# A CORPORATE TAX UPDATE

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*This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.*

*This outline was completed on September 19, 2017 and does not reflect developments after that date.*

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# 1. RECENT DEVELOPMENTS

## 1.1 Form over substance I – *Summa Holdings v. Commissioner*

1.1(a) An operating C corporation owned by the Benenson family paid commissions to a DISC. The DISC was owned by a C corp holding company which was owned by Roth IRAs for the sons of the founder of the business. The DISC allowed the export sales to be deferred and taxed once, when distributed to holding company, at C corporation tax rates. The holding company distributed the after-tax amounts to the Roth IRAs tax-free.[1] The distributed funds in the Roth IRAs earned income tax-free and could be distributed tax-free to the family. The arrangement eluded the strict limits on contributions to Roth IRAs.

1.1(b) The IRS said it was too good to be true.

1.1(c) The Tax Court said it was too good to be true.[2]

1.1(d) The Sixth Circuit Court of Appeals said that the Benensons were doing exactly what Congress allowed them to do. Be-

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[1] The holding company was a blocker corporation that prevented the Roth IRAs from having unrelated business income tax.

[2] Summa Holdings v. Comm'r, 109 T.C.M. (CCH) 1612, *reversed* 848 F.3d (6th Cir. 2017).

cause the family satisfied the letter of the Internal Revenue Code, the IRS had no right to question the purpose of the transactions. DISCs and Roth IRAs are supposed to save taxes, and the Benenson family had the right to use them this way. The Sixth Circuit basically spanked the IRS and the Tax Court in a very well-written and wildly entertaining opinion.[3]

## 1.2 Form over substance II – *Austin v. Commissioner*

1.2(a) The Tax Court got the message! In April it upheld an ESOP-owned S corporation. The "real" shareholders were not treated as shareholders because their shares were subject to forfeiture if they terminated employment too soon. So all of the business income was allocated to the ESOP, which was not required to pay any tax on the income.

1.2(b) When Congress caught on that it was giving away the store, the S corp sold its assets to an LLC owned by the "real" shareholders. All of the gain on the sale was allocated to the ESOP, and was exempt from tax. But the LLC got a basis step up to the purchase price of the assets. So the appreciation in value until the sale permanently escaped income tax.

1.2(c) The real shareholders and their attorneys did a masterful job of documenting these transactions and presenting all this to the Tax Court, which followed the *Summa* analysis and basically said "Yep, Congress allowed all this for several years. It works. The IRS cannot recharacterize it as something else." The Tax Court looked at transactions that many tax attorneys would have avoided and, following the *Summa* case, held that

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3 Summa Holdings v. Commissioner, 848 F.3d 779 (6th Cir. February 16, 2017).

the transactions worked because they were straight outta the Internal Revenue Code.[4]

## 1.3 Form over substance III – *Block v. Commissioner*

1.3(a) In a case appealable to the 9th Circuit, the Tax Court applied the form over substance doctrine to ignore royalty payments to an LLC owned by Roth IRAs for the family of the operating company's sole shareholder.[5]

1.3(b) "We find that [the LLC] was just a conduit to shunt money to the … Roth IRAs and was not engaged in any real business activity. We therefore find that [the LLC's] transfers to the … Roth IRAs were excess contributions that triggered the excise tax the Commissioner [of the IRS] seeks."

1.3(c) "We do acknowledge that the substance-over-form doctrine is not something the Commissioner can use to pound every Roth IRA transaction he doesn't like. The Sixth Circuit recently reversed one of our decisions rooted in the doctrine. … In *Summa*, the taxpayers had a similar setup: a business entity whose sole purpose was to transfer money into Roth IRA accounts. But there the entity was a domestic international sales corporation. … Because a DISC's congressionally sanctioned purpose was tax avoidance, the Sixth Circuit held that neither the Commissioner nor the courts had any basis to recharacterize the transactions at issue according to their substance. … But … LLCs, unlike DISCs, are meant to have a real business purpose. The Sixth Circuit in *Summa* specifically okayed the use of the substance-over-form doctrine in cases where taxpayers

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4 Austin v. Commissioner, 113 T.C.M. 1326 (CCH) (April 24, 2017). The *Austin* decision was appealable to the 4th Circuit.

5 Block v. Commissioner, 114 T.C.M. 68 (CCH) (July 18, 2017). Unlike in the *Summa* and *Austin* cases, the taxpayers in *Block* did not respect the formalities of their transactions.

used a corporate form that lacked any substance to facilitate a tax-avoidance scheme…."

## 2. POSSIBLE FEDERAL LEGISLATION[6]

2.1 **House Republican Tax Plan** ("A Better Way: Our Vision for a Confident America"):[7]

2.1(a) Maximum individual rate: 33%

2.1(b) Maximum rate for C corps: 20%

2.1(c) Maximum rate for pass-through entities: 25%

2.1(d) Immediate deduction for cost of tangible and intangible assets (like a Section 179 deduction with no cap)

- ◊ No deduction for land
- ◊ No deduction for financial assets like stock

2.1(e) No deduction for interest, except against interest income

2.1(f) NOLs

- ◊ No carry back

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6 I am indebted to Kathleen L. Farrell of Davis Polk & Wardwell LLP, New York, New York, to David S. Miller of Proskauer Rose LLP, New York, New York, to Shane Kiggen of Ernst & Young LLP, Washington, D.C. and to Michael L. Shler of Cravath, Swaine & Moore LLP, New York, New York for their excellent materials and presentation on *Tax Planning under the (Hypothetical) Major Tax Reform Act of 2017* for the Corporate Tax Committee of the ABA Tax Section on May 13, 2017.

7 Daily Tax Rep. (BNA) June 27, 2016 in TaxCore/Congressional Documents/Statements.

◊ Carry forward indefinitely, with interest

◊ Can offset no more than 90% of taxable income.

2.1(g) Territorial approach to tax on foreign income

◊ Border tax on imports

◊ No border tax on exports

◊ Sales from foreign business to consumer – not clear

◊ Repatriate foreign earnings at an 8.75% tax rate to the extent held in cash or cash equivalents and otherwise a 3.5% rate (with the taxes due over 8 years)

2.1(h) Repeal estate tax

2.2 ***Candidate* Trump's proposal**:[8]

2.2(a) Maximum individual rate: 33%

2.2(b) Repeal 3.8% tax on net investment income

2.2(c) Repeal estate tax

2.2(d) Tax capital gains at death, with a $10M exempt amount per couple

2.2(e) Corporate tax rate of 15%;

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8 K. Cirilli and J. Jacbs, *Trump Seeks Reset with Revised Tax Plan, Curb on Regulations*, Daily Tax Rep. (BNA), No. 153 at G-1, August 9, 2016.

