WILL SERVICE AUTOMATION COMPANIES QUALIFY FOR THE Q.S.B.S. EXEMPTION?

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INTRODUCTION

Many U.S. investors and business owners are familiar with the tax exemption provided to U.S. individuals recognizing gains from the sale of certain U.S. stock defined as qualified small business stock ("Q.S.B.S.").[1] The Q.S.B.S. exemption plays an important role in the growth of hi-tech industry, which is dependent on investments by U.S. persons. It typically benefits U.S. individuals who invest in start-up software companies.

The Q.S.B.S. exemption is not available for investment gains related to shares of stock of corporations engaged in a business involving the provision of specified nonqualified service. In recent years, many start-up software companies have focused on the development of technological tools to provide automated services. Some of those services are of a type considered to be nonqualified business activity for Q.S.B.S. purposes. This raises several interesting questions:

- Will investment gains in these software companies qualify for the Q.S.B.S. exemption?
- In what circumstances are the software companies considered to be providers of nonqualified services?
- In what circumstances are the software companies only providing software tools that are sold to service providers?

This article addresses those questions.

THE GENERAL FRAMEWORK OF THE Q.S.B.S. EXEMPTION

Code §1202 provides that gains from the sale of qualified small business stock held for more than five years are not included in the taxable income of a U.S. individual

[1] Section 1202 of the Internal Revenue Code of 1986, as amended (the "Code"). The Q.S.B.S. exemption was enacted to incentivize investment in U.S. corporations as a vehicle for business start-ups. For many years, the exemption was limited to 50% or 60% of the gain. The limitation was removed by the Tax Cuts and Jobs Act of 2017.

shareholder.[2] The exempt amount is the greater of $10 million or 10 times the aggregate basis in the stock held in the Q.S.B.S.[3]

To qualify for the Q.S.B.S. exemption, the following requirements must be met with regard to the issuer of the stock:[4]

- **A U.S. Corporation.** The corporation must be incorporated in the U.S.[5] or under the laws of one of the states of the U.S.[6] The U.S. corporation cannot be a D.I.S.C., former D.I.S.C., R.I.C., R.E.I.T., R.E.M.I.C., or cooperative.[7] In addition, neither an L.L.C. that has not elected to be taxed as a corporation nor an S-corporation that generally is not subject to corporate tax in the U.S. is considered to be a corporation for purposes of the Q.S.B.S. exemption.

- **An Active Business.** The corporation must be engaged in an active qualified business as defined in Code §1202(e) during substantially all of the shareholder's holding period for the stock.[8] This requirement is at the center of this article and is further discussed below.

- **A Small Business.** The aggregate gross assets of the corporation, including money, must not exceed $50 million both before and immediately after the issuance of the stock.[9] The aggregate gross assets amount is measured by the adjusted bases of the assets the corporation.[10] For this purpose, all corporations that are members of the same parent-subsidiary controlled group are treated as one corporation.[11]

- **Originally Issued Stock.** The stock must have been originally issued to the U.S. individual in exchange for money or property other than shares. Stock originally issued as compensation for services also qualifies. Certain exceptions apply. Stock acquired by gift, bequest, or as a distribution from a partnership generally will qualify if the transferor was the holder of the originally issued stock.[12] Stock held through pass-through entities generally are treated as originally issued stock.[13]

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2 Code §1202(a)(4).

3 Code §1202(b)(1). However, for stock purchased before 2010, the exemption is limited to 50% of the gain derived on the sale. See, Code §§ 1202(a)(1) & (4).

4 Code §§1202(c), (d) & (e).

5 A corporation formed in the District of Columbia is clearly included as a corporation formed in the U.S.

6 Code §1202(d)(1). A domestic corporation is defined in Code §7701(a)(4).

7 Code §1202(e)(4).

8 Code §1202(c)(2)(A).

9 Code §1202(d)(1).

10 Code §1202(d)(2)(A).

11 Code §1202(d)(3). The term "parent-subsidiary controlled group" means any controlled group of corporations as defined in section 1563(a)(1), except that more than 50%-ownership is the measuring stick rather than at least 80%.

