither of these features is rare in the tax law. IRC Section 6001 obliges taxpayers to keep their old records. Other Code provisions oblige third parties to file information returns, and Treas Reg §1.6001-1(a) obliges these persons to maintain records to support these returns.

Part of what makes QSBS unique is how it pushes the limit on both issues: For a corporation formed in late 1993, one would need 30 years of corporate records to satisfy certain tests. And those records are generated almost entirely by the corporation. The other thing that makes QSBS unique is that the law imposes no obligation, or even incentive, on the corporation to maintain, produce, or analyze those records.

In this section, I describe the legal planning which the shareholder should take in order to fully protect himself in this environment. In the next section I explain why it is rare to see shareholders achieve this degree of protection.

The process begins when an investor is considering investing in a company. Both the investor and the company should retain their own legal counsel. Investor's counsel should help the investor weigh the advantages of owning QSBS (potential exclusion or rollover of gain) against the disadvantages (double-taxation of dividends due to C Corp status, prohibition on non-QTBs, etc.). Counsel should also explain all the ways in which either party could destroy the QSBS tax benefits.

As part of this discussion, investor should be made to understand that, from the company's perspective, breaking the rules is completely cost-free. If the investor has clout, he may be able to extract a promise from the company as to how it will report on its QSBS compliance. Although companies do not enjoy any tax benefits from meeting the QSBS requirements, a company will be willing to undertake these promises if it is investor-controlled, or if there is enough investor demand for qualifying investments to permit the entity to increase its management fee at least enough to cover these extra costs and risks. In that case, company's counsel should educate the company regarding the nature of these additional costs.

The National Venture Capital Association encourages investors to negotiate for specific promises from companies prior to investing. This language appears at Section 5.4 of the NVCA's "Enhanced Investors' Rights Agreement," available at https://nvca.org/model-legal-documents/. Under this agreement, "The Company shall use commercially reasonable efforts to refrain from taking any action that could reasonably be expected to cause the shares" to not qualify as QSBS, unless its board decides in its "good-faith business judgment" that qualifying is not in the company's best interests. In addition, within 20 days of a request by <u>any</u> investor, the company commits to respond to all investors. Under the agreement, the company "shall use commercially reasonable efforts to ensure the accuracy of" this response, but it shall not be liable "for any damages arising from any errors or inaccuracies" unless made "in a manner either grossly negligent or fraudulent."

Annex I of the agreement (herein, the "NVCA checklist") prescribes the format of the company's response. Loosely paraphrased, the company must certify whether (or not) each of the following is true:

i. On each Issue Date, the Company was a domestic C corporation.
ii. At all times of the Company's existence after August 10, 1993 through the time immediately following the Issue Date, the Company's aggregate gross assets were $50 million or less.
iii. Prior to executing this statement, the Company has agreed to comply with any IRS reporting requirements with respect to Section 1202.
iv. The Company is engaged in a qualified trade or business.
v. The Company is an entity *other than* a DISC, a former DISC, a RIC, a REIT, a REMIC, or a cooperative.
vi. For substantially all of the taxpayer's holding period, at least 80% of the value of the Company's assets were used in the conduct of one or more QTBs.
vii. For substantially all of the taxpayer's holding period, no more than 10% of the value of the Company's assets (in excess of liabilities) consisted of "portfolio stock".
viii. For substantially all of the taxpayer's holding period, no more than 10% of the total value of the Company's assets consisted of real property not being used in the active conduct of a qualified business.
[In lieu of confirming items vi, vii, and viii, the Company may instead confirm that: "The Company is a "specialized small business investment company" licensed to operate under Section 301(d) of the Small Business Act of 1958."]
ix. The Company has not redeemed stock from the Stockholder or, to the Company's knowledge, any related party (within the meaning of Sections 267(b) or 707(b) of the Stockholder) at any time during the four year period beginning on the date two years before the Issue Date of the stock in question, other than *de minimis* redemptions and certain disregarded redemptions.
x. The Company has not redeemed stock during the two year period beginning on the date one year before the Issue Date with an aggregate value (as of the time of the redemption) exceeding 5% of the aggregate value of all the Company's stock as of the beginning of such two year period, other than *de minimis* redemptions and certain disregarded redemptions.