- ◊ Worldwide income still subject to U.S. tax and foreign tax credit;

- ◊ Possible tax on off-shore cash, but one-time 10%/4% tax on unrepatriated earnings

2.2(f) Pass-through entities could elect the 15% rate

- ◊ For large pass-throughs that made the election, their distributions would be taxed the same as C corporation dividends

2.2(g) AMT: repealed

2.2(h) Carried interest: taxed as ordinary income

2.2(i) Taxpayers could have an unlimited Section 179 deduction or an interest expense deduction, but not both

2.3 ***President* Trump's proposal**:[9]

2.3(a) Maximum individual rate: 35%

2.3(b) Repeal 3.8% tax on net investment income

2.3(c) Repeal estate tax

2.3(d) Corporate tax rate: 15%

- ◊ Territorial system

- ◊ One-time tax on unrepatriated earnings

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[9] S. Kapur and S Pettypiece, *White House Presents Trump's Opening Bid for "Biggest Tax Cut."* Daily Tax Rep. (BNA) No. 80 at G-5, April 27, 2017.

2.3(e) Pass-through rate of 15% on business income[10]

2.3(f) Individual AMT: repealed

2.3(g) Corporate AMT: repealed

2.4 No proposals for **transition rules** (but 2005 Camp proposal might offer clues)

2.4(a) Will the new rules be phased in?

2.4(b) Continue to depreciate or amortize basis in existing business assets?

2.4(c) Continue to deduct interest on existing debt?

2.5 Other Federal Proposals

2.5(a) "White House advisers and congressional leaders have promised a tax framework outlining more details the week of September 25."[11]

2.5(b) Senator Hatch favors a corporate deduction for dividends paid ("corporate integration").[12]

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10 "'If you're an accountant firm and that's clearly income, you'll be taxed an income rate, you won't be taxed a pass-through rate,' [Treasury Secretary] Mnuchin said. 'If you're a business that's creating manufacturing jobs, you're going to get the benefit of that rate because that's going to be passed through to help create jobs and better wages.'" *Mnuchin: Some Services Companies Won't Get 'Pass-Through' Rate Under Tax Plan*, WALL ST. JOURNAL (online), September 12, 2017.

11 E. Wesson, *Senate Budget Committee Weighs Tax Cuts Totaling $1.5 Trillion*, Daily Tax Report (BNA) online, September 19, 2017.

2.5(c) The AICPA submitted comments on tax reform to the Senate Finance Committee and to the Tax Policy Subcommittee of the House Ways and Means Committee. The letters supported a simplified tax rate structure, simplified incentives for college tuition, administrative help for victims of identity theft and tax fraud, repeal of the kiddie tax, permanent disaster relief and modernizing the IRS.[13]

## 3. POSSIBLE CALIFORNIA LEGISLATION

### 3.1 Single-payer health care

3.1(a) SB 562 was shelved by the Assembly Speaker in June, but could be on the ballot in November, 2018.[14]

3.1(b) A legislative analysis for the Senate Appropriations Committee, chaired by a sponsor of the bill, said that:

"The projected costs and revenue needs for the proposed Program are as follows....

- Total annual costs of about $400 billion per year, including all covered health care services and administrative costs, at full enrollment.

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*(footnote continued from previous page)*

12 K. Basu, *Hatch Continues to Support Corporate Integration*, Daily Tax Report (BNA) online, September 19, 2017.

13 Letters from Annette Nellen to Hon. Orrin Hatch, July 17, 2017 and to Hon. Peter Roskam and Hon. Lloyd Doggett, August 1, 2017.

14 M. Mason, *California won't be passing a single-payer healthcare system any time soon — the plan is dead for this year*, Los Angeles Times (June 23, 2017).

- Existing federal, state, and local funding of about $200 billion could be available to offset a portion of the total program cost.

- About $200 billion in additional tax revenues would be needed to pay for the remainder of the total program cost. Assuming that this cost was raised through a new payroll tax (with no cap on wages subject to the tax), the additional payroll tax rate would be about 15% of earned income."[15]

### 3.2 Tax on drinking water

3.2(a) "[SB 623] would generate roughly $110 million per year through a 95-cent monthly fee on home water bills as well as taxes on businesses of up to $10 per month. Another $30 million would come from higher fees on agricultural and dairy businesses, industries whose chemicals contribute to the problem of contaminated groundwater."[16]

3.2(b) The bill was shelved for 2017 and will be reconsidered in 2018. "Assembly Appropriations Chair Lorena Gonzalez, D-San Diego, called it important legislation in announcing it will become a two-year bill."[17]

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[15] Senate Committee on Appropriations, for hearing on May 22, 2017 on SB 562.

[16] *First-ever water tax proposed to tackle unsafe drinking water in California*, The [San Jose] Mercury News (online), August 24, 2017.

[17] *Closely Watched Bills Killed by Legislative Spending Committees*, KQED News (online), September 1, 2017.

## 4. "MAIN STREET" CORPORATE TAX ISSUES (UNDER CURRENT LAW)

### 4.1 Using a Section 1014 basis step up in a business entity

4.1(a) Partnership[18] – Make a Section 754 election to step up the basis of the "inside" assets for that partner

4.1(b) S corporation – Sell stock. Or … Sell the "inside" assets to an *unrelated* party and distribute the proceeds to the shareholders in a *liquidating distribution* in the *same year*. "Inside" capital gain is offset by "outside" capital loss. If there is no built-in gain tax, there would be one level of tax on shares that did *not* get a Section 1014 basis step up. Also, ordinary income (such as depreciation recapture) will be taxed to all the shareholders. Best if the decedent was the sole shareholder (or the spouse of a sole shareholder if the shares are held as community property).[19]

4.1(c) C corporation – sell stock, or make an S corporation election and wait out the built-in gain recognition periods: 5 years for federal, 10 years for California. Then proceed as above for an S corporation without a built-in gain tax problem.

### 4.2 Disappearing stock basis in a C corporation redemption

4.2(a) When a C corporation buys its shares, those funds are not available to transfer to the other shareholders, so the other shareholders suffer the economic detriment of paying for the shares.

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[18] Includes an LLC classified as a partnership for income tax purposes.

