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In this article, Spiro examines the ambiguities of owning qualified small business stock through a partnership and how those ambiguities should be addressed in future guidance.

This article uses real-world examples to explore ambiguities in the ownership of qualified small business stock (QSBS) through partnerships, and it offers suggestions for sensible guidance to provide flexibility in the use of partnerships in QSBS transactions while preserving the fundamental purposes of section 1202.

I. The General Statutory Framework

A. General Description of QSBS

Several excellent articles[1] (and one pretty good one)[2] have examined how section 1202 allows for the exclusion of capital gain recognized upon the sale of QSBS if certain holding period requirements are met. Before the One Big Beautiful Bill Act (P.L. 119-21), QSBS was eligible for 100 percent exclusion if held for more than five years. For QSBS issued after the effective date of the OBBBA, QSBS is eligible for (1) 50 percent exclusion if held for at least three years, (2) 75 percent exclusion if held for at least four years, and (3) 100 percent exclusion if held for five years or more.

To be QSBS, stock must be (1) issued by a qualified small business; (2) acquired at original issuance in exchange for money or property other than stock of a corporation; and (3) the issuer must be engaged in an active business during substantially all of the taxpayer's holding period of the stock.

B. Qualified Small Business

To be a qualified small business, a C corporation must at all times before and immediately after the issuance of the relevant stock have aggregate gross assets of $75 million or less (subject to inflation adjustments for calendar years after 2026).[3] For this purpose, the term "aggregate gross assets" is generally based on the tax basis of the corporation's property. However, property that is contributed to a corporation in kind will be deemed to have an adjusted tax basis equal to its fair market value on the date of its contribution.[4] The House conference report to the 1993 Revenue Reconciliation Act clarified that for stock acquired through the exercise of options or

[1] *See, e.g.*, Janet Andolina and Kelsey Lemaster, "Candy Land or Sorry: Thoughts on Qualified Small Business Stock," *Tax Notes*, Jan. 8, 2018, p. 205; Paul S. Lee et al., "Qualified Small Business Stock: Quest for Quantum Exclusions," *Tax Notes Federal*, July 6, 2020, p. 15; Lee et al., "Qualified Small Business Stock: Quest for Quantum Exclusions, Part 2," *Tax Notes Federal*, July 13, 2020, p. 217; Lee et al., "Qualified Small Business Stock: Quest for Quantum Exclusions, Part 3," *Tax Notes Federal*, July 20, 2020, p. 409; Stefan Gottschalk and Joseph Wiener "Travels Through 1202," *Tax Notes Federal*, Sept. 27, 2021, p. 2083.

[2] Michael P. Spiro, "Private Equity and Qualified Small Business Stock: Tax Implications of Various Holding Company Structures for Control Investments," 23(1) *J. Priv. Equity* 10 (2019).

[3] Section 1202(d)(1); section 1202(d)(4). For QSBS issued before the OBBBA, the aggregate gross assets limit was $50 million, which was not indexed for inflation.

[4] Section 1202(d)(2).

warrants, the determination of whether the gross assets test is met is made at the time of exercise.[5]

C. Active Business

To issue QSBS, a corporation must meet an active trade or business requirement for substantially all of the taxpayer's holding period in the stock.[6] A corporation meets this requirement as long as it is a U.S. corporation and at least 80 percent of its assets are used in the conduct of a qualified trade or business.[7] A qualified trade or business is generally any business other than the following: (1) 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 in which the principal asset of the trade or business is the reputation or skill of one or more of its employees; (2) any banking, insurance, financing, leasing, investing, or similar business; (3) any farming business (including the business of raising or harvesting trees); (4) any business involving the production or extraction of products of a character for which a deduction is allowable under sections 613 or 613A (for example, oil and gas extraction); and (5) any business of operating a hotel, motel, restaurant, or similar business (collectively, the nonqualified businesses).[8] A corporation will be deemed to be engaged in any trade or business engaged in by a subsidiary corporation owned more than 50 percent by the corporation.[9]

D. QSBS and Partnerships

Although the statute generally contemplates that QSBS would be held and disposed of directly by a noncorporate taxpayer, section 1202(g) provides that otherwise qualifying taxpayers that own QSBS indirectly through a passthrough entity can likewise qualify for exclusion if certain requirements are met. For this purpose, a PTE includes a partnership.[10] Under section 1202(g), amounts included in income by reason of holding an interest in a PTE can qualify for capital gains exclusion if the following requirements are satisfied:

> (A) Such amount is attributable to gain on the sale or exchange by the pass-thru entity of stock which is qualified small business stock in the hands of such entity (determined by treating such entity as an individual) and which was held by such entity for at least 3 years (more than 5 years in the case of stock acquired on or before the [effective date of OBBA]), and
>
> (B) Such amount is includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-thru entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-thru entity.[11]

The exclusion does not apply "to the extent such amount exceeds the amount to which paragraph (1) would have applied [that is, the amount that would have been eligible for exclusion as a distributive share of passthrough income] 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."[12]

Section 1202(h)(2)(C) provides that stock transferred by a partnership to a partner "with respect to which requirements similar to the requirements of subsection (g) are met at the time of the transfer (without regard to the 5-year holding period requirement)" can continue to be QSBS. Stock acquired by gift also retains its character as QSBS.[13]

[5] H.R. Rep. No. 103-213.

[6] Section 1202(c)(2).

[7] Section 1202(e).

[8] Section 1202(e)(3).

[9] Section 1202(d)(3)(A).

[10] Section 1202(g)(4)(A).

[11] Section 1202(g)(1)(A)-(B).

[12] Section 1202(g)(3).

[13] Section 1202(h)(2)(A).