The NVCA agreement is well thought-out. However, from the investor's perspective, it could be strengthened. In my view, to ensure that the company can document each of these claims if challenged by the IRS, the agreement should include a second checklist, consisting of questions that the company must answer each year during which its shares are held by investors seeking QSBS benefits (herein, an "Annual Checklist"). The company should promise to retain the underlying records indefinitely (or: until the company can determine that no party to the Investors'

Agreement is seeking QSBS benefits). Finally, the company should notify the shareholder parties if it ever determines that it cannot answer a question favorably, or cannot locate supporting records, for the current or any previous year.

An Annual Checklist might read as follows:

1. Was the company a C corporation for the entire year?
2. During the year, was the company was a member of a "controlled group" (i.e. a tree of parent-child ownership relationships, including all corporations owned at least 50% by other members of the tree)? Identify the other members of that group.
3. If so: was any of those members a "subsidiary" of the company? (i.e., a corporation owned 50% by vote or value). Identify those subsidiaries.
4. Identify all the assets of:
    a. The company;
    b. Its subsidiaries; and
    c. The members of its controlled group other than its subsidiaries.
5. During any part of the year, was the company a DISC or former DISC, a RIC/REIT/REMIC, or a cooperative?
6. Identify all of the trade(s) or business(es) engaged in by the company, and determine whether any of these were not QTBs.
7. For the company and its subsidiaries, determine the FMV of the items described below:
    a. Aggregate value of all assets;
    b. real property not used in the active conduct of a QTB;
    c. corporate stock and securities (other than "subsidiaries");
    d. assets held as a part of the reasonably required working capital needs of a QTB of the company;
    e. assets held for investment and reasonably expected to be used within 2 years to finance research and experimentation in a QTB or increases in working capital needs of a QTB;
    f. assets used in start-up activities described in section 195(c)(1)(A), activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174, or activities with respect to in-house research expenses described in section 41(b)(4), in connection with any future QTB;
    g. rights to computer software which produces active business computer software royalties.
8. During the year, did the company issue shares?
9. If yes: For all members of the "controlled group," determine

    (i) the amount of cash owned;
    (ii) the FMV of all contributed assets; and
    (iii) the adjusted basis of all other assets.
10. Determine

    (i) whether the company redeemed stock during the year;
    (ii) from whom;
    (iii) what was the value of the redeemed stock; and

(iv) what was the aggregate value of the company's stock on the date of the redemption.

[Only in years when shares are issued, determine the info in (i) and (ii) for the previous <u>two years</u>, and determine the info in (iii) and (iv) for the previous <u>one year</u>. (The company will already have all the info in this paragraph starting in its third year of QSBS compliance.)]

11. Confirm that the company "agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section."

Years later, a shareholder may ask the company for guidance as to whether her stock is QSBS. Using the Annual Checklists which the corporation completed over the years, the company (or its legal counsel) can prepare and circulate the NCVA Checklist very quickly.

If the company did not prepare these Annual Checklists, the company will need to ascertain the answers to the NCVA Checklist from scratch. To do this, counsel asks the officers to provide relevant records for the relevant time period. These records might include the stock ledger, stock certificates, relevant minutes, CP261 notice (approval of conversion from C to S corporation), tax returns, year-end financial statements, and internal or third-party valuations of the valuations of assets. Where there are gaps in this information, the company could instead provide an unsupported assertion (*e.g.,* "The valuation of Asset X has never exceed $10 million"). In that case, counsel should request a signed certificate from an officer, stating that the determination was made by that officer after a reasonable inquiry.

