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The MICHIGAN TAX LAWYER is a publication of the Taxation Section of the State Bar of Michigan that is designed to be a practical and useful resource for the tax practitioner. Input from members of the Taxation Section is most welcome. Our publication is aimed toward involving you in Section activities and assisting you in your practice. The Taxation Section web address is www.michigantax.org. If you have suggestions or an article you wish to have considered for publication, please contact JSheridan Dupont, (616) 649-1974, sdupont@honigman.com.

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Letter from the Chair

Dear Members of the Taxation Section:

It is my honor to serve as the Chair of the Section for the 2025-2026 fiscal year. I am looking forward to working with the Section's Council and Committees to build upon the solid foundation laid by my predecessors. This year, members will see a continuation of our historically successful offerings, such as the Annual Tax Conference scheduled for May 21, 2026 in a new location, Troy, MI, Committee educational meetings, pro bono referral and grant programs and Tax Court Luncheons.

We are also focused on increasing Section membership. The Taxation Section maintains its vitality by growing membership and attracting practitioners with different types of tax practices. The diverse experiences of our members are shared through our many Section events, which I encourage all members to attend. Many of these events are hosted by our Committees. Our Committee Chairs devote a significant amount of time and effort to identifying useful subject matter, interesting and accomplished speakers, and accessible locations for the presentations. These Committee presentations will once again be provided in our traditional format of regularly scheduled events with some being in person and others being virtual.

The Section is committed to educational programming for and by our members, and Committee Chairs can provide speaking opportunities for those who are interested in giving back to the Section. Members interested in participating in Committee events, whether as a speaker or as an attendee, should contact the relevant Committee Chair:

Federal Income Tax: Bella Jordan

Estates & Trusts: Joseph Haddad

State & Local Tax: Scott Foess

Employee Benefits: Katina Gorman

Young Tax Lawyers: Kathryn Ahlbrand

Our website - <http://connect.michbar.org/tax/home> - contains useful information for Section members and we also can be found on LinkedIn. Please look for us there! I look forward to another great year for the Section and hope to meet many of you at our events.

Ryan J. Peruski

Section Committee Reports

YOUNG TAX LAWYERS



Kate Ahlbrand

Committee Chair, Young Tax Lawyers Committee

Kate is a member of Varnum LLP's Tax Planning, Compliance and Litigation Practice Team. She concentrates her practice on the full spectrum of federal, state, and local tax matters with a particular emphasis on sophisticated corporate tax planning, tax controversy, and multistate tax issues. She counsels public and private companies and high-net-worth individuals on structuring transactions, maximizing tax credits and incentives, navigating tax compliance, and resolving disputes with tax authorities at all levels.

Kate also has an extensive background in international tax matters, including cross-border transactions, transfer pricing and compliance. She advises clients on the tax implications of inbound and outbound investments and assists with structuring international operations to achieve tax efficiency.

FEDERAL INCOME TAX



Bella Jordan

Committee Chair, Federal Income Tax Section

As a member of Plante Moran's National Tax Office, Bella specializes in federal tax consulting for corporations and partnerships on tax matters in the context of mergers and acquisitions, accounting methods, and tax legislation. She consults with clients throughout the lifecycle of their business to optimize tax strategies from initial entity choice to ultimate exit planning. Her clients range from closely held start-ups to multinational corporations and private equity groups. Bella received her Juris Doctor and Master of Business Administration from Ohio State University.

EMPLOYEE BENEFITS



Katina Gorman

Committee Chair, Employee Benefits

Katina K. Gorman is a Senior Attorney at Miller Canfield specializing in employee benefits law. She has extensive experience advising clients on plan design, administration, and regulatory matters. She frequently drafts benefits-related documents including plan documents, summary plan

descriptions, and plan amendments. Katina routinely represents clients before the IRS and DOL during audits and investigations. Please contact Katina with any questions you may have regarding the Employee Benefits Committee: gorman@millercanfield.com.

STATE AND LOCAL TAX



Scott Foess

Committee Chair, State and Local Tax Section

Scott Foess concentrates his practice on advising clients on U.S. federal and state and local tax matters. He advises clients on mergers and acquisitions, income tax positions, exposure analysis, for both corporate and partnership taxation as well as a focus on the taxation of financial products. For state and local tax matters, Scott supports multistate businesses with economic nexus positions, exposure to gross receipts and sales taxes, apportionment models, unclaimed property, performance-based incentive negotiations, and voluntary disclosure agreements underlying many merger and acquisition transactions.

ESTATES AND TRUSTS



Joseph Haddad

Committee Chair, Estates and Trusts Section

Joseph Haddad represents high net worth individuals in connection with estate planning, trust and estate administration, and other matters related to tax planning and business ventures.

“Waiving” Farewell to 280G: Advising Privately Held Corporations Regarding Parachute Payments

By Brandon P. Cross



I. INTRODUCTION

It is not uncommon in the legal profession that the subject of employee benefits can get the “short shrift” within the context of corporation mergers or transactions. And this can be surprising, considering the potential size of the dollar amounts involved and what they often represent to recipients—financial security. With the complexities and pitfalls that lawyers must advise clients of during a change in control of a for-profit corporation (“CIC”), often under the hazard of an impending closing date, section 280G¹ (“280G”) is an easy provision to overlook.