II. Ownership of QSBS Through Partnerships: Selected Issues

A. Partnership Transfers

1. QSBS contributed to a partnership.

Section 1202 is silent about whether QSBS contributed to a partnership in a tax-free transfer under section 721 would disqualify the stock. In general, to qualify as QSBS under section 1202(c)(1)(B), stock must be acquired "by the taxpayer at its original issue (directly or through an underwriter) in exchange for money or other property (not including stock) or as compensation for services provided to such corporation (other than services performed as an underwriter of such stock)." Under section 1202(g), stock sold by a PTE is only eligible for exclusion to the extent the stock "is qualified small business stock in the hands of such entity (determined by treating such entity as an individual)." Likewise, transfers under section 721 do not appear on the list of exceptions to the original issuance requirement under which transfers of QSBS do not disqualify the stock.

Therefore, although not addressed, it certainly appears that a transfer of QSBS to a partnership in exchange for partnership interests would disqualify the QSBS. Indeed, this is the conclusion the House arrived at in its official committee report, saying that "if qualified small business stock is transferred to a partnership and the partnership disposes of the stock, any gain from the disposition will not be eligible for exclusion."[14] This strict entity approach (in which a partnership is expressly treated as a separate taxpayer from its partners) is unique in section 1202 to transfers to a partnership. It is difficult to articulate a policy rationale for this significant trap for the unwary, but in the absence of guidance to the contrary, the statute seems to foreclose any alternative interpretation.

One question that arises is whether an inadvertent disqualification of QSBS by virtue of a partnership contribution can be remedied by a partnership distribution. Consider the following example.

Example 1. Individual A acquires QSBS at original issuance. On December 31 of the year in which the stock was issued, A, on the advice of his estate planners (who were unaware of the stock's status as QSBS), transfers the QSBS to partnership ABC, a family limited partnership, to facilitate interfamilial gifting. On January 30 of the following year,[15] A's advisers become aware that the transfer of the stock had likely disqualified the QSBS. Can an in-kind distribution of the stock to A reestablish its status as QSBS?

When the QSBS was issued to A, the stock qualified as QSBS. Under section 735(b) and section 1223(2), when the stock is distributed to A by ABC, A's holding period of the stock will include the period during which it was held by ABC. Thus, unless the disqualification of the stock that occurred when the QSBS was transferred to ABC was permanent, it might appear as though the stock remains QSBS in the hands of A. Put another way, did A's original acquisition of the stock at original issuance remain in effect after the transfer to ABC, or did the transfer to and from ABC introduce a second acquisition of the stock by A — which second acquisition was not at original issuance but rather a transfer from a separate taxpayer (ABC)?

The IRS would likely argue that the original issuance requirement had been violated upon the subsequent transfer to and from ABC. However, the statute is silent on this point, and in the absence of guidance, a taxpayer could certainly argue that the acquisition at original issuance is the only relevant consideration if it is the seller of the stock that is attempting to claim exclusion. In this connection, it would seem inconsistent for the IRS to treat an acquisition by distribution from a partnership as a disqualifying event given that the statute explicitly provides for QSBS that is distributed by a partnership to retain its character as such.

2. Transfers of interests in partnerships that own QSBS.

It is not entirely clear whether a transfer of an interest in a partnership that holds QSBS to a

[14] H.R. Rep. No. 103-111.

[15] Because the transfer crosses a tax year, the IRS would generally take the position that the recission doctrine would not be available to simply undo the transaction. *See* Rev. Rul. 80-58, 1980-1 C.B. 181.

second partnership (an upper-tier partnership) would result in the loss of capital gain exclusion. Consider the following example.

Example 2. Partnership ABC holds QSBS. Partner B holds a 30 percent interest in ABC, which it held on the date that the QSBS was issued to ABC. Partner B contributes its interest in ABC to a new partnership (DEF) of which B is the 95 percent owner. If ABC sells the QSBS after five years, is the gain allocable to B through DEF eligible for exclusion?

As observed above, the statutory language provides that gain recognized indirectly through a PTE can qualify for exclusion so long as (1) the stock qualifies as QSBS in the hands of the PTE selling the stock and (2) the amount is included by the taxpayer by reason of holding an interest in that entity on the date the PTE acquired the stock and at all times after.

In this example, ABC is a partnership that acquired the QSBS at original issuance. Thus, the stock itself remains QSBS despite the transfer of ABC interests. When ABC sells the QSBS, gain will flow through ABC to DEF and through DEF to B. The question arises whether the gain that flows through DEF to B remains excludable QSBS gain, or whether the transfer of the ABC interests to DEF causes the gain to lose its status as excludable gain when it is allocated to DEF.

The answer appears to depend on whether DEF is the taxpayer for this purpose (in which case, DEF would not qualify for exclusion as it did not own an interest in ABC on the date the QSBS was issued) or whether the relevant taxpayer is B — who did own an interest in ABC when the QSBS was issued, and continued to hold that interest indirectly (as to B's 95 percent interest in DEF) at all times until the sale. The statute itself offers no guidance on this (or any other) issue involving tiered partnerships. The legislative history is somewhat instructive. During the proceedings and debates concerning the 1993 adoption of H.R. 2264, the final version of the Budget Reconciliation Act that created section 1202, then-Sen. Joseph Lieberman, one of the two sponsors of the legislation in the Senate, entered the following explanations into the Congressional Record to clarify the intent of the PTE provisions of section 1202:

> A taxpayer who is an individual holding an interest in an upper tier partnership that is a partner in a lower-tier partnership shall be entitled to exclude that taxpayer's share of gain realized on the sale or exchange by the lower tier partnership of stock that would be qualified small business stock if held directly by an individual, subject to limitations similar to those applicable to taxpayers holding direct interests in the lower-tier partnership but determined by reference to both the upper tier partnership's interest in the lower tier partnership at the time that stock was acquired, and by the taxpayer's interest in the upper tier partnership at such time.[16]

The notion that the limitations would apply at both the upper-tier partnership and the lower-tier partnership would indicate that the upper-tier transfer probably results in a loss of gain exclusion because B did not hold its interest in DEF on the date that ABC acquired the QSBS. Further, as a matter of statutory construction, section 7701(a)(14) defines the term "taxpayer" as "any person subject to any internal revenue tax." Although partnerships are not subject to federal income tax, they are subject to other internal revenue taxes, including payroll taxes and excise taxes. This has generally led courts to construe the term "taxpayer" to include partnerships.[17] Thus, while there is an argument that the transfer of ABC interests to DEF would not disqualify the stock, B seems to be on shaky ground.