Using this information, counsel will reach an opinion on the relevant legal questions. Since its purpose is to protect the company against tax penalties, this opinion should be kept confidential (*i.e.,* attorney-client privileged with the corporation). Depending on the conclusion, counsel may then authorize the company to give shareholders the NCVA Checklist, or a similar letter, affirming that the stock is QSBS, or affirming certain facts relevant to that determination.

When the shareholder receives this letter, they (or their tax advisor) should confirm that the corporation has answered all the questions that only the corporation can answer, and that the shareholder has answered any of the questions that only the shareholder could answer (or, questions that the corporation has not answered, but the shareholder could answer). In particular, the shareholders should have independent access to the following information.

1. Determine when, and from whom, the shareholder acquired their stock.
2. Determine the nature of the acquisition transaction (e.g., redemption, distribution, reorganization, Section 351 contribution, gift, death, and so on).
3. Determine what consideration the company received in exchange for the shares (and, if issued for property, the property's basis and value; if issued for services, whether the stock was restricted at the time).
4. Determine whether the company has ever redeemed stock from the shareholder or a related party.
5. Confirm that the shareholder will be relinquishing his stock in a "sale or exchange."
6. For a QSBS rollover, confirm that the shareholder "purchased" replacement stock within 60 days of the sale, in a transaction that otherwise would have a cost basis; that the

replacement stock is also QSBS; and that they will make the election on their return for the year of the sale.

7. For a QSBS exclusion, confirm that the value of their relinquished stock was not protected by an "offsetting short position."

III. PRACTICAL OBSTACLES TO ACCURATE QSBS REPORTING

In reality, the process described in the previous section is totally unheard of. Corporations do not constantly update shareholders as to the QSBS status of their shares. When shareholders ask, the corporations haven't already collected all the information into exhibits and digested these into checklists. Absent a contract, the corporation owes no obligation to the shareholder to even respond to this inquiry, let alone to retain the records. If the shareholder is a former employee who was fired for cause, the corporation might be affirmatively looking for legal reasons *not* to cooperate unless forced to do so.

One disturbingly common pattern is where the corporation responds to the shareholder's request by merely giving "lip service" to the idea of cooperation—that is, cooperating just enough to mollify to the shareholder, who may not have a professional advisor, but without directly addressing the legal issues in the QSBS statute. Perhaps the corporation wants to conceal the fact that it tried, but failed, to cause the stock to be QSBS. Or perhaps it does not know because it failed to keep adequate records. In my view, if a reasonable reader would understand such a response to be a yes, this constitutes a yes and could lead to a claim of misrepresentation. However, other professionals seem to feel differently, and prefer the path of misdirection.

Sometimes, these kinds of letters omit key facts. Other times, they contain purely factual statements but no legal conclusions. The goal of the latter kind of letter is to unload the legal analysis (and thus, liability for that analysis) onto the shareholder's advisors. For example, some letters simply identify the nature of the business and its assets, without opining whether 80% of assets was used in a QTB.

When these letters fall short, it is because they do not provide enough information for the shareholder to draw key inferences. For example: How can the shareholder decide what the "reasonably required" working capital needs of the company are, if they do not know the risks faced by the company, its strategy, or its proposed investments? How can the shareholder know if a principal asset of the company is the "reputation or skill" of a key employee, if they are not personally familiar with the industry? How can the shareholder know whether assets were "used in the active conduct of" a trade or business, unless they had first-hand knowledge of the business activities?

Even where there are no legal consequences for giving a direct "no," I understand why companies prefer to write a cautious and misleading "yes." Admitting "no" is psychologically hard to do. The executives will incur wrath and lose face. It is easier to say something incomplete and let the shareholder sort it out with his own advisors. Still, unless the corporation discloses all the necessary information that only the corporation can know, in substantially the same language as the elements in the QSBS statute, this style of letter does not give the shareholder "reasonable cause" (for penalty purposes) for claiming QSBS benefits.