[19] Note that a distribution of depreciable or amortizable assets by the S corporation to a shareholder who owns more than 50% of the shares (directly or by constructive ownership) would result in ordinary income to the shareholders under Section 1239. The "outside" capital loss would not offset more than a small amount of the "inside" ordinary income. The distribution would trigger one level of tax at ordinary income rates. No cash would be generated, so the inside ordinary income would be "phantom income" – a tax disaster.

4.2(b) But the corporation does not have any basis in the purchased shares. Also, the corporation cannot deduct the payment for the shares, so there is one level of tax (on the corporation) on the income used to buy the shares. The shareholders did not buy anything, so the do not get a basis step up.

4.2(c) Compare if the shareholders received the funds from the corporation, possibly as compensation, and bought the shares – There would be one level of tax on the income (at the shareholder level) and the shareholder would have basis in the shares.

4.2(d) This is not an issue with S corporations because the undistributed profit used to pay the former shareholder will increase the basis of the other shareholders.

### 4.3 Disappearing stock basis in a purchase of target stock by an S corporation followed by a QSub election for target

Example:

4.3(a) Target has zero basis in its assets.

4.3(b) S Parent buys Target shares for $10M.

4.3(c) S Parent does not want Target to be a C corporation, so S Parent either liquidates Target into S Parent *or* makes a QSub election for Target.

4.3(d) Under Section 334(b) S Parent has a carryover basis in the … assets of Target.[20] The $10M basis in the shares? It *disappeared*.

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[20] Treas. Reg. § 1.1361-4(a)(1)(2)(i), (ii) *Example 1* (QSub election treated as a Section 332 liquidation of a subsidiary into a parent corporation)..

4.3(e) If S Parent made a Section 338(h)(10) election for Target, the basis of Target's assets would increase to $10M, so the carryover asset basis would not be a problem.

## 4.4 **Life insurance held by C corporations**

4.4(a) Inside build-up, surrender proceeds and death benefits are ACE adjustments, and so subject to AMT for a C corporation,[21]

4.4(b) Not an issue for an S corporation.[22]

## 4.5 **Unplanned termination of QSub status**

4.5(a) A QSub must be 100% owned by its S parent[23]

4.5(b) Issuing or transferring shares can terminate the QSub status.[24] The existing (but until then disregarded) subsidiary is treated as if the S parent transferred all the subsidiary's assets to it and the subsidiary assumed all of its liabilities from the S parent.[25]

4.5(c) If the subsidiary's liabilities exceed its basis in its assets, it would recognize gain under Section 357(c).[26]

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21 I.R.C. § 56(c)(1), (g)(4)(B); Treas. Reg. § 1.56(g)–1(c)(5)(ii) (inside build-up), (iv) (distributions and surrender).

22 I.R.C. § 56(G)(6)

23 I.R.C. § 1361(b)(3)(B); Treas. Reg. § 1.1361-2(a)(1).

24 I.R.C. § 1361(b)(3)(C).

25 I.R.C. § 1361(b)(3)(C)(i).

26 If the new shareholder acquires more than 20% of the shares, a taxable "busted Section 351 transfer" is avoided by the fiction that first a proportionate part of the assets are

*(footnote continued on next page)*

4.6 **Section 355 split-ups and spin-offs**

4.6(a) Best to assume that this is a Wall Street provision that is too complex, and consequently too expensive, for most Main Street transactions.

4.7 **Exposure of C corporation to audits about unreasonably high compensation[27] or the accumulated earnings penalty tax[28]**

4.7(a) Make an S corporation election if possible

◊ Consider buying out any shareholders that prevent the S corporation election

4.8 **Creating holding companies to limit the claims of creditors of a business to the assets of that business**

4.8(a) Organize a new S corporation to act as "S parent."

4.8(b) The historic operating company ("OldCo") becomes a QSub of new S parent. Probably a tax-free Type "F" reorganization.

4.8(c) S parent organizes a new single-member LLC that it owns.

4.8(d) The OldCo can transfer its "other asset" to the new LLC wholly owned by S parent – not an income tax event because both the QSub and the single-member LLC are disregarded entities.

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*(footnote continued from previous page)*

transferred to the new shareholder, then the new shareholder and the S parent transfer the assets to the "new" corporation. I.R.C. § 1361(b)(3)(C)(ii)(II).

27 I.R.C. § 162(a)(1); *see* B. Bittker & J. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS at ¶ 8.06[3] (7th ed. 2000 & Supp. 2017-2).

28 I.R.C. § 531 (accumulated earnings penalty tax).

All of the assets are owned by S parent for income tax purposes.

4.8(e) The “other asset” might be another business, land, art, boat, aircraft, etc.

4.8(f) The goal would be to keep the “other asset” away from the creditors of OldCo, and to keep the assets of OldCo away from claims arising from the “other asset” (especially if it is a new business or a boat or aircraft).

4.8(g) New S parent (the holding company) does not do anything that could invite a claim against it.

## 4.9 Tax-free conversion of target S corporation into an LLC

4.9(a) Target is an S corporation but buyer (possibly an LLC or limited partnership) does not want to buy stock, and for some reason buying assets will not work.

4.9(b) Create S parent and make a QSub election for Target. Probably a tax-free “F” reorg

4.9(c) Convert Target, a disregarded QSub, into a single-member LLC owned by S parent – a non-event for tax purposes.

4.9(d) S parent sells Target LLC interests to buyer. Shareholders of S parent pay tax on the gain and get a basis step up in the shares of S parent.

4.9(e) S parent distributes the sale proceeds to its shareholders. No second tax whether or not S parent liquidates.

4.10 **Busted Section 351 contributions to capital**

4.10(a) To avoid gain in the transfer of appreciated assets to a corporation (whether an S or C corporation), the transferors must control 80% of the shares after the transaction.

4.10(b) So a transfer of the assets of my business to your corporation in exchange for stock totaling 50% of the shares outstanding after the transaction will be a taxable exchange for me – because I don't control 80% when the dust settles and you did not transfer anything to the corporation in this transaction.

4.10(c) But if your corporation and I transfer assets to a new LLC, Section 721 makes both transfers tax-free.

4.10(d) If your corporation and I transfer assets to a new corporation, the transaction is also tax-free to both transferors, because together we control over 80% of the shares of the new corporation.