B. Issuances of QSBS and Non-QSBS by Wholly Owned Corporations in a Single Transaction

In some cases, a corporation will be formed as a wholly owned subsidiary of a partnership.[18] In those cases, there are many ways in which contributions to the corporation can result in the issuance of both QSBS and non-QSBS. When potentially qualifying and nonqualifying shares

[16] 139 Cong. Rec. S10680-01 Proceedings and Debates, at S10732-S10733 (Aug. 6, 1993) (hereinafter, the "Senate Debates").

[17] *See, e.g., Hayden v. Commissioner*, 112 T.C. 115 (1999).

[18] For a description of the many tax and nontax reasons underlying this common top hat structure, *see* Spiro, *supra* note 2.

are issued to a sole shareholder in the context of a single transaction, there is no guidance regarding the rules to apply in determining the QSBS status of the issued stock.

Example 3. ABC is a private equity fund and seeks to acquire the stock of DEF. DEF is engaged in a qualifying trade or business. Its aggregate gross assets (based on tax basis) are $10 million and all other requirements for the issuance of QSBS are met. However, all the outstanding stock of DEF was issued before 1993, so its outstanding shares are not QSBS. ABC intends to acquire the stock of DEF from its shareholders (the Sellers) for a total enterprise value of $50 million. To structure the acquisition, ABC forms DEF Holdings LLC, a limited liability company taxed as a partnership (DEFH LLC). DEF LLC in turn forms DEF Holdings Inc. (DEFH Inc.). At the closing of the transaction, ABC will contribute $40 million in cash to DEFH LLC in exchange for 80 percent of the equity of DEFH LLC, and the Sellers will contribute $10 million of stock of DEF (in which they have a tax basis of zero) to DEFH LLC in exchange for 20 percent of the equity of DEFH LLC. DEFH LLC will in turn contribute both the $40 million in cash and the $10 million of DEF stock to DEFH Inc. in exchange for 100 shares of stock in DEF Inc., representing 100 percent of the capital stock of DEF Inc. DEF Inc. will then use the $40 million in cash to purchase the remaining stock of DEF from the Sellers. To what extent is stock issued by DEFH Inc. QSBS?

In this example, the business of DEF meets all the requirements for QSBS. As a newly formed corporation, all the stock of DEFH Inc. will be acquired by DEFH LLC at original issuance. However, the stock of DEFH Inc. will be acquired by DEFH LLC in exchange for both (1) $40 million in cash and (2) non-QSBS stock of DEF.[19]

Section 1202(c)(1)(B) provides that to qualify as QSBS, stock must be acquired at original issuance "in exchange for money or other property (not including stock)." There are at least two ways to view the exchange of cash and non-QSBS for newly issued stock. The first (and more advantageous option) is that there is an issuance of 80 shares of new QSBS in exchange for the $40 million in cash and an issuance of 20 shares of new non-QSBS in exchange for the $10 million of non-QSBS (separate share treatment). The second (and less advantageous option) is that there is an issuance of 100 shares, each in exchange for 20 percent non-QSBS and 80 percent cash (bifurcated share treatment). If the bifurcated share treatment were adopted, it is unclear whether none of the new DEFH Inc. shares would be QSBS (as each share was issued in exchange for cash and stock, thus failing the requirement that shares be issued for "money or other property (not including stock)") or if each share would be QSBS in part and non-QSBS in part (because there is nothing the in the statute that would seem to disqualify the portion of a share issued in exchange for money).

The argument in favor of adopting a bifurcated share approach to this scenario would generally be based on Rev. Rul. 85-164, 1985-2 C.B. 117. In that ruling, the IRS considered a situation in which a sole proprietor contributed the assets of a trade or business to a newly formed corporation in exchange for all the capital stock of the corporation in a transaction governed by section 351. At issue was whether the transferor was permitted, for purposes of determining the tax basis and holding period of the stock received in the exchange, to designate specific property exchanged for specific securities. The IRS ruled against a specific identification of property for shares approach, finding that:

> The aggregate basis of the property transferred is allocated among the stock and the securities received in proportion to the fair market values of each class. The holding period of the Y stock and securities received by A is determined by referring to the assets deemed exchanged for each portion of the stock and securities.

[19]This article does not address whether it is consistent with the legislative purpose of section 1202's original issuance requirement for it to apply to corporations that are formed to acquire the stock of existing corporations. However, it is reasonably clear that the statutory requirements of section 1202 can be met in that structure. Moreover, there are several non-section 1202 related reasons that a new corporation might be formed to facilitate that acquisition — creating a credit structure that allows for debt to be incurred at the corporate level, formation of a credit party that can offer a single pledge of the shares of the operating corporation to a lender, etc. — so that it would be very difficult for the IRS to attempt to invoke section 269 or the economic substance doctrine to attack the application of section 1202.

Thus, in the QSBS context, the IRS could argue that each share of DEFH stock was issued in exchange for both non-QSBS stock and cash.

Despite the appeal of the bifurcated share approach, it is my view that the separate share approach is more appropriate (and may even be mandated) in the context of a partnership transfer. Reg. section 1.704-3(a)(8)(i) provides in relevant part that:

> If a partnership transfers an item of section 704(c) property together with other property to a corporation under section 351, in order to preserve that item's built-in gain or loss, the basis in the stock received in exchange for the section 704(c) property is determined as if each item of section 704(c) property had been the only property transferred to the corporation by the partnership.