In short, the lack of a formal QSBS reporting process leads to false positives (shareholders claiming QSBS benefits who shouldn't) and false negatives (shareholders not claiming QSBS benefits because of a lapse by the company).

IV. PROPOSED REVENUE PROCEDURE

Treasury has an interest in improving the quality of information which corporations communicate to shareholders on QSBS matters. The problem here is not simply that shareholders are losing out on tax benefits which they're otherwise entitled to. The problem is also that some shareholders are claiming QSBS benefits when they shouldn't.

One way to do so would be to impose new information reporting requirements on corporations. Treasury has the power to do so under IRC Section 1202(d)(1)(C), which states that to constitute a "qualified small business" under 1202, a corporation must "agree[] to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section." In my understanding, this section constitutes a congressional grant of authority to Treasury to impose additional reporting requirements (i.e., as long as corporations consent to these requirements). I liken this to IRC Section 1501, which permits the "privilege" of filing consolidated returns on the condition that all corporations consent to the consolidated return regulations. Thirty years ago, when Congress created the QSBS statute, it also required corporations to consent to future reporting rules; by doing so, it made clear that it expected the IRS to take an active role in ensuring accurate reporting. Yet Treasury has still not yet sought to exercise this authority.

There are a number of steps which Treasury might take. For example, it might choose to borrow a page from Opportunity Zones. That is, it might require investors and corporations to make an initial election; it might require both to file forms with the IRS annually, certifying their compliance; and it might impose penalties in certain cases, e.g. in cases of incorrect reporting. Or it might simply require certain annual disclosures from the corporation to the investor.

In this paper, I propose a much less ambitious form of reporting, as an initial step. I propose that the IRS should publish a form of a certificate by which corporations can communicate to shareholders whether stock meets certain elements of QSBS. At a bare minimum, it will help educate shareholders and corporations as to the steps for causing stock to qualify as QSBS and how to report this.

This certificate will be optional. However, the IRS may wish to promote its use—for example, by giving benefits to shareholders who attach the certificate to their returns or to corporations which issue it. Conversely, to prevent undeserving taxpayers and shareholders from enjoying these safe harbors, the IRS may wish to attach burdens when claims in the certificate are false.

The main beneficiary of this proposal is the IRS, in that the widespread adoption of this certificate will incentive corporations to maintain ongoing records and respond candidly to shareholder inquiries. Conversely, if a corporation cannot submit a perfect certificate, this puts the shareholder on notice that he should not claim QSBS benefits, or at least that he is making a risky claim which is likely to be audited. In turn, the IRS can treat a shareholder's failure to attach a complete certificate as a red flag for an audit. The proposal will reduce improper claims of QSBS benefits, and will help the IRS target claims which cannot be substantiated.

The details of this revenue procedure will depend on how the IRS chooses to answer the following three questions.

A. Contents

First, what statements should be in the certificate?

The certificate will ask the corporation to confirm various statements relevant to whether the shareholder's stock is QSBS in the current year. At a minimum, the certificate should ask about information which the shareholder may not have access to. It could ask for information which is typically known by both shareholder and corporation, or only by the shareholder (though, this would be optional).

Another drafting decision is how much detail the certificate should call for. At one extreme, it would merely ask for affirmation of the relevant legal questions. This is how I would characterize the NVCA checklist, discussed above. The NCVA gives the shareholder all the information he needs to claim QSBS benefits, and Treasury could reasonably choose to adopt this format.

However, Treasury might also choose to elaborate on these questions, in order to extract more information from the company (that is, about how the corporation determined this information), force it to put this information on the record, and (potentially) penalize it for misstatements.