12 Code §1202(h).

13 Code §1202(g).

THE "ACTIVE BUSINESS" REQUIREMENT

The Q.S.B.S. exemption may be claimed by an individual investor with regard to shares of a corporation engaged in an active business. For a corporation[14] to be engaged in an "active business" for purposes of the Q.S.B.S. exemption, at least 80% of its assets, measured by value, must be used by the corporation in the active conduct of one or more "qualified trades or businesses."[15]

The term "qualified trade or business" is defined by exclusion. Under Code §1202(e)(3), all trades or businesses qualify, other than the following:

Health	Consulting	Financing
Law	Athletics	Leasing
Engineering	Financial services	Investing
Architecture	Brokerage services	Farming
Accounting	Hotel	Actuarial science
Banking	Restaurant	Performing arts
Insurance	Any trade of business in which the principal asset is the skill or reputation of the employees	Producing or extracting natural resources

Moreover, certain activities specifically qualify even though they may not meet the general understanding of an active trade or business.[16] These activities include the following:

- **Start-Up Activities.** These are activities described in Code §195(c)(1)(A) for which two conditions are met:
    - The activity takes the form of expenditures (i) to investigate the creation or acquisition of an active trade or business, (ii) to create an active trade or business, or (iii) incurred in any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.
    - The expenditures would be allowable as a deduction for the taxable year in which paid or incurred if paid or incurred in connection with the operation of an existing active trade or business in the same field.

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[14] Not including a corporation which is a D.I.S.C. or a former D.I.S.C., R.I.C., R.E.I.T., R.E.M.I.C. and a cooperative. See, Code §1202(e)(4).

[15] Code §1202(e)(1). The assets and activities of 50% owned corporations are also taken into account. See, Code §1202(e)(5).

[16] Code §1202(e)(2)(A).

- **Research and Experimental Expenditures.** These are research or experimental expenditures which may be charged to capital account and amortized ratably over a 5-year period under Code §174, provided they are paid or incurred in connection with the taxpayer's trade or business.
- **In-House Research Expenses.** These are research expenses incurred in-house by a taxpayer if the principal purpose for making such expenditures is to use the results of the research in the active conduct of a future trade or business. In broad terms, a credit is allowed as provided in Code §41.

WHEN DO AUTOMATED SERVICES CONSTITUTE A QUALIFIED BUSINESS ACTIVITY?

Software companies are generally treated as meeting the active business requirement. As a result, U.S. individual shareholders may qualify for the Q.S.B.S. exemption, assuming all other conditions are met. In fact, the Code specifically mentions that rights to computer software used to produce active business computer software royalties are generally treated as assets used in the active conduct of a trade or business. However, a tax question often asked by investors is whether the development of a software tool loses its status as a qualified activity if the software is developed to assist a provider of a disqualified service to provide services faster, better, cheaper, or more quickly.

"Software companies are generally treated as meeting the active business requirement."

An I.R.S. private letter ruling and an I.R.S. Chief Counsel Advice shed light on the answer.[17] The general approach adopted by the I.R.S. is favorable where the development activity merely creates a software tool that is used by another person in the conduct by that other person of a disqualified business activity, such as consulting. On the other hand, if the software is used by the development company to supplant the person conducting the disqualified business activity, the activity of the software company is properly treated as a nonqualified activity. In the former case, the software company receives software royalties. In the latter case, it receives income from a disqualified trade of business.

The favorable result involved the developer of a medical testing device used by health care providers. The unfavorable result involved the developer of "D.I.Y." software that could be used as a listing device by owners of real property held for lease to the public.

