Issues in Selling a Closely Held Business

Agenda

- Three ways you can terminate your S election and how to fix them:
  - State-law LLC, offending language in operating agreement (Rev. Proc. 2022-19)
  - Ineligible trust shareholders (Rev. Proc. 2013-30)
  - Missing spousal consents (Rev. Proc. 2004-35).
- Three things you need to keep on file to prepare your client for an acquisition
  - ORIGINAL, executed copies of the Form 2553, 8869
  - ORIGINAL, executed copies of any QSST or ESBT elections.
  - Trust documents for any trust shareholders.

Failure #1: State-Law LLC Electing S

- For purposes of this subchapter, the term “small business corporation” means a **domestic corporation** which is not an ineligible corporation and which does not—
  - (A) have more than 100 shareholders,
  - (B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual,
  - (C) have a nonresident alien as a shareholder, and
  - (D) have more than 1 class of stock.
- Domestic corporation: a domestic corporation can elect S status even if it’s registered as a corporation in a foreign country.

Single Class of Stock

- In order to qualify for an S election, the corporation **must have a single class of stock.**
- Why? To make the pass-through provisions of subchapter S workable, and to avoid the complications that would come with the strict pro-rata allocation rules of subchapter S. What if the income were allocated evenly among all shareholders, but only preferred shareholders received distributions?
- As might be expected, determination of whether a single class of stock exists is more complex than inquiring as to the number of classes of stock outstanding:
- Consider the following:
  - Voting vs. nonvoting;
  - Preferences afforded for certain classes of stock;
  - Debt vs. equity determinations.
  - LLCs that checked the box: LOOK AT THE OPERATING AGREEMENTS

Reg. § 1.1361-1(l)(1)

- A corporation that has more than one class of stock does not qualify as a small business corporation.
- Except as provided in [Reg. § 1.1361-1](l)(4) … (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights **to distribution and liquidation proceeds**.
- Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.

Reg. § 1.1361-1(l)(2)(i). Determination of … identical rights to distribution and liquidation proceeds

- The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions).
- If state law requires payment and withholding of income tax on behalf of some but not all shareholders. This will not be treated as a second class of stock provided the underlying governing provisions do not confer different rights.

Reg. § 1.1361-1(l)(2)(i). Determination of … identical rights to distribution and liquidation proceeds

- The Tax Court (court) in *Maggard v. Commissioner* (T.C. Memo 2024-77, Aug. 7, 2024) held that the founder of an S corporation is liable for taxes on income that was never distributed to him because the corporation's S corporation election was not terminated when the S corporation made disproportionate distributions to its other shareholders.

Reg. § 1.1361-1(l)(2)(i). Determination of … identical rights to distribution and liquidation proceeds

- James Maggard was one of the founders of an engineering consultant partnership that was incorporated into an S corporation. The bylaws provided for 10,000 shares of one class of common stock, which entitled each owner under the relevant state law to a pro-rata share of any dividends as well as any distribution of the corporation's assets on liquidation. Maggard maintained a 40% interest in the corporation and sold a 60% interest to two individuals (40% to one and 20% to the other).
- According to the court, the two individuals proceeded to misappropriate funds and make disproportionate distributions to themselves. In addition, they did not file Forms 1120S with the IRS or send Maggard Schedules K-1 showing his share of distributions.
- Maggard accused the individuals of embezzling more than $1 million from 2012–2015. The individuals then cut Maggard off from the corporation's books and out of meetings, voted to increase their salaries and benefits, and authorized payouts to themselves based on retroactively increasing their paid time off.
- Maggard filed his taxes in 2018 for tax years 2011–2016. His attorney asked one of the individuals to give him Maggard's share of the corporation's income and expenses and the individual provided a napkin with the number $300,000 written on it, representing Maggard's pro rata portion of the corporation's losses for tax year 2014. The individual did the same for 2015 with a loss of $50,000. The corporation subsequently issued Schedules K-1 to Maggard for the 2011–2016 tax years showing his proportionate share of the earnings as profits, not losses.
- The IRS audited Maggard and determined that he and his wife did not correctly report income from the corporation for the years 2014–2016.