An expanded version of the NCVA checklist might be as follows:

1. Identify the years during which the shareholders receiving this certificate held shares in the company (herein, "Tested Years").
2. Identify the Tested Years during which the company was a C corporation.
3. Identify the Tested Years during which the company was a member of a "controlled group" (i.e. a tree of parent-child ownership relationships, including all corporations owned at least 50% by other members of the tree).
4. Identify the Tested Years during which the company had any "subsidiaries" (i.e., corporations owned 50% by vote or value).
5. Identify the Tested Years during which the company was <u>none of</u>: a DISC or former DISC, a RIC/REIT/REMIC, or a cooperative.
6. Identify the Tested Years during which <u>all</u> of the trade(s) or business(es) engaged in by the company were QTBs.
7. List each of the Tested Years for which the company and its "subsidiaries" possess <u>**records sufficient to determine**</u> the FMV of the items described below:
    (i) Aggregate value of all assets;
    (ii) real property not used in the active conduct of a QTB;

(iii) corporate stock and securities (other than "subsidiaries");
(iv) all working capital,
(v) working capital held as a part of the reasonably required working capital needs of a QTB of the company;
(vi) assets held for investment and reasonably expected to be used within 2 years to finance research and experimentation in a QTB or increases in working capital needs of a QTB;
(vii) assets used in start-up activities described in section 195(c)(1)(A), activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174, or activities with respect to in-house research expenses described in section 41(b)(4), in connection with any future QTB;
(viii) rights to computer software which produces active business computer software royalties.

8. List each of the Tested Years for which the company met the "active business" requirements.
9. Identify any Tested Years during which the company issued shares.
10. List each of the Tested Years for which the company possesses records sufficient to determine, for all members of the "controlled group", (i) the amount of cash owned; (ii) the FMV of all contributed assets; and (iii) the adjusted basis of all other assets.
11. List each of the Tested Years for which the company possesses records sufficient to determine
    (i) whether the company redeemed stock during the year;
    (ii) from whom;
    (iii) what was the value of the redeemed stock; and
    (iv) what was the aggregate value of the company's stock on the date of the redemption.
    [Only in years when shares are issued, determine the info in (i) and (ii) for the previous <u>two years</u>, and determine the info in (iii) and (iv) for the previous <u>one year</u>. (The company will already have all the info in this paragraph starting in its third year of QSBS compliance.)]
12. Confirm that the company "agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section."
13. Affirm that the corporation will retain records for at least six years from the date of the certificate, sufficient to document the statements in the certificate.

B. Concessions

Second, should concessions be extended to shareholders who obtain the certificate, and/or to corporations which supply it?

Optionally, Treasury could treat this revenue procedure as setting forth a safe harbor, by which taxpayers will be deemed to have reasonable cause, for purposes of penalties under Chapter 68 of the Code, if they incorrectly claim exclusion or nonrecognition of gain under Code Sections 1202 or 1045 relating to Qualified Small Business Stock in reliance on a favorable questionnaire.

The Commissioner may rebut this presumption by showing that the taxpayer knew, or reasonably should have known, information which contradicts information in the statement.

Treasury could also grant some concession to corporations which use the form. These concessions would probably take the form of some exemption from to-be-determined compliance burdens on other corporations.

C. Conditions

Third, should burdens be imposed on shareholders who obtain the certificate, and/or to corporations which supply it?

If there is sufficient investor demand for corporations to issue this certificate—or if Treasury mandates the use of this certificate—this gives the IRS leverage to impose new demands on the corporations which do choose to use it. I imagine a further provision in the revenue procedure which provides that, if the company answers a question incorrectly, it will be jointly liable with the shareholder for the underpayment, unless it can show that the error was due to reasonable cause.

IV. CONCLUSION

With QSBS, all the decisionmaking and the recordkeeping is in the hands of the corporation, but the corporation has no incentive to comply. Up till now, Treasury has (intentionally or not) taken a *laissez-faire* approach, placing the burden on shareholders to try to coax corporations to cooperate.

Shareholders have not succeeded. This harms shareholders, but also the IRS, to the extent it leads to shareholders claiming QSBS benefits when they're not entitled to them.

Treasury has authority to clarify corporations' reporting obligations in this area, and it should do so. As part of this response, Treasury should consider a checklist like the kind proposed in this paper.