This regulation is not consistent with Rev. Rul. 85-164 and appears designed to operate as an exception to the general rule established by that ruling.[20] This exception is appropriate in the context of a partnership transferor, as it is necessary to preserve an aggregate result in the formation transaction so that built-in gain or loss with respect to contributed property cannot be shifted by making a transfer described in section 351. That is, when a contribution in a section 351 transaction is traceable to an individual partner's contribution of built-in gain or built-in loss property by a specific partner, adopting a separate share approach to the stock received in exchange allows for the continued tracking of that aggregate result to the applicable partner to prevent the type of income and loss shifting that was the goal of section 704(c).[21]

Moreover, even if Rev. Rul. 85-164 were to apply to the current scenario, by its terms, that ruling applies as a matter of controlling tax basis and holding period. It does not necessarily follow that the same characterization should apply for purposes of determining whether stock was issued in exchange for money or stock for purposes of section 1202. That is, even if the federal tax basis and holding period were determined under a bifurcated share approach, section 1202 appears to be based on a factual analysis of the consideration for a particular share of stock.[22] It is an axiom of tax law that "State law creates legal rights and property interests while the Federal law determines what, and to what extent, interests or rights, so created shall be taxed."[23] Thus, if state law treated the exchange of shares as being severable, then in the absence of guidance to the contrary, that state law characterization would govern the analysis of whether the stock was issued in exchange for money or stock — even if federal tax law imposed a different analysis for determining basis and holding period. In fact, Delaware corporate law generally allows the board of directors of a Delaware corporation to determine the consideration allocable to shares of the corporation's stock by resolution.[24] In this connection, the position that separate shares of the corporation can be issued in exchange for separate consideration could be bolstered by having DEFH Inc. issue two separate classes of voting shares — one for cash and the other for non-QSBS shares. State law would seemingly respect this bifurcation so long as the corporation memorialized the separate consideration in appropriate resolutions of the board of directors. Thus, although there is an argument to the contrary, it appears that the position can be taken that the shares issued to DEFH LLC ought to be treated as two separate lots of shares — 80 shares of QSBS issued in exchange for cash and 20 shares of non-QSBS issued in exchange for non-QSBS.

[20] *See* New York State Bar Association Tax Section, "Report on Various Issues Arising Under Section 704(c)(1)(A)," Report No. 1519, at 13 (Jan. 9, 2026) ("A literal reading of the Substituted Property Rules would require using the specific identification approach. Moreover, the blended basis approach clashes with general section 704(c) principles.").

[21] Reg. section 1.704-3(a)(1) ("The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss.").

[22] Section 1202 has its own rules for determining basis and holding period for purposes of computing excludable gain.

[23] *Estate of Craft v. Commissioner*, 68 T.C. 249, 263 (1977).

[24] 8 Del. Code section 152(a) (2025) ("The consideration for subscriptions to, or the purchase of, the capital stock to be issued by a corporation shall be paid in the form and in the manner that the board of directors shall determine. The board of directors may authorize capital stock to be issued for consideration consisting of cash, any tangible or intangible property or any benefit to the corporation, or any combination thereof. Stock may be issued in 1 or more transactions, in the numbers, at the times and for the consideration as set forth in a resolution of the board of directors.").

C. Allocations of Gain by Partnerships on Sale of QSBS

The gain on the sale of QSBS allocated by a partnership is not eligible for capital gains exclusion "to the extent such amount exceeds the amount to which [exclusion] 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."[25]

This seemingly simple rule raises several questions. First, it is not at all clear what is meant by "interest" in a partnership. Here, too, the only legislative history on point is Lieberman's guidance:

> In the case of a partnership, it is intended that a partner's interest in that partnership at the time the partnership acquired qualified small business stock will be equal to the greater of the partner's interest in the capital or profits of the partnership at that time.[26]

This guidance is somewhat at odds with the regulatory guidance provided under section 1045. Section 1045 allows for the rollover of gain from the sale of QSBS when gain from the sale of QSBS held for more than six months may be reinvested on a pretax basis in replacement QSBS. Section 1045(b)(5) provides that "Rules similar to the rules for subsections (f), (g), (h), (i), (j) and (k) of Section 1202 shall apply." In 2007 Treasury promulgated final regulations under section 1045. Under these regulations, the maximum amount that a partner of a partnership holding QSBS may defer under section 1045 is limited to the product of (x) the partnership's realized gain from the sale of QSBS times (y) the partners' smallest percentage interest in partnership capital from the date of the partnership's acquisition of QSBS.[27] In the preamble to this regulation, Treasury expressed its view that this requirement is "consistent with Section 1202(g)(2) and (3)."[28]

Despite this language, Treasury has not taken the opportunity to promulgate similar regulations under section 1202, and the section 1045 regulations would seem to fly in the face of congressional intent in their use of the term "interest" in the partnership. Moreover, in the absence of statutory language to the contrary, it seems reasonable to assume that the words "the interest the taxpayer held" in a PTE would, when applied to a partnership, have the same meaning as the statutory words "partner's interest in the partnership" (PIP) as that term is used in section 704(b). As discussed below, the PIP has long been the standard by which partnership allocations of income, gain, loss, and deduction are tested. There is little to suggest that a different standard was intended for QSBS (although, as discussed below, the application of this standard in the QSBS context remains highly ambiguous).

This disconnect between the regulations under section 1045 and the statutory language of section 1202 has frequently been discussed in determining whether the holder of a profits interest in a partnership on the date the partnership acquires QSBS at original issuance can qualify for the exclusion under section 1202.[29] This question remains open to interpretation. Less commonly discussed are issues concerning how to allocate excludable and nonexcludable gain among partners — and the questions involving those allocations can have meaningful economic implications.

Allocations of gain on QSBS and non-QSBS. In Example 3 above, both QSBS and non-QSBS were issued to a partnership in a single transaction. In that transaction, certain partners contributed cash in exchange for QSBS, and other partners contributed stock in exchange for non-QSBS. In

[25] Section 1202(g)(3).

[26] Senate Debates, *supra* note 16, at S10732-S10733.

[27] Reg. section 1.1045-1(d)(1), (2).

[28] T.D. 9353, 72 F.R. 45346-45358 (Aug. 14, 2007).