4.11 **Busted Section 332 liquidation of a subsidiary (or QSub election)**

4.11(a) Generally, a liquidation of a subsidiary into its parent is tax-free if the parent owns at least 80% of the subsidiary.[29] If Section 332 applies, the subsidiary does not recognize any gain if it uses appreciated assets to pay off its debt to its parent.[30]

4.11(b) If the value of all of the subsidiary's assets (including goodwill and other intangibles) is less than the amount of its liabilities, Section 332 will not apply.[31] So the transaction will be taxable,

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[29] I.R.C. §§ 332, 337.

[30] I.R.C. § 337(b)(1).

[31] Treas. Reg. § 1.332; see L. Zarlenga, CORPORATE LIQUIDATIONS, Tax Mgmt. Port. (BNA) No. 784 at III.C. (3d ed. 2017).

and any appreciated property used by the subsidiary to satisfy its debt to the parent will be trigger gain taxable to the subsidiary.[32]

4.11(c) Solution: merge the parent into the subsidiary[33] (possibly renaming the subsidiary with the parent's name) in a tax-free Type "A" reorganization.

## 4.12 Solving a C corporation's personal holding company tax problems

4.12(a) C corporation owns passive investment assets, possibly after selling its operating assets, and has taxable income. It probably is a personal holding company[34] that will be subject to a penalty tax that will force it to distribute its income to its shareholders, incurring the "double tax."

4.12(b) Make an S corporation election, if the corporation is eligible (or if it can be made eligible).

4.12(c) To avoid an excess passive receipts problem with more than 25% passive receipts,[35] invest in a natural gas pipeline partnership or LLC with publicly traded investment units.[36] Section 702(b) and (c) cause the character of the receipts to pass through to the S corporation.

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32 Treas. Reg. § 1.1001-2(a)(1), (c) *Example 8*.

33 A "downstream merger."

34 I.R.C. § 541.

35 I.R.C. §§ 1362(d)(3), 1375.

36 These entities are not taxed as corporations, even though their units are publicly traded, because their income is "qualifying income" from transporting gas. I.R.C. § 7704(d)(1)(E).

4.12(d) Note the need to check annually on the amount of active income required by the S corporation and the amount of active income per unit provided by the investment.

4.12(e) Don't let a new investment adviser sell these units!

## 5. WHAT'S THE BEST STRUCTURE FOR EXITING A BUSINESS (UNDER CURRENT LAW)?

From best to worst:

5.1 **Tax-free dispositions**:

5.1(a) **Sale of C corporation stock** after a **Section 1014 basis step up at the death of the shareholder** (or the spouse of the shareholder if the shares are held as community property), when the estate of the shareholder is less than the **estate tax exclusion**, so the marginal estate tax rate will be zero. 100% liquidity after the sale. Unline an S corporation or a partnership, no limitation on the basis step up for the corporation's items that would be IRD if held by the shareholder.[37] No federal *or California* income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. But ... unlike a partnership, no basis increase for the heir's share of the C corporation's liabilities. Section 1202 deferral, Section 1045 deferral, sale of stock to an ESOP and tax-free reorg all available as a back-ups for lifetime disposition.

5.1(b) **Sale of partnership interest** after a **Section 742/1014 basis step up at the death of the partner** (or the spouse of the partner if the interest was held as community property), when the

[37] "IRD" is "income in respect of a decedent." The Section 1014 basis step up does not apply to assets held by the decedent that would generate IRD. An extension of his rule applies to partnership interests and S corporation stock held by the decedent, but not to shares of a C corporation.

estate of the partner is less than the **estate tax exclusion**, so the marginal estate tax rate will be zero – unlike a corporation, the basis in the interest increase for the heir's share of the partnership's liabilities - a limitation applies to the basis step up to the extent that the value of the interest is attributable to the partnership's items that would be IRD if held by the decedent[38] – otherwise, no federal or California income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. Often difficult to achieve a tax-free combination as a back-up.

5.1(c) **Sale of S corporation stock** after a **Section 1014 basis step up at the death of the shareholder** (or the spouse of the shareholder if the shares are held as community property), when the estate of the shareholder is less than the **estate tax exclusion**, so the marginal estate tax rate will be zero – unlike a partnership, no basis increase for the heir's share of the S corporation's liabilities - a limitation applies to the basis step up to the extent that the share value is attributable to the S corporation's items that would be IRD if held by the shareholder[39] – otherwise, no federal or California income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. Tax-free reorg available as a back-up for lifetime disposition.

5.1(d) **Sale of C corporation stock** when the 100% gain exclusion in **Section 1202** applies – Zero federal income tax on the sale (to the extent the gain is attributable to appreciation after the assets were contributed to the corporation). Careful, long-term plan-

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[38] Note that this will severely limit the basis step up for the shares of an S corporation used to conduct a professional practice, if much of the value is attributable to work in process and accounts receivable for personal services, which are IRD items.

[39] Note that this will severely limit the basis step up for the shares of an S corporation used to conduct a professional practice, if much of the value is attributable to work in process and accounts receivable for personal services, which are IRD items.

ning needed to protect the Section 1202 exclusion. No AMT preference for stock acquired after September 27, 2010.[40] This exclusion does not apply for California income tax purposes. Tax-free reorg available as a back-up. (Note that the ranking assumes that the sale proceeds are not subject to estate tax.)

5.1(e) **Sale of C corporation stock** to an **ESOP** (sponsored by the corporation) in a Section 1042 transaction – Possible zero federal *and California* income tax on sale. No gain on sale of shares if sale proceeds rolled into securities of U.S. companies, carryover basis; margin loans available to tap the cash; step up in basis at death escapes any tax. Capital gain on boot or sale of the U.S. securities. Requires feasibility study and annual appraisal and administration costs. Sale of all shares might require several years. Tax-free reorg available as a back-up.

5.1(f) Exchange of target[41] stock for buyer stock in a **tax-free reorganization** – No tax on exchange for stock, if strict rules are satisfied. Seller's basis in buyer stock equals seller's basis in exchanged target stock. Seller loses control of the business and still has a concentrated, undiversified investment. Cash, if any, received by seller in the exchange is generally taxed as capital gain. Buyer has a carryover basis in the target's assets. Buyer uses newly issued shares and not cash for acquisition. California generally follows federal rules.

5.1(g) **Sale of C corporation stock** to which a partial gain exclusion would apply under Section 1202, followed by **Section 1045** reinvestment in other "qualified small business stock." Zero federal income tax on the sale. Careful, long-term planning needed to protect eligibility for the Section 1045 rollover.[42] No

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[40] See *Using Section 1202 to Eliminate or Reduce Tax on the Sale of C Corporation Stock* below at page 24.

[41] The "target" is the corporation that owns the business that is being sold.