Reg. § 1.1361-1(l)(2)(i). Determination of … identical rights to distribution and liquidation proceeds

- Because an S corporation is a pass-through entity, the IRS argued, Maggard must pay tax on his share of the corporation's income for the years at issue, regardless of whether the income was distributed to him. Maggard, however, argued that the corporation's S election terminated before the years at issue by virtue of the repeated disproportionate distributions made by the corporation, which, Maggard maintained, violated IRC Section 1361(b)(1)(D)'s requirement for an S corporation to have only a single class of stock. As a result, Maggard asserted, the corporation was no longer a pass-through entity from 2014–2016, and Maggard should not be required to pay tax on his share of the corporation's income.

- In concluding that the disproportionate distributions made before the years at issue did not terminate the corporation's S election, the court cited the relevant regulations and emphasized that, despite the history of disproportionate distributions, the corporation did not formally change its governing documents or authorize or create a second class of shares. Thus, the governing provisions continued to provide for identical rights to distributions and liquidation proceeds.

- Citing case law and the regulations, the court said that "[o]ne cannot help but sympathize with a taxpayer caught in this situation. But it is a situation that we've seen before."

Reg. § 1.1361-1(l)(2)(i). Determination of … identical rights to distribution and liquidation proceeds

- Of all the statutory requirements that must be satisfied for a taxpayer to be eligible to be an S corporation, perhaps the most misunderstood is IRC Section 1361(b)(1)(D)'s requirement for a corporation to have only a single class of stock. Many taxpayers and tax advisers alike interpret this rule to mean that an S corporation must make every distribution precisely pro-rata, and that even a single disproportionate distribution will result in an immediate, cataclysmic termination of the corporation's S election.

- As the Tax Court reminded everyone in Maggard, however, that is not how the regulations at Treas. Reg. Section 1.1361-1(l) work. Instead, those regulations look not to what a corporation actually does in making its distributions, but rather to what the corporation's governing provisions say. This rule creates a fascinating and often-confusing dichotomy: as evidenced in Maggard, a corporation may make years of disproportionate distributions, but those distributions should not create a second class of stock as long as the governing provisions provide for identical rights to distribution and liquidation proceeds. Conversely, if an S corporation makes every distribution pro-rata to the penny but confers non-identical rights to distribution and liquidation proceeds in its governing provisions, the election will terminate (See, for example, PLR 202247004).

- A common concern for practitioners has been the fear that the IRS would treat a pattern of repeated disproportionate distributions as creating a deemed, implied, governing provision. But it is difficult to imagine a longer — or more egregious — pattern of disproportionate distributions than the one found in Maggard, and yet the IRS and Tax Court refused to terminate the corporation's S election.

- Of course, all S corporations should make each distribution pro-rata. After all, an S corporation must allocate all income pro-rata on a per-share, per-day basis; as a result, if distributions are made disproportionately, at least one shareholder will be burdened with paying tax on his or her pro-rata share of income without a corresponding pro-rata distribution of cash.

Single Class of Stock

- The goal of the final 1992 regulations is to make it very difficult to disqualify an S corporation on grounds of a second class of stock provided:
  - The corporation has not overtly attempted to issue shares of different classes (except for voting rights), and
  - State corporate law does not impose non-identical rights to distributions or liquidation proceeds.
- In practice, where are we likely to run into the most problems with a second class of stock? PLR 20198004
  - LLC's that check the box to be treated as an S corporation. If the LLC operating agreement contains standard partnership agreement language:
    - Section 704(c)
    - Distributions in accordance with positive balances of capital accounts
    - Qualified income offset
  - These are "governing provisions" that create a second class of stock, as they confer different rights to distribution and liquidation proceeds.

Purpose of Rev. Proc. 2022-19

- Rev. Proc. 2022-19 provides taxpayer assistance procedures, including under § 1362(f) of the Internal Revenue Code (Code), to allow S corporations and their shareholders to resolve frequently encountered issues ***without requesting a private letter ruling (PLR).***
- Sections 3.01 through 3.05 concern issues that the IRS historically has identified as not affecting the validity or continuation of a corporation's election under § 1362(a) of the Code to be treated as an S corporation (S election); or an S corporation's election under § 1361(b)(3)(B)(ii) of the Code to treat its corporate subsidiary as a qualified subchapter S subsidiary (a QSub).
- Section 3.06 provides retroactive corrective relief procedures under section 1362(f) in certain circumstances to allow taxpayers to retroactively preserve S elections that are invalid or terminated solely as the result of one or more non-identical governing provisions (as defined in Rev. Proc. 2022-19 section 2.03(6)(a)).
- Section 4 provides areas in which the IRS **will not rule,** or will not ordinarily rule, regarding the validity or continuation of an S election or a QSub election.