[29] *See* Andolina and Lemaster, *supra* note 1, at Section III.F.3; Spiro, *supra* note 2, at 15.

the absence of a partnership, it is reasonably clear that the shareholder who exchanged cash for QSBS would hold its stock as QSBS and the shareholder that exchanged stock for non-QSBS would hold stock that is not QSBS. However, the interposition of a partnership could affect this result.

Example 4. Same facts as Example 3. Seller owns a 20 percent partnership interest in DEFH LLC, received in exchange for a $10 million contribution of stock. ABC owns an 80 percent partnership interest in DEFH LLC, which was received in exchange for a $40 million cash contribution. DEFH LLC owns 80 shares of QSBS in DEF Inc. (received in connection with the contribution of cash) and 20 shares of non-QSBS (received in connection with the contribution of DEF stock). After five years, DEF Inc.'s stock is sold for $100 million in cash. Because the DEF stock contributed by Seller had a $0 basis at the time of the contribution, the $10 million of built-in gain on that stock will be allocated to Seller under section 704(c). The remaining $50 million in gain (the 704(b) gain) is allocable, $40 million to ABC and $10 million to Seller. The DEFH LLC partnership agreement meets the economic effect safe harbor requirements of reg. section 1.704-1(b)(2)(ii). How should excludable and nonexcludable gain under section 1202 be allocated among the partners?

Under section 704(a), income and gain of a partnership are generally allocated among partners in accordance with the partnership agreement. Section 704(b) then goes on to explain that if an allocation is not provided in the partnership agreement or if an allocation provided in the partnership agreement lacks substantial economic effect, then the relevant item is allocated in accordance with the partners' interests in the partnership. In the present scenario, it seems that there are two potential ways to allocate the excludable and nonexcludable gain among the partners: Either (1) ABC and Seller could each receive an allocation of gain that is 80 percent QSBS excludable gain and 20 percent non-QSBS excludable gain (the blended approach), or (2) the 80 percent excludable gain attributable to the shares issued for the ABC contribution could be allocated to ABC and the 20 percent of nonexcludable gain attributable to the shares issued for the Seller contribution could be allocated to Seller (the tracking approach). At the outset, it is clear that the tracking approach would best replicate the aggregate result in the absence of a partnership. However, that is not necessarily the determinative factor.

If the partnership agreement of DEFH LLC specifies that either the blended approach or the tracking approach should be used, the first question is whether that allocation would have a substantial economic effect under section 704(b) and the regulations. The partnership agreement of DEFH LLC includes the required provisions to ensure economic effect and indeed, the allocation of $40 million to ABC and of $10 million to Seller will match their respective entitlements to gain from the sale of DEF Inc. stock. Thus, an allocation under either approach should have an economic effect.

The general test for substantiality is that there be "a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership independent of tax consequences."[30] That is, if the allocation affects the pretax economic returns of the partners receiving it, it will be substantial. The regulation then imposes a second after-tax test, which provides that even if this general test is met, an allocation is not substantial:

> If at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. . . . References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation (or allocations) were not contained in the

[30] Reg. section 1.704-1(b)(2)(iii).

> partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners' interests in the partnership (within the meaning of paragraph (b)(3) of this section), disregarding the allocation (or allocations) being tested under this paragraph (b)(2)(iii).[31]

The first question is whether the allocations under the tracking approach or the blended approach meet the general test of whether the allocation "will affect substantially the dollar amounts to be received by the partners from the partnership independent of tax consequences." Depending on how the regulatory language is read, this can be a difficult test to apply. On one hand, the allocation of gain to each of Seller and ABC will affect their economic entitlements because it will give rise to an entitlement to receive proceeds from the sale of DEF Inc. stock upon the partnership's liquidation. That is to say, the allocation has economic effect and will therefore affect the dollar amounts to be received without regard to tax consequences. On the other hand, if, instead of looking at either approach in a vacuum, the allocation under the tracking approach is compared with an allocation under the blended approach (or vice versa), the allocation will fail this test because there is no difference in the amount that any partner will receive between these two approaches. In short, depending on how this pretax test is read, either both the tracking approach and the blended approach meet the requirements of the test (as both result in a substantial effect on the economic rights of the recipients), or neither meets the requirements of the test — as neither, relative to the other, affects the pretax economic consequences of the allocation. The regulations that explain the substantiality requirements do not include an example in which substantiality is missing solely as a result of an allocation of a specific type of income lacking an economic effect relative to an allocation of a different character of income. Based on the regulatory history and the plain language of the regulation, most commentators take the view that the pretax requirement is simply that the allocation must be reasonably expected to result in some realization of income without taking taxable character into account at all.[32]

If we assume that the pretax test has been met in the scenario above, using either the tracking approach or the blended approach to make gain allocations would be substantial. Seller was a 20 percent partner of DEFH LLC on the date the QSBS of DEF Inc. was issued to DEFH LLC. Thus, under the blended approach, Seller would be entitled to exclude its share of excludable gain allocated for the QSBS. Thus, if Seller was allocated $8 of excludable gain and $2 of nonexcludable gain and ABC was allocated $32 of excludable gain and $8 of nonexcludable gain, and each of Seller and ABC was subject to tax on the nonexcludable gain at the same rate, the overall tax paid would be the tax on $10 of nonexcludable gain. This is the same aggregate tax result as in the tracking approach in which ABC recognizes $40 of excludable gain, and Seller recognizes $10 of nonexcludable gain.

Substantial economic effect being present, no further analysis under the PIP standard is required. Under this reading, unlike if Seller and ABC had directly formed the corporation (in which case, ABC would hold QSBS and Seller would hold non-QSBS), the presence of a partnership allows the blended approach to be used, in which ABC can share the QSBS exclusion with Seller. Indeed, although not completely clear, this result might even persist in situations in which the relevant allocation may not have substantial economic effect.