Medical Device Fact Pattern

In a Private Letter Ruling from 2017,[18] a software company developed a technological tool to perform laboratory tests ordered by healthcare providers. The facts presented to the I.R.S. were as follows:

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[17] Under Code §6110(k)(3), neither a Private Letter Ruling issued to a taxpayer nor a Chief Counsel Advice to an I.R.S. field examiner reviewing a taxpayer's tax return may be cited as authority by anyone other than the taxpayer involved in the matter. Nonetheless, each illustrates the thinking of the National Office of the I.R.S. or the Office of Chief Counsel at the time of issuance. In addition, both may be cited as authority for the limited purpose of demonstrating the existence of reasonable cause to prevent the imposition of a penalty.

[18] P.L.R. 201717010.

[Taxpayer] owned stock in Company and filed a joint tax return. [Taxpayer] was a founder of Company and served as its chairman and C.E.O. since its formation. [Taxpayer] purchased stock in Company on Date 1 and Date 2.

Company, a C corporation, was incorporated in Year 1 to develop a tool to provide more complete and timely information to healthcare providers. Specifically, Company uses proprietary [software] and other technologies for the precise detection of [medical condition]. [Taxpayer] represent[s] that Company is the only person that can legally perform X testing and that its expertise is limited to its patented X testing.

Company analyzes the results of X testing and then prepares laboratory reports for healthcare providers. Company's clients are doctors and other healthcare providers. [Taxpayer] represent[s] that the information the Company provides in a typical laboratory report only includes a summary of z detected and z tested for and not detected. Company's laboratory reports do not diagnose or recommend treatment. [Taxpayer] represent[s] that Company does not discuss diagnosis or treatment with any healthcare provider, and is not informed by the healthcare provider as to the healthcare provider's diagnosis or treatment. Company's sole function is to provide healthcare providers with a copy of its laboratory report. Company receives compensation for reporting results of tests to healthcare providers, which is based on each test performed.

Company accepts orders for tests only from health care professionals. Patients cannot order tests from Company. Although Company in rare instances may provide a copy of a test to a patient, it does not explain its laboratory reports to patients. Instead, Company directs patients to contact their healthcare provider if they have any questions. The only other contact Company has with a patient is in billing situations. Company will bill a patient directly if the patient is self-insured, uninsured, or if the insurance company pays the patient directly.

[Taxpayer] represent[s] that the laboratory director is required to be an M.D., D.O. or a Ph. D. * * *. The lab director reviews results for quality control and quality assurance. [Taxpayer] represent[s] that to the best of his knowledge, other than the laboratory director, Company's laboratory personnel are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority. [Taxpayer] also represent[s] that laboratory director never has direct contact with patients and that none of the Company's personnel diagnose, treat or manage any aspect of any patient's care.

[Taxpayer] represent[s] that Company's employees, who are well educated, receive up to a year of training to perform the X testing. However, [Taxpayer] represent[s] that the skills employees bring with them when Company hires them are almost useless when performing the X tests and that the skills they acquire at Company are not useful to other employers.

> Company maintains a research division to develop additional uses for its proprietary technology. Company has also developed additional uses for its X testing. For example, it tests for z in food and agricultural products.

On those facts, the I.R.S. ruled that the U.S. corporation owned by Taxpayer engaged in a qualified trade or business under the definition that appears in Code §1202(e)(3).

> Company provides laboratory reports to health care professionals. However, Company's laboratory reports do not discuss diagnosis or treatment. Company neither discusses with, nor is informed by, healthcare providers about the diagnosis or treatment of a healthcare provider's patients. Company's sole function is to provide healthcare providers with a copy of its laboratory report.
>
> Company neither takes orders from nor explains laboratory tests to patients. Company's direct contact with patients is billing patients whose insurer does not pay all of the costs of a laboratory test.
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> In addition, you represent that the skills employees bring to Company are not useful in performing X tests and that skills they develop at Company are not useful to other employers.
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> Further, none of Company's revenue is earned in connection with patients' medical care. Other than the laboratory director, Company's laboratory technicians are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority.
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> Although Company's laboratory reports provide valuable information to healthcare providers, Company does not provide health care professionals with diagnosis or treatment recommendations for treating a healthcare professional's patients nor is Company aware of the healthcare provider's diagnosis or treatment of the healthcare provider's patients. In addition, the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers.
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> Thus, based on the facts and representations submitted, we conclude that for purposes of § 1202(e)(3), Company is not in a trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.