Six areas for which issues are resolvable without a PLR

- PLR requests
  - IRS frequently receives requests for PLRs seeking relief under § 1362(f).
- Rev. Proc. 2022-19 section 2.03(1) through 2.03(6) details six areas that are resolvable ***without*** a PLR:
  1. **One class of stock requirement and governing provisions, including "principal purpose" conditions.**
  2. **Disproportionate distributions.**
  3. Certain inadvertent errors or omissions on Form 2553 or Form 8869.
  4. Missing administrative acceptance letter for S election or QSub election.
  5. A Federal income tax return filing inconsistent with an S election or a QSub election.
  6. **Non-identical governing provisions.**

Section 3.06: Procedures for retroactively correcting one or more non-identical governing provisions

- Definitions
  - **Applicable shareholder**: a current or former shareholder of a corporation who owns or owned stock of the corporation at any time during the period
    - Beginning on the date on which the non-identical governing provision was adopted (on its own or as part of another governing provision); and,
    - Ending on the date on which the non-identical governing provision was removed or modified in a manner such that the governing provision complies with the one class of stock requirement.
  - **Discovered by the IRS**: before the failure is discovered by IRS [the meaning given the term in § 301.9100-3(b)(1)(i) of the Procedure and Administration Regulations].
  - **Disproportionate distribution**: any distribution (including actual, constructive, or deemed distributions) of property by a corporation with respect to shares of its stock that ***differs in timing or amount*** from the distribution with respect to any other shares of its stock. *See* Treas. Reg. § 1.1361-1(l)(1) and (2).
  - **Non-identical governing provision**: a non-identical governing provision is a governing provision, as defined by Treas. Reg. § 1.1361-1(l)(2)(i), on its own or as part of another governing provision, that for Federal income tax purposes results in the S corporation having more than one class of stock under Treas. Reg. § 1.1361-1(l)(1) (even if the S corporation never made a non-pro rata distribution or liquidating distribution).

Failure #2: Ineligible Trust Shareholder

… [T]he following trusts may be shareholders. This subparagraph shall not apply to any foreign trust.

(i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States. (revocable or grantor trusts).

(ii) A trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner's death.

(iii) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 2-year period beginning on the day on which such stock is transferred to it (testamentary trusts).

(iv) A trust created primarily to exercise the voting power of stock transferred to it.

(v) An electing small business trust. Section 1361(c)(2)((B)(v): each potential current beneficiary must be an eligible shareholder (with an exception for nonresident aliens post TCJA).

(vi) Qualified Subchapter S Trusts: the income beneficiary is considered to be the shareholder. In the case of a corporation which is a bank (as defined in section 581) or a depository institution holding company (as defined [under 12 U.S.C. 1813(w)(1)], a trust which constitutes an individual retirement account under section 408(a), including one designated as a Roth IRA under section 408, but only to the extent of the stock held by such trust in such bank or company as of [Oct. 22, 2004].

Grantor Trusts

- Section 1361(c)(2)(i) permits a trust to hold S corporation stock if it is a trust all of which is treated:
  - As owned by an individual (under subpart E of part I of subchapter J)
  - Who is a citizen or resident of the United States.
- The trust must contain certain powers that cause all of the ordinary income and income allocable to corpus to be deemed to be owned for federal income tax purposes by one person who created the trust (the “grantor”) or by a beneficiary of the trust, if § 678 applies.