While 280G can be an expected issue in public company CICs, but it is less commonly understood that 280G may apply in privately held for-profit corporation CICs where the corporation must be treated as a C corporation for federal income tax purposes. The goal of this Article is to highlight a couple points for practitioners about private corporation CICs: First, avoid assuming 280G will not be a problem with private company CICs. Second, while it may be possible to “fix” a 280G problem with a shareholder vote, it will require diligence and some forethought. Given the personal nature of much executive compensation, the time and effort to obtain 280G-compliant shareholder approval could very well mean the difference between a successful CIC and a “dead” deal.

II. 280G, GENERALLY

A. PARACHUTE PAYMENTS

The focus of 280G is “excess parachute payments.”² If anything falls within the definition of an “excess parachute payment,” then 280G forbids a tax deduction for it for the payor.³ Additionally, a nondeductible 20% excise tax will be assessed against the recipient of any excess parachute payments.⁴

Commonly, “parachute payments” are payments under executive agreements or plans that would not have been made “but for” a CIC.⁵ However, 280G’s reach extends well beyond this, potentially including “any payment in the nature of compensation” to a disqualified individual that is contingent on a CIC.⁶ This definition can include bonus payments, stock awards, and even the value of accelerated vesting that results from a CIC, regardless of whether there is an associated payment upon the CIC.⁷ A treatise on everything that falls within 280G’s definition of “parachute payment” is beyond the scope of this Article, but lawyers should be wary of any payments (even what could be considered “normal” salary payments or employment agreement amendments) being made to executives in the years immediately before and immediately after a CIC. A best practice for lawyers would be to have an experienced executive compensation lawyer review such payments and benefits that will vest upon the CIC at the time the CIC agreement is being negotiated and well in advance of closing.

B. DISQUALIFIED INDIVIDUALS

Even if a payment would otherwise qualify as a “parachute payment,” it won’t be considered one under 280G unless it is paid to a “disqualified individual.”⁸ A “disqualified individual” is a “person” (which includes personal service corporations and similar entities) who is an officer, shareholder, or an individual who ranks among the highest paid 1% of the corporation’s employees or highest paid 250 employees, if less.⁹ If the “person” isn’t an employee, they are treated as if they were an employee for purposes of this test.¹⁰

C. *BASE AMOUNT*

Crucial to determining whether a parachute payment is an “excess parachute payment,” 280G introduces the concept of a disqualified individual’s “base amount.”¹¹ A disqualified individual’s base amount generally is the sum of annual payments from the company to the individual that are included in gross income, averaged over the five calendar years prior to the year of the CIC.¹² Multiplying an individual’s base amount by three creates the threshold for determining whether or not a parachute payment is an “excess parachute payment.”¹³ If the *present value* of a disqualified individual’s parachute payments exceeds *three times* the individual’s base amount, the present value of the individual’s parachute payments that exceeds *one times* the individual’s base amount are “excess parachute payments.”¹⁴

III. 280G EXEMPTIONS FOR PRIVATELY HELD COMPANIES

Thankfully, 280G has some important exemptions that will save many privately held companies from having to deal with lost deductions or penalties for their executives. Payments from S corporations, and those companies which would otherwise be eligible for an S corporation election at the time of a corporate transaction, enjoy a broad exemption from 280G. Other privately held companies may still be able to exempt parachute payments from 280G if approved by the company’s shareholders.

A. *S CORPORATIONS*

280G expressly exempts payments from S corporations from the definition of “parachute payment.”¹⁵ Considering that over half of small businesses have made an S corporation election¹⁶, this exemption pulls many payments out of 280G’s reach. Interestingly, the exemption for S corporations focuses on *eligibility* for an S corporation election at the time of the transaction rather than whether the taxpayer has made the election.¹⁷ This means that a corporation may well fit within this exemption despite being classified as a C corporation at the time of a CIC.¹⁸ As discussed below, this exemption is the simpler of the two exemptions available for privately held companies. When determining how to counsel a client regarding 280G during a transaction, lawyers should first consider whether the payor is an S corporation or would be eligible to become one at the time of the transaction.

B. *SHAREHOLDER APPROVAL*

If a company does not qualify for the S corporation exemption, 280G also provides an exemption for payments made from privately held companies that are shareholder-approved.¹⁹ Unfortunately, as discussed for the remainder of this Article, the work for companies (and counselors) does not end there. Payments from privately held companies will not be exempt from 280G without strict adherence to 280G’s disclosure and voting requirements.