Example 5. The facts are the same as in Example 4, but the Seller is subject to tax at the individual capital gains rate, and the owners of ABC are tax-exempt. The DEFH LLC partnership agreement specifies that a blended approach should be used to allocate the excludable and

[31] *Id.*

[32] This reading is the one generally adopted by most commentators. The pretax test has been explained as being different from the general test for economic effect, only in that it includes a focus on likelihood that the allocation will result in a realized economic gain or loss (rather than representing a transitory amount). *See* W. Eugene Seago and Kenneth N. Orbach, "Partnership Allocations That Are 'Special,'" *Tax Notes*, Feb. 13, 2017, p. 861 ("The substantiality test accounts for the reasonable possibility that the capital adjustment each year might be countered by events occurring after the end of the tax year of the allocation. 'Reasonable possibility' suggests a degree of certainty or its converse, risk.").

nonexcludable gain on the sale of DEF Inc. stock. Is the allocation valid?

In this case, allocating excludable and nonexcludable gains pro rata between ABC and the Seller will result in a lower overall tax liability than would be the case if a tracking approach were used. If the tracking approach had been used, all the gain attributable to the QSBS would have been allocated to ABC, which would not have paid tax because of the tax-exempt nature of the ABC partners. The $10 million of 704(b) gain allocated to Seller would all be subject to tax at a 20 percent capital gains rate, resulting in aggregate tax paid of $2 million.

However, using the blended approach means that of the $10 million in 704(b) gain allocated to Seller, 80 percent is eligible for exclusion under section 1202, reducing Seller's tax to $400,000. ABC continues to pay no tax because of the tax-exempt status of its partners. Clearly, if viewed relative to use of the tracking approach, the blended approach would lack substantial economic effect. However, the regulations require that the alternative against which an allocation is tested for this purpose is based on the PIP standard.

The term "partner's interest in the partnership" is notoriously ambiguous. The regulations define PIP as:

> The manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction or credit (or item thereof) that is allocated. . . . This sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner's capital account back up to zero.) The determination of a partner's interest in the partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners.[33]

The regulations then recite certain facts considered in making a PIP determination, including the partners' relative contributions to the partnership, the interests of the partners in economic profits and losses, the interests of the partners in cash flow and other nonliquidating distributions, and the rights of the partners to distributions of capital upon liquidation.[34] There are two examples in the regulations that consider scenarios in which a partnership with two partners who pay tax at different marginal rates allocates the returns on tax-exempt and taxable securities separately between the partners in a manner that lacks substantiality.[35] In reg. section 1.704-1(b)(5), Example 5, the facts are as follows:

> Individuals I and J are the only partners of an investment partnership. The partnership owns corporate stocks, corporate debt instruments, and tax-exempt debt instruments. Over the next several years, I expects to be in the 50 percent marginal tax bracket, and J expects to be in the 15 percent marginal tax bracket. There is a strong likelihood that in each of the next several years the partnership will realize between $450 and $550 of tax-exempt interest and between $450 and $550 of a combination of taxable interest and dividends from its investments. I and J made equal capital contributions to the partnership, and they have agreed to share equally in gains and losses from the sale of the partnership's investment securities. I and J agree, however, that rather than share interest and dividends of the partnership equally, they will allocate the partnership's tax-exempt interest 80 percent to I and 20 percent to J and will distribute cash

[33] Reg. section 1.704-1(b)(3)(i).

[34] Reg. section 1.704-1(b)(3)(ii).

[35] Reg. section 1.704-1(b)(5), examples 5 and 7.

> derived from interest received on the tax-exempt bonds in the same percentages. In addition, they agree to allocate 100 percent of the partnership's taxable interest and dividends to J and to distribute cash derived from interest and dividends received on the corporate stocks and debt instruments 100 percent to J.

The regulatory example explains that because this allocation is likely to result in a reduction in the overall tax liabilities of the partners, it lacks substantiality and must be reallocated in accordance with PIP. The example then explains this reallocation using the results of a sample year as follows:

> In the first partnership taxable year in which the allocation arrangement described in (i) applies, the partnership realizes $450 of tax-exempt interest and $550 of taxable interest and dividends, so that, pursuant to the partnership agreement, I's capital account is credited with $360 (80 percent of the tax-exempt interest), and J's capital account is credited with $640 (20 percent of the tax-exempt interest and 100 percent of the taxable interest and dividends). The allocations of tax-exempt interest and taxable interest and dividends (which do not have substantial economic effect for the reasons stated in (i) will be disregarded and will be reallocated. Since under the partnership agreement I will receive 36 percent (360/1,000) and J will receive 64 percent (640/1,000) of the partnership's total investment income in such year, under paragraph (b)(3) of this section the partnership's tax-exempt interest and taxable interest and dividends each will be reallocated 36 percent to I and 64 percent to J.

The example does not go through a facts and circumstances-based analysis of why PIP would mandate a pro rata allocation of both taxable and tax-exempt income. The fact that I and J had agreed to share equally in gains and losses from the sale of the securities is noted but never enters into the analysis. Thus, it is unclear whether the example means to imply that (1) PIP always requires a pro rata allocation of income of different character (even, as in this example, when the income of different character may actually result in a change in economic ownership) or (2) that if PIP requires pro rata allocation (based on a facts and circumstances analysis that is omitted from the example) the allocation will apply in all cases.

Reg. section 1.704-1(b)(5), Example 7 does not provide much in the way of additional color. In Example 7, the facts are similar:

> M and N are partners in the MN general partnership, which is engaged in an active business. Income, gain, loss, and deduction from MN's business is allocated equally between M and N. The partnership, M, and N have calendar taxable years. . . . In order to enhance the credit standing of the partnership, the partners contribute surplus funds to the partnership, which the partners agree to invest in equal dollar amounts of tax-exempt bonds and corporate stock for the partnership's first 3 taxable years. M is expected to be in a higher marginal tax bracket than N during those 3 years. At the time the decision to make these investments is made, it is agreed that, during the 3-year period of the investment, M will be allocated 90 percent and N 10 percent of the interest income from the tax-exempt bonds as well as any gain or loss from the sale thereof, and that M will be allocated 10 percent and N 90 percent of the dividend income from the corporate stock as well as any gain or loss from the sale thereof. At the time the allocations concerning the investments become part of the partnership agreement, there is not a strong likelihood that the gain or loss from the sale of the stock will be substantially equal to the gain or loss from the sale of the tax-exempt bonds, but there is a strong likelihood that the tax-exempt interest and the taxable dividends realized from these investments during the 3-year period will not differ substantially. These allocations have economic effect, and the economic effect of the allocations of the gain or loss on the sale of the tax-exempt bonds and

corporate stock is substantial. The economic effect of the allocations of the tax-exempt interest and the taxable dividends, however, is not substantial under the test described in paragraph (b)(2)(iii)(c) of this section because there is a strong likelihood, at the time the allocations become part of the partnership agreement, that at the end of the 3-year period to which such allocations relate, the net increases and decreases to M's and N's capital accounts will be the same with such allocations as they would have been in the absence of such allocations, and that the total taxes of M and N for the taxable years to which such allocations relate will be reduced as a result of such allocations. If in fact the amounts of the tax-exempt interest and taxable dividends earned by the partnership during the 3-year period are equal, the tax-exempt interest and taxable dividends will be reallocated to the partners in equal shares under paragraph (b)(3) of this section. If not, the tax-exempt interest and taxable dividends will be reallocated between M and N in proportion to the net increases in their capital accounts during such 3-year period due to the allocation of such items under the partnership agreement.

Here, the facts differ from reg. section 1.704-1(b)(5), Example 5 in that the partners also agreed to share the proceeds of the sale of securities based on separate tracking. However, once the example determined that substantiality was missing, it assumed that a pro rata allocation was appropriate under PIP without any further analysis.

If these regulations are read to mean that PIP always mandates a blended approach to allocating items of income, gain, loss, and deduction, then in the above example, even though the blended approach to making tax allocations for the sale of the stock of DEF Inc. results in a much lower overall tax liability than the tracking approach, use of the blended approach would still be substantial because there would be no basis for comparing the approach to the use of a tracking approach. This would seem to suggest that a blended approach will always be respected — even though it frustrates the legislative purpose of section 1202 and can achieve a far more tax-favorable result than allocating gain from QSBS on an aggregate basis. This inefficiency could be used by savvy investors to manipulate business economics. Consider the following example.

Example 6. F is the owner and founder of a C corporation (B) with a market value of $40 million. F has held his stock since before 1993, so it is not QSBS. F seeks to raise $10 million for 20 percent of the stock of B (at an implied pre-investment valuation of $40 million). F has a $0 basis in his stock. Venture capital fund CDE offers to make a $10 million primary investment on the terms requested by F. Before F can accept the proposal, family office O (which is subject to tax at the same rate as F) makes an alternative proposal. Instead of making a direct primary investment in B and receiving QSBS, O proposes that it form a partnership (FO). O will contribute $10 million to FO in exchange for 22.22 percent of FO, and F will contribute the stock of B at an implied pre-investment valuation of $35 million. FO will exchange the $10 million of cash for QSBS issued by a newly formed corporation and will exchange the $35 million of B stock for non-QSBS issued by the newly formed corporation. FO will use a blended approach in allocating the excludable and nonexcludable gain.

In evaluating the two offers, F considers the consequences of a subsequent sale of the stock of B (or its direct parent) for $100 million after five years.

Under CDE's proposal, upon a sale of B for $100 million, CDE's gain on its $10 million investment would be $10 million. All $10 million would be eligible for exclusion as QSBS, leaving CDE with after-tax profit of $10 million and after-tax proceeds of $20 million. F would receive $80 million of gain and would pay tax at a 20 percent rate, leaving F with after-tax proceeds of $64 million.

Under O's proposal, the new corporate parent of B would be sold for $100 million. The gain determined for purposes of section 704(b) would be equal to $55 million (the $100 million sale price minus the $45 million of FO capital accounts as of the date of formation). $35 million of built-in gain would be allocated to F under section 704(c). The

$55 million of section 704(b) gain would consist of $12.22 million in gain attributable to the sale of QSBS (eligible for exclusion) and $42.78 million of gain attributable to the sale of non-QSBS (not eligible for exclusion). $42.78 million of gain would be allocated to F, consisting of $33.27 million of taxable gain and $9.51 million of excluded gain. $12.22 million would be allocated to O, consisting of $9.5 million of taxable gain and $2.72 million of excluded gain.

F would therefore receive pretax proceeds of $77.78 million. He would pay tax at a 20 percent rate on $68.27 million of gain and exclude $9.51 million of gain, resulting in his receipt of after-tax proceeds of $64.13 million. O would receive after-tax proceeds of $20.32 million.

In this case, O's proposal is more economically efficient for both O and F. O receives the benefit of a higher percentage of B growth by virtue of the lower initial valuation. F receives a larger share of after-tax proceeds because the interposition of partnership FO has permitted F to, in effect, obtain QSBS in exchange for his contribution of non-QSBS stock.

Of course, there are many situations in which a blended approach is far worse for the taxpayers than the use of a tracking approach. Consider the following example.

Example 7. Venture Capital Fund ABC and Founder F own 100 shares of QSBS of corporation B through partnership ABCF, of which ABC owns 80 percent and F owns 20 percent (the First Block) for $100. At a time when B's gross assets have increased beyond $75 million, a new investor, G, invests in ABCF and acquires a 10 percent interest in ABCF for $22.22. ABCF uses the cash invested by G to purchase an additional 11.11 shares of non-QSBS issued by B (the Second Block). More than five years after the acquisition of the First Block, the B stock owned by ABCF is sold for $333.33. The ABCF partnership agreement meets the requirements for economic effect and uses a tracking approach, whereby all gain and loss on the sale of the First Block will be allocated to ABC and F, and all gain or loss on the Second Block will be allocated to G. It is highly likely that both the First Block and the Second Block will be sold in a single transaction at the same price per share.