[42] See *Section 1045 Exclusion and Rollover* below at page 32.

liquidity and continued concentration in one asset. No AMT preference. This exclusion does not apply for California income tax purposes. Tax-free reorg available as a back-up.

5.2 **Taxable dispositions – *one* level of tax**:

5.2(a) **Sale of S corporation stock** – One level of tax. All gain taxed as capital gain, installment sale treatment available. Undistributed S corporation income in prior years will have increased the seller's share basis, decreasing gain on sale. Section 336(e) or 338(h)(10) election (discussed below) and tax-free reorg available as back-ups. (Note that the ranking assumes that the sale proceeds are not subject to estate tax.)

5.2(b) **Sale of C corporation stock** when no Section 1042, 1045 or 1202 exclusion is available. One level of tax. All gain taxed as capital gain, installment sale treatment available. Basis in shares might be tiny. Tax-free reorg available as a back-up. (Note that the ranking assumes that the sale proceeds are not subject to estate tax.)

5.2(c) **Sale of S corporation stock** with a **Section 336(e) or 338(h)(10)** election – One level of tax. Treated as sale of assets, so ordinary income on gain from cash method receivables, on inventory and depreciation recapture; capital gain (taxed at low federal rates) on sale of goodwill. Big tax benefit to buyer, who might gross up the price to cover the ordinary income. Installment sale method available for income other than depreciation recapture. Tax-free reorg available as a back-up. (Note that the ranking assumes that the sale proceeds are not subject to estate tax.)

5.2(d) **Sale of assets by S corporation** – One level of tax. Ordinary income and capital gain as noted above for sale of S corporation stock with a Section 338(h)(10) or 336(e) election. Sales tax likely without pre-sale planning. Installment sale method available for income other than depreciation recapture; with proper planning, distribution of installment note does not trigger tax on deferred gain. Tax-free reorg available as a back-up. (Note that the ranking assumes that the sale proceeds are not subject to estate tax.)

5.2(e) **Sale of *interest in* multi-member LLC or partnership** – One level of tax. Ordinary income and no installment method to the extent the sale price is allocable to income from providing services and inventory. Capital gain and installment method available for rest of price. Often difficult to achieve a tax-free combination as a back-up. (Note that the ranking assumes that the sale proceeds are not subject to estate tax.)

5.2(f) **Sale of *assets by* multi-member LLC or partnership** – One level of tax. Possibly the same as a sale by an S corporation, with a different the California entity-level tax. Gain might be allocated to the "partner" who contributed the assets sold. Often difficult to achieve a tax-free combination as a back-up. (Note that the ranking assumes that the sale proceeds are not subject to estate tax.)

5.2(g) **Sale of assets by C corporation followed by a liquidating distribution to which the Section 1202 exclusion applies** – One level of federal tax.[43] Corporate tax rates apply to gain on all assets, including goodwill. Sales tax likely without pre-sale planning. Installment sale method available for income other than depreciation recapture, but distribution of installment note triggers the deferred gain. Double California income tax (on both sale and distribution of after-tax sale proceeds). Tax-free reorg available as a back-up. (Note that the ranking assumes that the sale proceeds are not subject to estate tax.)

5.2(h) **Sale of C corporation stock** after a **Section 1014 basis step up at the death of the shareholder** (or the spouse of the

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43 See *Using Section 1202 to Eliminate or Reduce Tax on the Sale of C Corporation Stock* below.

shareholder if the shares are held as community property), when the **federal 40% estate tax rate applies** – no limitation on the basis step up for the corporation's items that would be IRD if held by the shareholder[44] - no federal or California income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. Unlike a partnership, no basis increase for the heir's share of the C corporation's liabilities - Tax-free reorg available as a back-up for lifetime disposition.

5.2(i) **Sale of partnership interest** after a **Section 742/1014 basis step up at the death of the partner** (or the spouse of the partner if the interest was held as community property), when the **federal 40% estate tax rate applies** – unlike a corporation, the basis in the interest increase for the heir's share of the partnership's liabilities - a limitation applies to the basis step up to the extent that the value of the interest is attributable to the partnership's items that would be IRD if held by the decedent[45] – otherwise, no federal or California income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. Often difficult to achieve a tax-free combination as a back-up.

5.2(j) **Sale of S corporation stock** after a **Section 1014 basis step up at the death of the shareholder** (or the spouse of the shareholder if the shares are held as community property), when the **federal 40% estate tax rate applies** – unlike a partnership, no basis increase for the heir's share of the S corporation's liabili-

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[44] "IRD" is "income in respect of a decedent." The Section 1014 basis step up does not apply to assets held by the decedent that would generate IRD. An extension of his rule applies to partnership interests and S corporation stock held by the decedent, but not to shares of a C corporation.

[45] Note that this will severely limit the basis step up for the shares of an S corporation used to conduct a professional practice, if much of the value is attributable to work in process and accounts receivable for personal services, which are IRD items.

ties - a limitation applies to the basis step up to the extent that the share value is attributable to the S corporation's items that would be IRD if held by the shareholder[46] – otherwise, no federal or California income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. Tax-free reorg available as a back-up for lifetime disposition.

5.2(k) **Sale of stock by C corporation** and buyer makes a **"straight" Section 338 election** (aka a "Section 338(g) election") – One level of tax. Treated as stock sale to seller, followed by a dissolution of the corporation by the buyer (triggering "inside" gain, resulting in a higher basis in the assets for the buyer and permitting the buyer to amortize goodwill over 15 years). Rare. Usually makes sense only for targets with big NOLs to absorb the gain. Tax-free reorg available as a back-up.

5.3 **Taxable dispositions – *two* levels of tax**:

5.3(a) **Sale of assets by C corporation** – Two levels of federal and California tax. Corporation pays tax on "inside" gain from sale. Shareholders pay tax on distribution of after-tax sale proceeds. "Outside" transaction is capital gain, with application of basis *if* the corporation elects to dissolve; otherwise, "outside" transaction is dividend with no application of basis. Sales tax might also apply to sales of tangible personal property not held for resale (generally, furniture, equipment and vehicles). Tax-free reorg available as a back-up.

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[46] Note that this will severely limit the basis step up for the shares of an S corporation used to conduct a professional practice, if much of the value is attributable to work in process and accounts receivable for personal services, which are IRD items.