Death of Grantor

- If a grantor trust ceases to be a grantor trust because of the death of the deemed owner, the trust will continue to be treated as a qualified S corporation shareholder for a period of two years.
- After the expiration of the two-year period, the trust will cease to be an eligible shareholder unless the trust otherwise qualifies as another type of trust permitted to be a shareholder; and any necessary elections are timely made or the trustee distributes the S corporation stock to a person eligible to be an S corporation shareholder.
- Treas. Reg. § 1.1361-1(h)(1)(ii)

Termination of Grantor Status

- If a grantor trust ceases to be a grantor trust because the deemed owner relinquishes powers that cause the trust to be treated as a grantor trust, the trust will cease to be an eligible shareholder unless:
  - The trust otherwise qualifies as another type of trust permitted to be a shareholder, and
  - Any necessary elections are timely made.
- Failure to make elections will terminate S status as of the date of the power relinquishment

§ 1361(d): Qualified Subchapter S Trust

- A trust qualifies as a QSST if all the following criteria are met [IRC Sec. 1361(d); Reg. 1.1361-1(j)]:
  - The trust has only one income beneficiary during the life of the current income beneficiary, and that beneficiary is a US citizen or resident.
  - All of the income of the trust is, or is required to be, distributed currently to the one income beneficiary. [However, a trust provision authorizing the trustee to accumulate income if the trust no longer holds S corporation stock does not preclude the trust from being a QSST (Rev. Rul. 92-20).]
  - Any corpus distributions that might occur, including a terminating distribution, must also go to that one income beneficiary if made during the beneficiary's lifetime.
  - The income interest of the beneficiary must terminate on the earlier of the beneficiary's death or the trust's termination.
  - An election to be treated as an eligible S corporation shareholder is made separately for the stock of each S corporation held by the trust.
- Once a QSST election is made, it is revocable only with the consent of the IRS [IRC Sec. 1361(d)(2)(C)].

§ 1361(d): Qualified Subchapter S Trust

- The QSST income beneficiary is treated as the shareholder for purposes of the pass-through rules, distributions, and adjustments to stock basis. Thus, the income beneficiary reports the S corporation's pass-through items of income, gain, loss, or deduction on his or her individual Form 1040 (Ltr. Rul. 9035048).
- The S corporation passes through the items of income and deduction to the QSST. In turn, the QSST generally files Form 1041 (US Income Tax Return for Estates and Trusts). The information section at the top of Form 1041, page 1, is completed and the box for "Grantor type trust" checked. A QSST holding only S corporation stock should not report on Form 1041 any part of the income that is taxable to the beneficiary. Rather, a separate statement is attached to the Form 1041 detailing the items of income and deduction that are taxable to the beneficiary, and Schedule K-1 is not used to report those items.

§ 1361(d): Qualified Subchapter S Trust

- A beneficiary of a QSST is required to file an election to have the trust treated as an eligible S shareholder. The election must be filed within two months and 16 days of the trust's receipt of stock. However, the IRS provides relief from inadvertent termination of S status caused by the beneficiary's failure to timely file a QSST election [IRC Sec. 1362(b)(5); Rev. Proc. 2013-30].
- The current income beneficiary of a QSST must elect to treat the QSST as an eligible S corporation shareholder. The QSST election can be made on Part III of Form 2553 (Election by a Small Business Corporation) if the S corporation stock is transferred to the QSST on or before the date that the S election is filed, and if the QSST election and S election have the same effective date.
- Otherwise, the QSST election is made by a separate statement filed with the IRS Service Center where the corporation files its tax return. A blank sample statement is included at Election E106. The following examples illustrate the election procedures necessary to qualify a trust as a QSST.