"D.I.Y." Software Supplanting Real Estate Broker Services

Like healthcare services, the provision of brokerage services is considered a non-qualified businesses for Q.S.B.S. purposes. In a 2022 Chief Counsel Advice,[19] the I.R.S. concluded that a company that developed the software for D.I.Y. real estate

[19] .C.A. 202204007. In comparison to a Private Letter Ruling, Chief Counsel Advice arises when a field agent of the I.R.S. who is examining a taxpayer's income tax return seeks legal advice from the Office of the Chief Counsel.

listings generated revenue from the performance of brokerage activities, a disqualified business activity. The facts were as follows:

> Taxpayer sold stock in Corporation. Corporation operates a website on which potential lessees may use the website to make nonbinding reservations for the use of certain facilities at specified rental rates from facility lessors that are included in the website data base. Corporation has no authority to enter into or sign leases on behalf of the potential lessors or lessees. A legally binding rental agreement for the use of a facility does not arise until the potential lessor and the potential lessee enter into a lease agreement. Corporation's website will show a user that is considering leasing one or more facilities in a particular location the facilities in that area that are included in the website database.
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> Potential lessees do not pay any fee to Corporation for the use of Corporation's website. In its "Terms of Service" for lessees, Corporation states that it has no control over the facilities to be leased and does not guarantee the accuracy of any listings. Nor does Corporation guarantee that a lessee will actually be able to lease a facility listed in its database.
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> The lessors are responsible for all payments to Corporation. As a condition of being listed in Corporation's public, searchable database, lessors agree to compensate Corporation. Specifically, Corporation charges lessors a recurring periodic fee for simply being listed in the database, and a contingent fee based on a percentage of rent paid by a lessee actually leasing a facility from a lessor through a search of Corporation's database. Corporation requires lessees to pay the rent for the leased facility through Corporation's website.
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> The facilities listed for lease on Corporation's website [includes] real property. In Corporation's "Terms of Service," Corporation represents to potential lessees that * * * it is not responsible for, and does not engage in, brokering, selling, purchasing, exchanging, or leasing posted properties. Although it may hold a real estate broker license in one or more states, Corporation asserts that it is not a broker with respect to the leasing of the facilities. Further, a lessee's use of the website constitutes an acknowledgement that Corporation has pre-negotiated rental rates with the lessors included on its website, part of which will be retained by Corporation as compensation for its services.
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> Corporation may also provide other services to lessors. For example, Corporation may charge a lessor a monthly fee to build and host a website for the lessor to be used in conjunction with the leasing of the lessor's facility. Liability for this monthly fee is not contingent on the lessor successfully leasing its facility to potential lessees.

In the C.C.A., Taxpayer characterized Corporation's activities as merely advertising, which is not a nonqualified business activity. However, the C.C.A. concluded that the activity of Corporation extended beyond passive advertising and constituted the provision of brokerage services.

Recognizing that neither the Code §1202 nor the regulations issued under that section define the term "brokerage services," the I.R.S. looked at how brokerage was defined in other areas of the tax law. In particular, it pointed to Code §6045(a), which requires every person doing business as a broker to file information returns regarding the person's customers in accordance with I.R.S. regulations. Code §6045(b) also requires the person doing business as a broker to provide a statement to the customer. The term broker is broadly defined in the statute without any restriction to a particular type of business. Specifically, Code §6045(c)(1) provides that the term broker includes—(A) a dealer, (B) a barter exchange, and (C) any other person who (for a consideration) regularly acts as a middleman with respect to property or services. Moreover, Code §6045(e) acknowledges that more than one person can serve as a broker for real estate and prescribes an ordering rule as to which of the persons identified as a broker with regard to a particular transaction has a reporting obligation.

