PLR INTERPRETS BROKERAGE SERVICES FOR SECTION 1202 QUALIFIED TRADE OR BUSINESS REQUIREMENT

On April 9, 2021, the Internal Revenue Service (IRS) issued Private Letter Ruling (PLR) 202114002, concluding that a company in the business of obtaining insurance for its customers (Company) is not performing "brokerage services" for purposes of whether it meets the qualified trade or business requirement under the rules for exclusion of gain on sales of qualified small business stock (QSBS). The QSBS rules, which are highly complex, are governed by Internal Revenue Code Section 1202.

Background on Section 1202

Section 1202 generally permits a noncorporate shareholder to exclude up to 100% of the gain from the sale or exchange of QSBS issued after September 27, 2010, and held for more than five years. A 50% or 75% gain exclusion is available for QSBS issued between August 10, 1993, and September 27, 2010. The overall gain exclusion per issuer is limited to the greater of $10 million or 10 times the aggregate adjusted basis of the disposed shares. Each partner in a partnership and each shareholder in an S corporation is entitled to their own $10 million limitation on dispositions of QSBS by the partnership or the S corporation.

QSBS is stock of a C corporation that was received by the shareholder on original issuance for cash, property other than stock, or services. In addition, to be considered QSBS:

- The issuing corporation's aggregate gross assets cannot exceed $50 million at any time up to and immediately after the issuance of the stock, and
- During substantially all of the shareholder's holding period, at least 80% of the assets of the corporation must be used in the active conduct of a **qualified trade or business**.

Section 1202(e)(3) provides a list of trades or businesses that are not considered qualified trades or businesses, and presumably, any trades or businesses not on that list are considered qualified trades or businesses. "Brokerage services" is among the excluded trades or businesses that are generally ineligible for Section 1202 benefits. However, prior to PLR 202114002, no guidance existed for defining "brokerage services" for purposes of Section 1202.

About PLR 202114002

According to the PLR, Company's business is working with its customers to obtain various types of insurance coverage. Company operates under two general business models. First, it contracts directly with insurance companies (or in some cases their representatives) to sell their products in return for commissions or similar compensation. Insurance companies use this model to select and control who can sell their products. In addition to containing the terms for the sales of insurance products, the contracts with the insurance companies require Company to perform certain administrative services, such as report incidents, claims, etc. to the insurance company or its designated claims adjuster; cooperate with investigations, adjustments and settlements; and maintain complete and accurate records of its business transactions, which the insurance companies may examine and audit. Company represents that for the duration of the time a certain shareholder held Company's stock, at least 80% (by value) of Company's assets were used in this first business model.

Second, Company also has contracts with insurance wholesalers. Under this business model, Company has a contract with a wholesaler and not an insurance company, and the wholesaler's contract with multiple insurance companies. Company selects an appropriate policy for a customer provided by a wholesaler. If the customer accepts the policy, the wholesaler procures the policy from the insurance company.

The IRS was asked to determine if Company is engaged in a qualified trade or business for purposes of Section 1202. In considering its ruling, the IRS focused on whether Company, which the IRS notes has been referred to as an insurance agent and broker, is engaged in the business of providing disqualified brokerage services under Section 1202(e)(3).

Based on the facts presented, the IRS concluded that Company's first business model is a qualified trade or business. In reaching its conclusion, the IRS relied on the common meaning of the term "broker" based on the Merriam-Webster dictionary definition of the term, which describes a broker as "one who acts as an intermediary." The IRS reasoned that because the contracts require Company to perform administrative services that are beyond what a mere intermediary would provide, Company's first business model is not brokerage services.

Insights

With respect to the interpretation of a "qualified trade or business" for purposes of Section 1202, the IRS previously issued two rulings that relate to the health and medical industry. In PLR 201436001, the IRS ruled that a taxpayer in the business of commercializing and manufacturing drugs was not in the field of health for purposes of Section 1202(e)(3). Similarly, in PLR 201717010, the IRS ruled that a taxpayer that uses its IP and technologies to provide a certain testing needed for healthcare providers was not engaged in the field of health but was engaged in a qualified trade or business. In both instances, each corporation did not have direct interaction with any patients.

PLR 202114002 is the first ruling in which the IRS interprets the term "brokerage services" in the context of Section 1202. PLR 202114002 is significant in the following ways:

- Given that very little guidance has been issued for interpreting the QSBS provisions, PLR 202114002 represents one of the few rulings to exist that analyzes what constitutes a qualified trade or business for purposes of Section 1202. This ruling provides taxpayers with valuable insight into the IRS's position in similar situations. While taxpayers with similar business operations may not rely on the new PLR to qualify for gain exclusion as each ruling is specific to the taxpayer that requested it, it provides a compass with respect to how similar business models should be evaluated. New ventures providing software or other technology platforms for financial and insurance products (often referred to as the "Fin Tech" industry) may find this PLR encouraging.
- In PLR 202114002, the IRS notably relied on the common dictionary definition of brokerage services rather than borrowing a definition from another section or sections of the tax law. For example, regulations under Sections 448 (T.D. 8143) and 199A (T.D. 9847) each provide a definition for "brokerage services," but the IRS did not mention these regulations in its ruling. This may indicate that unless additional guidance is issued, taxpayers may be able to rely on the ordinary, contemporary, common meaning of the services that are included on the list of the disqualified trades or businesses.

- It could be interpreted from PLR 202114002 that the IRS may view the integral components of a taxpayer's trade or business on an aggregated basis (as opposed to on a segregated basis). From the facts presented in the ruling, Company's first business model appears to contain a brokerage component as Company partially arranges sales of insurance products between buyers and sellers. The IRS nonetheless ruled in favor of Company because Company also offers a number of administrative services.
- It may be possible to use the rationale behind this ruling to draw an analogy to other administrative service businesses. For example, the performance of administrative services in the context of Management Service Organizations that process back office billing and collection functions for healthcare clinical entities may also qualify by comparison.
- Taxpayers traditionally considered to be agents or brokers should closely review the facts presented in PLR 202114002. If the taxpayer provides administrative services in addition to acting as an intermediary between buyers and sellers, it is possible the taxpayer would not be considered engaging in brokerage services for Section 1202 purposes. What is still unclear from the ruling, however, is the scale or extent of administrative services required.
- Section 1202 imposes many requirements that a taxpayer needs to satisfy to obtain capital gain exclusion. In light of the view taken by the IRS in PLR 202114002, shareholders that have assumed a corporation's trade or business ineligible for the Section 1202 benefits should review the corporation's specific business activities and revisit whether those activities can qualify.