§ 1361(e): Electing Small Business Trust

- An electing small business trust (ESBT) can own S corporation shares [IRC Secs. 1361(c)(2)(A)(v) and (e)]. An ESBT can provide that income will be distributed to (or accumulated for) one or more beneficiaries [Regs. 1.1361-1(m)(1)(ii) and -1(m)(4)(vi)]. Thus, an individual can establish a trust to hold S corporation stock and split income among family members or others who are trust beneficiaries.
- The price paid for this flexibility is that the trust (not the beneficiaries) is taxed on income related to the S corporation stock at the highest individual rate (currently 37% on ordinary income, 20% on long-term capital gains, 25% for unrecaptured Section 1250 gain, and 28% for collectibles gain) [IRC Sec. 641(c)(2)(A); Regs. 1.641(c)-1(d) and -1(e); CCA 200948059].
- To qualify as an ESBT, all trust beneficiaries must be individuals, estates, or charitable organizations eligible to be S shareholders. A nonresident alien can now be a potential current beneficiary of an ESBT while not an eligible S shareholder. In addition, certain political entities are permitted as contingent beneficiaries so long as they are not potential current beneficiaries [IRC Sec. 1361(e)(1)(A)(i); Reg. 1.1361-1(m)(1)].
- No interest in the trust can be acquired by purchase (that is, with a cost basis determined under IRC Sec. 1012) [IRC Sec. 1361(e)(1)(A)(ii); Reg. 1.1361-1(m)(1)(iii)]. Thus, an interest in the trust must generally be acquired by gift, bequest, or transfer in trust. But see PLR 201834008.

§ 1361(e): Electing Small Business Trust

- A potential current beneficiary is a person who is entitled to (or at the discretion of any person may) receive a distribution from the principal or income of the trust. [See Reg. 1.1361-1(m)(4)(i).]
- A person entitled to receive a distribution only after a specified time or when a specified event occurs (such as the death of a holder of a power of appointment) generally ***does not become a potential current beneficiary until the time arrives or event occurs*** [Reg. 1.1361-1(m)(1)(ii)(C)]. Additionally, an ESBT has one year to dispose of the S stock to avoid disqualification after an ineligible shareholder becomes a potential current beneficiary. Each "potential current beneficiary" of the trust (and that beneficiary's family members) is counted as one shareholder for the 100-shareholder limitation. If there are no potential current beneficiaries, the trust is treated as the shareholder.
- If an ESBT held shares of an S corporation before 2018, each potential current beneficiary of the ESBT was treated as a shareholder. This meant that each potential current beneficiary had to be eligible to be an S corporation shareholder. Thus, a nonresident alien could not be a potential current beneficiary of an ESBT. Effective January 1, 2018, the Tax Cuts and Jobs Act amended IRC Sec. 1361(c)(2)(B)(v) to exempt nonresident aliens from the rule treating each potential current beneficiary as an S corporation shareholder.

§ 1361(e): Electing Small Business Trust

- The taxable income of an ESBT consisting solely of stock in one or more S corporations includes: (1) the S corporation items of income, loss, or deduction allocated to it (i.e., passed through on Schedule K-1 of Form 1120S) as an S corporation shareholder; (2) gain or loss from the sale of the S corporation stock; and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses [IRC Sec. 641(c)(2)(C); Reg. 1.641(c)-1(d)]. Capital losses are allowed only to the extent of capital gains.
- Under the "ordinary" trust rules, a trust is taxed on its taxable income reduced by a distribution deduction. A deduction for distributions to beneficiaries is allowable when calculating taxable income because the beneficiaries will include those distributions in income. An ESBT, however, is taxed on its income before considering distributions to beneficiaries. Therefore, distributions from an ESBT holding only S corporation stock are not taxable at the beneficiary level [Reg. 1.641(c)-1(i)].

§ 1361(e): Electing Small Business Trust

- The trustee files the ESBT election with the IRS Service Center where the corporation files its income tax return. If the corporation is electing S status simultaneously with making the ESBT election, the election may be attached to the corporation's Form 2553 (Election by a Small Business Corporation). The ESBT election must be filed within the 16-day-and-2-month period [prescribed in Reg. 1.1361-1(j)(6)(iii)] beginning on the date S corporation stock is transferred to the trust [Regs. 1.1361-1(m)(2) and 1.1362-6(b)(2)(iv)].
- The trustee makes the ESBT election and also consents to the S election. Even though each potential current beneficiary of an ESBT counts as a shareholder for the 100-shareholder limit, only the trustee is required to consent to the S corporation election [Reg. 1.1361-1(m)(2)]. If the ESBT has more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S election. Further, if the ESBT is a grantor trust, both the trustee and the deemed owner of the trust are required to consent to the S election [Regs. 1.1361-1(m)(2) and 1.1362-6(b)(2)(iv)].