## 6. USING SECTION 1202 TO ELIMINATE OR REDUCE TAX ON THE SALE OF C CORPORATION STOCK (UNDER CURRENT LAW)

6.1 Gain on the sale or exchange of qualified small business stock issued after September 27, 2010 and held for at least five years is excluded from *both* federal regular tax *and* federal alternative minimum tax.[47] Up to $10 million in gain can be excluded for a single corporation.[48]

6.1(a) As a consequence, in a stock sale there would be no gain to the seller.[49]

6.1(b) In a sale of assets followed by a liquidation of the seller corporation, there would be one level of tax – on the "inside" gain.[50]

6.1(c) There is currently no corresponding California provision.[51]

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[47] Partial exclusions apply for shares acquired after February 10, 1993 and before September 28, 2010, along with an AMT preference for some of the excluded gain.

[48] See Section 6.3 below.

[49] Except that appreciation in assets before the date on which they were transferred to the corporation is still subject to tax. I.R.C. § 1202(i).

[50] When a corporation distributes money or property to its shareholder while the corporation is in the process of liquidating, the distribution is treated as gain to the shareholder. I.R.C. § 331. The amount realized is the value of the assets distributed on the date of the distribution. I.R.C. § 301(b).

[51] So Section 1202 applies for federal income tax purposes only. Cal. Rev. & Tax. Code § 18152. Section 18152.5 of the Revenue and Taxation Code was a corresponding provision that expired on December 31, 2015. Cal. Stat. 2013, chapter 546, Section 2. The 1998 version of this statute was held to violate the commerce clause of the U.S. Constitution because it allowed the partial exclusion "only if the stock sold and purchased was issued by corporations that used 80 percent of their assets in the conduct of business in California and that maintained 80 percent of their payrolls in California." Cutler v. Franchise Tax Bd., 208 Cal. App. 4th 1247 (2012).

6.1(d) For the tax return preparer, it is important to document and appropriately report the exclusion.

6.2 An overview - Making sense of the confusing structure of Section 1202[52]

6.2(a) Every rule in Sections 1202 (and, to a lesser extent, Section 1045) is subject to exceptions and exceptions to the exceptions. It reflects political give and take (rather than logic or economics) in every line. So intuition is not helpful because there are no overriding principles from which to infer. There are several very similar defined terms.[53] Section 1045 defines "small business stock" in a way that is different than the definition in Section 1202. Some rules apply when the stock is issued, others during the time the taxpayer held the shares, others at the date of disposition. Because a huge amount of gain can be excluded – but only if the taxpayer can prove that the taxpayer and the corporation satisfied the requirements at several points in time, a monumental amount of records need to be collected and kept in case of an audit.[54]

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52 For additional detail, see my outline *Stock Transactions - Tax Issues (including the Gain Exclusion under Section 1202, Documenting a Section 1202 Exclusion or a Section 1045 Rollover, the Section 1045 Gain Exclusion and Rollover, and Section 1244 capital losses recharacterized as ordinary losses)* at www.staleylaw.com, which includes an Appendix on *Documenting a Section 1202 Exclusion or a Section 1045 Rollover*.

53 "Qualified small business stock," "qualified small business," and "qualified trade or business." None of these are the same as a "small business corporation" which can make an S corporation election. I.R.C. § 1361(b)(1).

54 If the taxpayers used the Section 1045 rollover one or more times, the taxpayer will need records his or her holding period for all of the corporations over all of the holding periods. If the shares were distributed to the taxpayer from a partnership or LLC, the taxpayer will need the records of the partnership or LLC.

◊ The Treasury Department and the IRS have issued one short regulation under each Section.[55] Although IRS gets many calls about Section 1202, it issues no guidance and few letter rulings. There are few cases, suggesting that there are few audits. Each Section is a prime candidate for repeal in a broad tax reform bill. The IRS is historically reluctant to allocate assets to complex provisions that might have a short life.

◊ This creates an often frustrating situation in which the stakes are high, there many ambiguities but little guidance for taxpayers, the statute has problems but Congress is more likely to repeal the provision than to fix it, and the IRS might be reluctant to audit. Nevertheless, taxpayers and their tax preparers who do not follow the confusing but unambiguous parts of the statute might be subject to penalties.

6.2(b) The exclusion applies to gain on the disposition of "qualified small business stock."[56] The stock must be held for five years.[57]

6.2(c) To be "qualified small business stock," the corporation must be a "qualified small business" on the date the shares were issued.[58]

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55 Treas. Reg. §§ 1.1202-2 (the -0 reg is a table of contents to the -2 reg, and there never was a -1 reg), 1-1045-1.

56 I.R.C. § 1202(a).

57 I.R.C. § 1202(a)(1).

58 I.R.C. § 1202(c)(1)(A), (d)(1).

◊ To be a "qualified small business," the business must be small, satisfying asset tests before and after the shares were issued.[59]

◊ The corporation must be a C corporation on the date that the shares were issued.[60]

◊ Also, the corporation must agree to submit to the IRS and to the shareholders such "reports" as the IRS may require to assure that Section 1202 applies.[61]

◊ Note that these tests apply when the shares are issued.

6.2(d) The shares also will not be "qualified small business stock" if the corporation's shares were redeemed soon before or after the issuance of the shares to which the exclusion might apply.[62] This rule exists "to prevent evasion of the requirement that the stock be newly issued."[63]

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[59] I.R.C. § 1202(d). Generally, the assets must not exceed $50 million in tax basis since 1993 until immediately after the shares are issued. However, for assets contributed to the corporation, the valued at the date of contribution is used, not the carryover basis from the contributing shareholder.

[60] I.R.C. § 1202(d).

[61] I.R.C. § 1202(d)(1)(C). There is no requirement to file this agreement with the IRS. The IRS can impose a $50 penalty for failing to provide each "report." I.R.C. § 6652(k). The penalty increases to $100 per "report" if the failure is "due to negligence or intentional disregard." But no penalty is imposed for a failure that is shown to be due to reasonable cause and not to willful neglect. See Treas. Reg. § 301.6652-1(f) (how to show reasonable cause).

[62] I.R.C. § 1202(c)(3).

[63] The 1993 Ways and Means Committee Report.

6.2(e) The shares will not be "qualified small business stock" unless, "during substantially all of the taxpayer's holding period," the corporation meets the *active business requirements* and is a C corporation.[64]

- ◊ Note that these tests are applied for each year that the shares are held by the taxpayer. A worksheet with a row for each requirement and a column for each year is useful. Then it's necessary to determine whether all of the requirements were satisfied for "substantially all" of the years.