"One example given in the regulations involves a taxpayer in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks."

In addition, Code §448 provides that partnerships conducting certain business activity are required to report income to the I.R.S. using the accrual method of accounting. Brokerage partnerships must report income using the accrual method of accounting. The regulations issued by the I.R.S. recognize that a person who provides both brokerage and advisory services is considered to be a broker for purposes of Code §448 if its right to income is based primarily on closing a transaction. One example given in the regulations involves a taxpayer in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. The taxpayer provides its clients with economic analyses and forecasts of conditions in various industries and businesses. Based on that data, the taxpayer makes recommendations regarding transactions in securities and commodities. Clients place orders with the taxpayer to trade securities or commodities based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the trade orders it fulfills. Based on the way the taxpayer is compensated, it is not considered to be engaged in the performance of services in the field of consulting. It is properly treated as a broker.

The Chief Counsel advice concludes that the corporation developing the software and maintaining the listing service met the definition of a broker for purposes of Code §1202, leading to a denial of the Q.S.B.S. exemption.

> We conclude that Corporation should be classified as a broker under the common meaning of the term and as it is defined under § 6045, rather than the more narrow a definition that applies for purposes of § 199A.* * * While Corporation states that it does not provide brokerage services but instead provides advertising services, it is our view that the actions and services provided by Corporation support our position that Corporation is a broker for purposes of § 1202(e)(3)(A).
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> A broker serves as an intermediary between a buyer and a seller, and Corporation does this. Corporation does not just passively publish advertisements on its website that are provided to it from potential lessors desiring to lease property. Unlike a search engine that provides content to users and also sends targeted advertisements to those users based on their search history, Corporation's website is solely devoted to effectuating agreements between potential lessors and potential lessees of certain property.

> Corporation charges a minimum flat fee to lessors irrespective of whether a potential lessor succeeds in entering into lease agreements as a result of the use of Corporation's website. However, Corporation is also compensated on a commission basis based on leasing transactions that are entered into as the result of the use of Corporation's website.
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> Corporation does not have the authority to enter into leasing agreements on behalf of lessors that use its services. Corporation only provides a vehicle for potential lessees to transmit non-binding reservation requests to potential lessors. Only the potential lessor and lessee have the authority to enter into a binding lease agreement. However, brokerage activity can include simply bringing a potential buyer and seller together to work out the transaction. * * *
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> The fact that Corporation's services are provided by software created by people rather than directly by people does not change the functional nature of the services. Because Corporation provides brokerage services within the meaning of § 1202(e)(3)(A), taxpayer is not entitled to exclude any of the gain from the sale of stock in Corporation under § 1202. *[Footnotes omitted.]*

CONCLUSION

For many years, computer software, digital platforms, and other technological tools have been used by service providers in facilitating what they do. To the extent that the customers of the software development company are, themselves, service providers that use the technology as a tool in providing the services they perform, the software development company is not expected to be treated as a service provider. Investors should seek to claim the Q.S.B.S exemption from tax for capital gains, provided all other requirements of Code §1202 are met. However, with the rise of artificial intelligence, more and more software tools will be used to perform analysis, draw conclusions, and even recommend proper business and professional decisions. At present, if the software is merely a data gathering tool for final decisions by a service provider who interfaces with a customer, the software developer corporation should not be viewed to be engaged in a disqualified business. However, once the software reaches the stage of making judgment calls that are communicated directly to a consumer rather than providing data – including conclusions – to an unrelated person that interfaces with a consumer, the software development corporation may find that it has crossed the line from being a compiler of data to become a participant that provides nonqualified business activity to customers. The risk will be greatest if the fee for using software program increases as its decisions are implemented. Here, individuals that invest in the software developer may face an I.R.S. challenge when claiming the benefit of a Q.S.B.S. exemption.