Late Relief

- Under Rev. Proc. 2013-30, the IRS provides inadvertent termination relief under IRC Sec. 1362(f) to corporations whose S status has been terminated because stock in the corporation was transferred to a trust whose trustee inadvertently failed to file a timely ESBT election under IRC Sec. 1361(e)(3) or QSBT election. Under Rev. Proc. 2013-30, the corporation is treated as if its S status had not terminated.
- If the IRS grants relief, the election becomes effective on the date on which the election was originally intended to be effective [Rev. Proc. 2013-30, Sec. 4.01(3)].
- Cannot go back beyond 3 years and 75 days. If the termination date was beyond that date, you must pursue a PLR.

Failure #3: Missing Shareholder Consent

- The general rule is that all persons who are shareholders on the date the S election is filed must consent to the election if the election is effective on the first day of the following tax year. Shareholders who join the corporation after the election is made need not consent to the election.
- **Example.** On January 1, 1993, three individuals own all of the stock of a calendar year subchapter C corporation. On April 15, 1993, the corporation, in accordance with paragraph (a)(2) of this section, files a properly completed Form 2553. The corporation anticipates that the election will be effective beginning January 1, 1994, the first day of the succeeding taxable year. On October 1, 1993, the three shareholders collectively sell 75% of their shares in the corporation to another individual. On January 1, 1994, the corporation's shareholders are the three original individuals and the new shareholder. Because the election was valid and binding when made, it is not necessary for the new shareholder to consent to the election. The corporation's subchapter S election is effective on January 1, 1994 (assuming the other requirements of section 1361(b) are met).

Reg. 1.1362-6(a)(2)(ii)(B)(2): Who must consent to election

- If the election is made before the 16th day of the third month of the tax year and is intended to be effective for that year, anyone who was a shareholder at any time between the first day of the effective tax year and the date the election is filed must consent.
- **Example.** On January 1, 1993, the first day of its taxable year, a subchapter C corporation had 15 shareholders. On January 30, 1993, two of the C corporation's shareholders, A and B, both individuals, sold their shares in the corporation to P, Q, and R, all individuals. On March 1, 1993, the corporation filed its election to be an S corporation for the 1993 taxable year. The election will be effective (assuming the other requirements of section 1361(b) are met) provided that all of the shareholders as of March 1, 1993, as well as former shareholders A and B, consent to the election.

Reg. 1.1362-6(b)(2): Who must consent to election

- The following rules apply in determining who is required to consent to the S election:
- ***Spousal and Joint Ownership of S Stock.*** Each person having a community interest in the stock (or income therefrom) and each tenant in common, joint tenant, and tenant by the entirety must consent to the election. Each person with an interest in the stock must separately consent to the election, even though (as in the case of spouses and family members) the individuals are counted as one shareholder for purposes of the 100-shareholder limit.
- ***Minor.*** A minor or the minor's legal representative must consent to the election. If no legal representative has been appointed and the minor cannot sign or is otherwise unable to consent, the consent is made by the minor's natural or adoptive parent.
- ***Estate.*** The consent of an estate must be made by an executor or administrator thereof, or by any other fiduciary duly appointed and having jurisdiction over the administration of the estate. In the case of a bankruptcy estate, the trustee consents to the S election.
- ***Trust.*** For a trust [other than an electing small business trust (ESBT)] that is an eligible S corporation shareholder, the persons treated as shareholders for purposes of the 100-shareholder limitation must consent to the election (see next slide). For married shareholders, both spouses must consent to the election if they have a community interest in the trust. The trustee of an ESBT consents to the election.
- ***Family Ownership.*** All family members are treated as one shareholder for purposes of determining the number of shareholders in the corporation. **For shareholder consent signatures, however, each person holding an interest in the S corporation's stock must sign the consent.**

Consent Relief Options

- Rev. Proc. 2013-30.
- Rev. Proc. 2004-35: automatic relief for spousal consents in community property states.
- Reg. Section 1.1362-6(b)(3)(iii) allows for an extension for a timely consent to be granted by the IRS if:
  - There was reasonable cause for the missed consent,
  - The request for the extension of time to file a consent is made within a reasonable amount of time under the circumstances, and
  - The interests of the government will not be jeopardized by treating the election as valid.

- If all else fails (for example, you need the consent of a deceased shareholder) the PLR process is available.