- ◊ There is no certainty about what "substantially all" means – 80% or more is probably good. Less than 80% is iffy. Less than 2 out of 3 years is probably not "substantially all" of the years.

6.2(f) To meet the *active business requirement*, the corporation must be an "eligible corporation" and at least 80% of its assets (by value) must be "used in … the active conduct of one or more qualified trades or businesses."[65]

- ◊ To be an "eligible corporation," the corporation can't be a foreign corporation, a DISC, a REIT, or qualify for a possessions tax credit.[66]

- ◊ Section 1202 contains a list of trades or businesses that cannot be "qualified trades or businesses."[67]

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64 I.R.C. § 1202(c)(2)(A).

65 I.R.C. § 1202(e)(1).

66 I.R.C. § 1202(e)(4).

67 I.R.C. § 1202(e)(3).

- A special rule applies to software companies that receive royalties.[68] A business that receives royalties is not on the list of trades or businesses that can't be "qualified trades or businesses." So the special rule seems to provide a "safe harbor" for the "active conduct" requirement. The special rule should not be the only way that a software business can be an active business for this purpose.

◊ Some assets are assumed to be used in a "qualified trade or business." These are assets used in startup activities, research and experiments, and in-house research, even if the corporation has no gross income.[69]

◊ Look-through rules apply to treat activities of a subsidiary as the activities of a parent for the "active business" tests.[70]

◊ The corporation will fail the active business requirement if for more than an insubstantial part of the taxpayer's holding period portfolio stocks and securities (a) make up more than 10% of the corporation's assets (net of liabilities; in other words, it's balance sheet "Equity") are , and (b) are not held for use as working capital or to deploy in an active business within two years.[71]

◊ The corporation will also fail the active business requirement if for more than an insubstantial part of the taxpayer's holding period more than 10% of its assets are real

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68 I.R.C. § 1202(e)(8).

69 I.R.C. § 1202(e)(2).

70 I.R.C. § 1202(e)(5)(A), (C).

71 I.R.C. § 1202(e)(6).

estate not used in an active trade or business (but owning, dealing in or renting real estate is not an active business for this purpose).[72]

6.3 If the taxpayer contributes to the issuing corporation more than \$1 million in cash or assets with a tax basis of more then \$1 million, or a combination of the two totaling more than \$1 million, the \$10 million limit on gain is increased to ten times the basis of the contributed assets.[73]

6.4 Note the many ways to fail to qualify for the exclusion. Often, the Section 1202 exclusion is best used as a planning tool when something else prevents the business from using an LLC or an S corporation.

6.4(a) When an investor is counting on the Section 1202 exclusion to make the exit from the investment tax-free (or subject to one level of tax in an asset sale), it is important to conduct a review of the Section 1202 requirements each year.

6.4(b) Many requirements must be met in the first year, a few more over the first two years. In the last year, the corporation must be a C corporation.

6.4(c) But other requirements must be satisfied for "substantially all years" in which the taxpayer held the shares. For those requirements, failing to meet the requirements for up to 20% of the years in the holding period might be OK. It is important to realize that "the train has left the tracks" before too many years go by and it becomes impossible to correct the problem.

6.5 In view of the complexity of Section 1202, the taxpayer should consider obtaining from a tax professional advice that will minimize the risk

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72 I.R.C. § 1202(e)(7).

73 I.R.C. § 1202(b)(1).

of a negligence penalty if the IRS challenges the exclusion and prevails. This will generally be a written analysis listing the requirements of Section 1202, the applicable facts and supporting documents, and reaching conclusions about whether the requirements are satisfied.[74]

6.6 How would Section 1202 fare in tax reform? It is certainly a candidate for repeal in any effort to broaden the tax base and reduce complexity in the Internal Revenue Code. But just eliminating the exclusion would not be fair to investors who relied on it when they bought their shares. So in a tax reform bill the exclusion might cease to apply to investments made after the reform became effective, but would probably continue to apply to sales of shares bought before the specific reform pro-

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74 Compare the situation in the *Holmes* case. "In late 2000, [the taxpayer] spoke with [a co-founder of original co.] 'about selling the [original co.] stock and putting it [the proceeds] into [replacement co.]'. [The co-founder] told him about an article he had read concerning a tax provision that permits taxpayers to roll over gain from a startup company 'into another start-up company and then defer that tax until the profit from the second investment.' He said that petitioner 'should look into it.' [The co-founder] is neither a tax professional nor a financial adviser and did not provide to [the taxpayer] a written financial opinion. [The taxpayer] did not seek advice from other individuals as to the provision's procedures or requirements, and there is no evidence that he even read the provision.... A taxpayer may avoid the [substantial understatement and negligence penalties] by showing that he had reasonable cause for a portion of the [tax] underpayment and that he acted in good faith with respect to that portion. Reasonable cause requires that the taxpayer exercise 'ordinary business care and prudence' as to the disputed item. ... Generally, the most important factor is the extent of the taxpayer's effort to assess his proper tax liability. A taxpayer may demonstrate reasonable cause through good faith reliance on the advice of an independent professional, such as a tax adviser, lawyer, or accountant, as to the item's tax treatment. To prevail, the taxpayer must show that he: (1) selected a competent adviser with sufficient expertise to justify reliance, (2) supplied the adviser with necessary and accurate information, and (3) actually relied in good faith on the adviser's judgment. The professional's advice must be based on all pertinent facts and circumstances." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (citations omitted) (considering stock purchased in 1997, then sold and the proceeds rolled over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd on other issues in an unpublished opinion* 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015) (affirming the Tax Court's findings that the taxpayer did not establish (a) that the shares were issued to him from the corporation and were not transferred to him from other shares, and (b) that at least 80% of the corporation's assets were used in the active conduct of a "qualified trade or business").

vision for Section 1202 was announced. However, there can be no certainty of this.

## 7. SECTION 1045 EXCLUSION AND ROLLOVER (UNDER CURRENT LAW)

7.1 If the stock is "qualified small business stock" under Section 1202 (except for the minimum holding period), the seller can escape federal income tax on its sale by rolling the proceeds over into "qualified small business stock" of another corporation.[75]

7.1(a) The exclusion is not available to *sellers* that are C corporations.[76]

7.1(b) This will rarely be attractive for sales of "qualified small business stock" held for five years and acquired after September 27, 2010 (to which the 100% gain exclusion and no AMT preference apply).

7.1(c) However, it is very attractive for sales of qualified small business shares acquired earlier, the gain from which is only partially excluded and some of which is an AMT preference item.

