

# IRS Provides Guidance on Code Section 1202 QSB Stock; Reinhart Helps Client Obtain Favorable Ruling

In Private Letter Ruling 202352009, the IRS ruled that a company engaged in interim executive staffing and permanent executive placement services operated a qualified trade or business under Internal Revenue Code (Code) section 1202(e)(3). The IRS concluded that the company was not engaged in consulting or a business where the principal asset was the reputation or skill of one or more of its employees. Reinhart attorneys Lucien Beaudry and Heidi Gabriel assisted in the ruling, which resulted in significant tax savings for the investors.

## Overview of Qualified Small Business Stock

Code section 1202(a) permits taxpayers who acquire qualified small business (QSB) stock after 2010 to exclude up to 100 percent of the gain recognized on the sale of the stock. Many requirements must be satisfied to obtain this benefit, including that the issuing corporation must be a “C” corporation and operate a “qualified business.” Also, the taxpayer must hold the QSB stock for at least five years.

### *Simplified Illustration of 1202 Tax Savings*

- Assume a Wisconsin founder acquires 1 million shares of stock in a startup in 2010 for \$1 per share and then sells the stock in 2024 for \$10 per share. The taxpayer would recognize \$9 million of capital gain, and assuming a 30 percent federal and state tax rate, would owe \$2.7 million in tax on the sale in 2024. However, if the stock is QSB Stock, and all other requirements under Code section 1202 are met, 100 percent of the \$9 million gain is excluded from income and the taxpayer saves \$2.7 million in taxes.

“Consulting” businesses, and any business where the principal asset is the reputation or skill of one or more of its employees, are excluded from the QSB benefit. These terms are not defined in the Code, and there is little other guidance on the meaning of these terms. This creates significant uncertainty for taxpayers operating a temporary employee and executive search business.

## Facts Surrounding the Company’s Business and QSB Risk

The company analyzed by the IRS provided executive search services and interim staffing of executive, technical and professional service providers. In each

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instance, the company used the term “consulting” in its marketing materials to emphasize the value it added for its customers. Also, the company had an excellent reputation of providing highly qualified temporary employees. All the temporary employees received their compensation and Form W-2 from the company. An initial review of these facts might lead one to conclude that the business does not qualify for QSB status.

## **The IRS Private Letter Ruling**

In reaching its conclusion, the IRS focused its analysis on the underlying legal relationships between the company and its customers:

- The company placed individuals who were treated as an “employee” of the customer.
- The placed professionals reported to the executives of the customer.
- The customer supervised and directed the professional, provided all necessary resources and was responsible for the outcomes achieved by the individual.
- The company merely served as a payroll processor when issuing paychecks and Form W-2 to the temporary employee.

The company's advice and counsel were limited to assisting the customer in finding the appropriate employee and it did not directly provide the advice and counsel related to the customer's underlying project. Given that the temporary employees were typically highly trained, specialized professionals, the company was required to provide extra service in locating and placing these individuals. While the company described this extra service as “consulting,” such service did not constitute “consulting” within the meaning of Code section 1202.

The company provided its executive search services by placing professionals in permanent executive positions at customer businesses. The IRS did not view this activity as “consulting,” nor did it view the activity as a business where the principal asset is the reputation or skill of one or more employees.

In addition, with respect to both interim staffing and executive search services, the customers did not engage the company to directly assist in achieving its goals, completing projects or solving problems. In many cases, the company's customers engaged a third-party consulting firm to provide analysis, counsel and business development plans. The company's role was to provide temporary



employees to implement or fill the business needs identified by the customer or its third-party consulting firm.

### **Key Takeaway**

Many service businesses may use the term “consulting” in marketing literature to demonstrate the value that is added to customer relationships. However, such a fact does not necessarily defeat Code section 1202 status. Taxpayers should analyze the underlying legal relationships and responsibilities of the parties to determine whether the business qualifies for QSB treatment. What might appear as a disqualified “consulting” business might actually qualify for the tremendous tax benefits of Code section 1202.

To learn more about QSB and if your company qualifies, please contact [Lucien Beaudry](#), [Heidi Gabriel](#) or your Reinhart attorney.

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