Three Things to Consider

- Three things you must keep to prepare for a potential acquisition of your client (the due diligence process)
  - ORIGINAL, executed copies of the Form 2553, 8869
  - ORIGINAL, executed copies of any QSST or ESBT elections.
  - Trust documents for any trust shareholders.

EY
Building a better working world

Excluding gain on qualified small business stock

Shareholders of private equity-backed portfolio companies can exclude gain on the sale of "qualified small business stock," but traps for the unwary loom.

Founders and private equity (PE) investors of a portfolio company may be able benefit from one of the most generous tax rules in all of the Internal Revenue Code: the ability to exclude a substantial amount of realized gain on the sale of "qualified small business stock" (QSBS) held longer than five years. For QSBS issued after July 4, 2025, a 50% exclusion is available after a 3-year holding period, a 75% exclusion can be claimed after four years, and a 100% exclusion is available after five years.

What portion of my gain from the sale of QSBS may be excluded?

Identifying the eligible exclusion percentage

QSBS issued after August 9, 1993, and before February 18, 2009, is eligible for a 50% exclusion. The exclusion percentage was increased to 75% for QSBS issued between February 18, 2009, and September 27, 2010. QSBS issued after that date is eligible for a 100% exclusion, subject to limitation. For QSBS issued after July 4, 2025, 50% and 75% exclusions after available after 3 and 4-year holding periods, respectively. Any eligible gain that is not excluded as a result of the percentage limitations is taxed at a rate of 28%.

The benefits

- A noncorporate shareholder who disposes of stock that meets the definition of QSBS may exclude from gain up to the greater of $10 million or 10 times the shareholder's basis in the stock. Thus, a shareholder who invests $2 million into QSBS may eventually exclude as much as $20 million of gain from taxable income. For QSBS issued after July 4, 2025, the $10 million limitation is increased to $15 million.
- If QSBS is sold before meeting the five-year holding period requirement, gain from the sale may be deferred — and eventually excluded from income — if the proceeds are reinvested into replacement QSBS within 60 days.
- Meeting the definition of QSBS requires that a portfolio company and its shareholders make sense of numerous terms of art and undergo several quantitative tests. Some of these tests must be met only at the date stock is issued while others must be met for substantially all of each shareholder's respective holding period.

1 Tests that must be met on the date stock is issued

For stock to eventually become QSBS in the hands of a shareholder, several tests must be met on the date the shareholder acquires the stock.

- The corporation must be a C corporation.
- The shareholder must acquire the stock at its original issuance in exchange for money, property or services.
- At all times from August 9, 1993, through immediately after the issuance, the aggregate gross assets of the corporation, taking into account amounts received in the issuance, must not have exceeded $50 million (for stock issued after July 4, 2025, the threshold is increased to $75 million).

2 Tests that must be met for substantially all of a shareholder's holding period

The following requirements must be met for substantially all of the shareholder's holding period:

- The corporation must be a C corporation.
- The corporation must be an "eligible business." Ineligible businesses include, among others, those in the field of health, law, engineering, performing arts, consulting, banking, financing or investing.
- The corporation must not be a domestic international sales corporation (DISC) or former DISC, a corporation with a Section 936 election in effect, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit, a financial asset securitization investment trust or a cooperative.
- 80% of the assets of the business (by value) must be used in the active conduct of a trade or business.

Special considerations for PE investors

When a PE investor taxed as a partnership sells QSBS, the gain is passed through to its partners, who may then exclude the gain at the individual level. Special rules govern which partners may exclude gain and to what extent the passed-through gain may be excluded.

We can help

There is no more tax-efficient exit than one that allows a shareholder to exclude the gain arising from the sale of the company's stock from taxable income. At first glance, the requirements may not seem that complicated; however, properly analyzing the QSBS requirements and documenting that stock qualifies as QSBS can be an involved and complicated process.

Most QSBS studies we perform are on behalf of the issuing corporation for the benefit of key shareholders, such as founding shareholders, executives who have acquired significant stockholdings through compensatory awards and private equity investors. QSBS studies may also be performed on behalf of a selling shareholder. Typically, we are engaged to perform a QSBS study when there has been, or there is planned, a liquidity event involving stock of the corporation.

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