7.1(d) It will also be attractive if the qualified small business stock was held for more than six months, but less than five years,

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[75] I.R.C. § 1045. There is currently no corresponding California provision. Cal. Rev. & Tax. Code § 18038.4. So Section 1045 applies for federal income tax purposes only. Section 18038.5 of the Revenue and Taxation Code was a corresponding provision that expired on December 31, 2015. Cal. Stat. 2013, chapter 546, Section 1.

[76] I.R.C. § 1045(a). If the seller is classified as a partnership for tax purposes, the partners who are not C corporations may use the exclusion, as long as they held the partnership interest when the partnership bought the original shares and until the partnership disposed of the shares. Treas. Reg. § 1.1045-1(a), (g)(3). If the partnership interest is transferred by gift or inheritance, the done or heir is treated as holding the partnership interest for the period that the donor/decedent held the interest. Treas. Reg. § 1.1045-1(g)(3)(ii). Look-though rules apply for tiered partnerships. Treas. Reg. § 1.1045-1(g)(iii), (iv).

because *six months is the minimum holding period for Section 1045*.[77]

7.1(e) It will also be useful if the C corporation stock ceased to meet the "active conduct of a trade or business" requirement after the taxpayer held the shares for at least six months.[78]

7.1(f) Section 1045 will also be attractive if the taxpayer transferred to the original Issuing Corporation assets that had a value substantially higher that their tax basis.[79]

7.2 The reinvestment must occur within 60 days after the sale.[80]

7.2(a) The reinvestment may be made through a partnership that buys the replacement stock.[81]

7.2(b) The taxpayer (and return preparer) must be prepared to prove that the reinvestment was made, the amount reinvested, and the date of the reinvestment.[82]

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77 I.R.C. § 1045(a).

78 I.R.C. § 1045(b)(4)(B). Section 1045 appears to be available if the issuing corporation was an S corporation for a period commencing sometime after the first 6 months of the taxpayer's holding period and ending sometime before the shares were sold. *Id.*

79 Section 1202 does not apply to that pre-contribution gain. I.R.C. § 1202(i). Does the Section 1045 exclusion apply to that gain? Section 1045 seems to say "Yes." I.R.C. § 1045(a). Does the reference later in Section 1045 to the basis rule in Section 1202 mean "No"? I.R.C. § 1045(b)(5). There is no answer.

80 I.R.C. § 1045(a)(1). "We agree the [taxpayer couple] met the 60-day requirement of section 1045(a)(1) when they signed the stock purchase agreement [for the original qualified small business stock] on June 17, 2002, and then deposited $1,916,827.07 into [the bank account of the corporation that issued the replacement stock] on August 14, 2002." Owen v. Comm'r, 102 T.C.M. 1135 (2012) (considering a sale in 2002).

81 Treas. Reg. § 1.1045-1(a).

7.3 An election must be made on the tax return for the year of the sale.[83]

7.4 Gain is recognized to the extent that the amount reinvested is less than the sale proceeds.[84]

7.5 The exclusion does not apply to gain treated as ordinary income.[85]

7.6 The purchase price basis in the new shares is reduced by the unrecognized gain in the shares sold.[86]

7.7 The holding period of the new shares includes the holding period of the shares sold.[87]

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*(footnote continued from previous page)*

82 "[C]ontrary to [the taxpayer]'s position that section 1045 shields him entirely from each year's deficiency in tax, he concedes that he failed to meet the section 1045(a)(1) 60-day requirement for some of his [36 replacement co.] stock purchases. At trial, he testified that he did not purchase [replacement co.] stock within 60 days of the 2000 [original co. stock] sale. In addition, on brief, he concedes his failure to reinvest all of his [original co. stock] 2001-04 sale proceeds in [replacement co.] stock, stating only that he reinvested 'a substantial portion of the proceeds from the sale of [original co.] stock ... in [replacement co/.] within the 60-day period following such sale'." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (considering stock purchased in 1997, then sold and the proceeds rolled over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd on other issues in an unpublished opinion* 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015).

83 I.R.C. § 1045(a).

84 *Id*.

85 I.R.C. § 1045(a). Neither the legislative history nor the one regulation and one revenue procedure issued by the IRS provide examples of stock sales that would be treated as ordinary income. Presumably, this limited to the Corn Products doctrine (that stock held as inventory is not treated as a capital asset) and Section 336(e) and 338 transactions in which the sale of shares is treated as a sale of assets.

86 I.R.C. § 1045(b)(3).

87 I.R.C. § 1045(b)(4)(A).

7.8 Reporting the Section 1045 Exclusion

7.8(a) The Section 1045 election is made on the return for the year in which the gain is realized.[88]

7.8(b) If the taxpayer has more than one sale of qualified small business stock during the year, the taxpayer can chose the sales to which the Section 1045 election will apply.[89]

7.8(c) The election, once made, cannot be revoked by filing an amended return unless the taxpayer first obtains a private letter ruling in which the IRS permits the revocation.[90]

7.9 Rules for Section 1045 rollovers involving partnerships have been published as regulations. These include extensive examples showing the mechanics of Section 1045.[91]

7.10 Note that a taxpayer (and the return preparer) using Section 1045 must be prepared to prove that both the original shares and the replacement shares satisfied all the requirements of "qualified small business stock" at the required times and for the required periods.[92] It's a bit like tak-

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88 Rev. Proc. 98-48, 1998-2 C.B. 367, Section 3.

89 Rev. Proc. 98-48, 1998-2 C.B. 367, Section 3.03.

90 Treas. Reg. § 1.1045-1(a); Rev. Proc. 98-48, 1998-2 C.B. 367, Section 3.04.

91 Treas. Reg. § 1.1045-1.

92 "Under section 1045, both the stock sold and the stock purchased by the taxpayer during the 60-day period beginning on the date of the sale must be qualified small business stock. ... Because [the taxpayer in this case] has failed to prove that any of the [replacement co.] stock he purchased was qualified small business stock, we need not consider the question of whether the [original co.] stock sold in each year in issue was qualified small business stock. We also need not address petitioner's argument that he reinvested the proceeds from those sales within a 60-day period, as prescribed by section 1045(a)(1)." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (considering stock purchased in 1997, then sold and the proceeds rolled

*(footnote continued on next page)*

ing a position that a 401(k) plan is a qualified plan – but without the assurance provided by a determination letter on the adoption of the plan and the involvement of a professional plan administrator for each year.

[End of outline.]

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over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd on other issues in an unpublished opinion* 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015).