Upon the sale of the B stock, ABCF will recognize (1) $200 of excluded gain for the First Block and (2) $11.11 of nonexcluded gain for the Second Block. Under the tracking approach, the $200 of excluded gain will be allocated to ABC and F and the $11.11 of nonexcluded gain will be allocated to G. Although the allocation has economic effect, it may lack substantiality. If instead of using the tracking approach, the blended approach had been used, ABC and F would still have been allocated $200 of gain, but that gain would have consisted of $189.48 of excluded gain and $10.52 of nonexcluded gain. The $11.11 of gain allocated to G would likewise have included $10.52 of excludable gain and $0.584 of nonexcluded gain. However, because G was not a partner of ABCF on the date that ABCF acquired the First Block, none of the excludable gain allocated to G would qualify for exclusion. Under the blended approach, G would still be taxed on its entire $11.11 of gain, but ABC and Fs' excludable gain would be reduced from $200 to $189.48. Thus, if the blended approach aligns with the "partner's interest in the partnership," the tracking approach allocation will lack substantiality and be reallocated in accordance with the blended approach under the PIP standard.

The upshot of assuming that a blended approach is mandated by PIP is that (1) a tracking approach may be permissible to allow partners to allocate a tax liability between themselves as an economic matter if the aggregate tax payable in the transaction is preserved; (2) in all other cases, a blended approach can be used — even when it materially reduces overall tax exposure. Further, as noted in Example 7, the combination of these rules can result in even more potential tax savings when valuations are adjusted to reflect the sharing of the tax benefits of QSBS. The upshot is to allow partnerships to be used to manipulate the economic effect of the gain exclusion rules of section 1202.

This result is highly unsatisfying and relies on a mistakenly narrow understanding of PIP. Despite the regulations explaining the use of a blended approach under PIP, the actual definition of PIP looks to a broad facts and circumstance-based analysis to determine the partners' interests in the partnership. This facts and circumstances-based approach should consider not only the economic ownership of partnership property, but

the underlying policy goals of other relevant provisions of the code, including section 1202. As noted in the partnership antiabuse rule of reg. section 1.701-2(e)(1), to prevent abuse of the entity theory of partnerships, "the Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder." If section 1202's legislative purpose of encouraging primary investments in qualifying businesses is included as a fact to be considered in the PIP analysis, one could very convincingly argue that the appropriate default allocation method for gain recognized on the sale of QSBS for PIP purposes should be a tracking approach. In some cases, a tracking approach will result in more aggregate tax paid than a blended approach. In other cases, a tracking approach will result in less aggregate tax paid than in a blended approach. But in all cases, a tracking approach will result in the same aggregate tax paid as would have been paid had the QSBS and non-QSBS at issue been held directly.

Adopting a PIP standard that assumes a tracking approach to partnership-owned QSBS could even be used to prevent use of a blended approach that causes distortions when an allocation has substantial economic effect (as in Example 4 and Example 6 above). Section 1202(g)(3) limits each taxpayer's right to exclude gain allocated by a partnership regarding gain recognized on the sale of QSBS to "the amount to which [exclusion] 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." If, as suggested above, a taxpayer's "interest" in a partnership were read to mean the "partner's interest in the partnership," and if PIP was determined based on a tracking approach to QSBS issued to a partnership, then in those examples, individuals would lose the opportunity to, in effect, churn nonqualifying stock to receive QSBS because their interest in the applicable partnership would assume an indirect interest solely in the underlying non-QSBS. This reading would ensure an aggregate result and preserve the achievement of the goals of section 1202.

III. Suggestion for Guidance

The tax law governing indirect ownership of QSBS through partnerships should, to the maximum extent possible, preserve an aggregate approach so that partnerships cannot be used to meaningfully alter the tax results intended by section 1202. In that connection, adoption of the following suggestions would simplify indirect ownership of QSBS and allow for more rational tax administration:

- Although it appears that legislation would be required to allow transfers of QSBS to a partnership in a section 721 transaction without disqualifying the QSBS as to the transferring partner, regulatory guidance could clarify that upon a subsequent distribution of the QSBS to the contributing partner, QSBS status can be preserved. A transferring partner who continues to participate in a QSBS investment indirectly through a partnership should not be permanently penalized without any policy rationale. Allowing taxpayers to change how they hold QSBS would introduce flexibility to augment the QSBS benefit.
- Guidance could also clarify that the IRS will not apply Rev. Rul. 85-164 to cause the interposition of a partnership to result in stock that would otherwise qualify as QSBS to be non-QSBS (in whole or in part). Many private corporations are wholly owned by partnerships for legitimate tax and nontax reasons. Guidance should clarify that this ownership will not limit the ability of the underlying corporation to issue QSBS to the same extent that it would be able to, had its stock been owned directly by the upstream partners and will not result in tax consequences that differ from a direct investment in QSBS by the partners.
- Guidance could further clarify that interest in a partnership for purposes of the exclusion limitation of section 1202(g)(3) means PIP, and that a partner's PIP in QSBS and non-QSBS held by a partnership should be presumed to be determined based on a tracking approach in which partners are deemed to have an interest in stock based on either (1) when stock is acquired with the proceeds of a capital contribution, the actual

tracing of those proceeds; or (2) when stock is acquired by a partnership at original issuance using the proceeds of a loan or cash on the balance sheet, based on the partners' relative interests in capital or profits on the date the stock was acquired (treating the parties as though the cash used to purchase the stock was distributed to the partners under the partnership agreement and then recontributed by those partners as capital contributions that can be traced in accordance with clause (1)). When a partner's direct tracking interest in QSBS and non-QSBS cannot be tracked (as in the case of a partnership profits interest), PIP would require that the blended approach be used.[36] This guidance would prevent economic distortions that can arise under the blended approach to allocating excludable gain.

These modifications to existing guidance would provide clarity to taxpayers investing in qualified small businesses and would preserve an aggregate approach to the ownership of QSBS through partnerships. ■

[36] Although a discussion of whether partnership profits interests should qualify for QSBS exclusion is beyond the scope of this article, it is my opinion that disallowing exclusion for partnership profits interests that meet the other requirements of section 1202(g) would go beyond the plain language of the statute and its legislative history and would therefore require legislative action.