IV. EXEMPTING SHAREHOLDER-APPROVED PARACHUTE PAYMENTS BY PRIVATELY HELD COMPANIES

Unlike the S corporation exemption from 280G, the shareholder vote exemption for privately held companies looks at the payments themselves rather than solely at the payor entity.²⁰ In other words, being a privately held company merely gets a company “in the door” for the exemption, rather than ending the analysis. The shareholder vote exemption requires a parachute payment to be (1) properly identified and materially disclosed to shareholders along with all other parachute payments to the identified individual, (2) made wholly contingent upon shareholder approval by more than 75% of the shareholders immediately prior to the transaction, and (3) be approved by a shareholder vote of more than 75% of the shareholders immediately prior to the transaction.²¹

A. *IDENTIFICATION AND “ADEQUATE DISCLOSURE” TO SHAREHOLDERS*

For a payment to be exempt under 280G, it must be disclosed and approved by more than 75% of the shareholders prior to the transaction.²² 280G, itself, does not contain the shareholder disclosure requirements for this approval; the requirements are found in the related regulations (“280G Regulations”).²³ The 280G Regulations define the shareholder approval exemption similar to 280G, while also introducing the concept of “adequate disclosure.”²⁴

For the shareholder disclosure to satisfy 280G, the 280G Regulations require disclosure of “all material facts” for all of the payments to an individual that would otherwise be parachute payments.²⁵ A “material fact” is one that is omitted from the disclosures that there is a “substantial likelihood that a reasonable shareholder would consider it important.”²⁶ The 280G Regulations provide several examples of required material facts, including: (1) the event that triggers payment, (2) the total amount of the payments that would be parachute payments if not shareholder-approved, and (3) a brief description of each payment.²⁷ The “brief description” should include the nature of the payment, such as whether it is from the accelerated vesting of an option, a bonus payment, or a salary payment.²⁸ The recipients of the disclosure must be “all persons entitled to vote.”²⁹

As indicated by the requirements above, lawyers should counsel clients to ensure that they are thorough when creating the necessary disclosures. The 280G Regulations permit shareholders to vote on only a portion of the payments to be made to a disqualified individual.³⁰ However, the 280G Regulations also require that *all* parachute payments to a disqualified individual be identified in the appropriate disclosures, not just payments that are being put to a shareholder vote.³¹ The result of this is, while companies have some flexibility on structuring which parachute payments go to a shareholder vote, the company must still disclose every parachute payment that will be made to the executives identified in the shareholder vote. This means, to satisfy the disclosure requirements, a complete 280G analysis and valuation must be prepared for every disqualified individual with a parachute payment that will go to a shareholder vote.

B. CONTINGENT UPON SHAREHOLDER APPROVAL

The 280G Regulations provide an additional requirement for the shareholder approval exemption that is not found in 280G: the shareholder vote must determine whether or not the disqualified individual is entitled to each payment subject to a vote.³² This means that the exemption is not available for payments that are already guaranteed by the company. Additionally, the 280G Regulations specify that if a parachute payment was already made to an executive and the shareholders do not approve the payment prior to the CIC, the disqualified individual must return the parachute payment to the company.³³ Ostensibly, this requirement must be written into the agreement awarding the payment to the disqualified individual or otherwise agreed upon by the parties prior to the shareholder vote.

C. SHAREHOLDER VOTE

Assuming adequate disclosure of all parachute payments is made to shareholders, the shareholder vote to approve the contingent parachute payments must otherwise follow the normal voting rules of the company.³⁴ The corporate transaction, itself, may not be conditioned on the approval of any parachute payments by the shareholders.³⁵ Understanding the timing considerations for orchestrating a vote, the 280G Regulations specify that the group of shareholders entitled to vote may be identified as of any date 6-months prior to the date of the transaction.³⁶

For purposes of determining the 75% threshold, stock owned by a disqualified individual who would receive shareholder-approved parachute payments subject to a shareholder vote is usually not counted as outstanding stock.³⁷ The only exception to this rule is if all of the company's shareholders would receive shareholder-approved parachute payments subject to a shareholder vote.³⁸ If this is the case, the disqualified individuals' stock *will* be counted as outstanding and entitled to vote on the matter.³⁹

The 280G Regulations also contain special rules for shareholders that are *entities* rather than *individuals*. These rules govern situations such as when a trust is the holder of shares that are entitled to vote on the approval of contingent parachute payments.⁴⁰ Approval by shareholder entities generally must be given by the person authorized by the entity to approve the payment (such as grantors/beneficiaries for trusts or directors for corporate entities).⁴¹ However, if the person authorized to vote for an entity is a "disqualified individual" who would receive shareholder-approved parachute payments, then that individual may not vote, but the entity may instead appoint another authorized person to vote.⁴² Additionally, if a "substantial portion" of a shareholder entity's assets are stock in the company that is the subject of the transaction at-issue, approval by the shareholder entity must be by a vote of more than 75% of the shareholder entity's outstanding shareholders.⁴³ In other words, the vote of a shareholder entity is passed through to the shareholders of the shareholder entity. For purposes of the 280G Regulations, the "substantial portion" condition is satisfied if the shareholder entity holds company stock that is equal to or exceeds one third of the value of the assets of the entity undergoing the transaction, determined without regard to any liabilities associated with such assets.⁴⁴

D. PROCESS AND DOCUMENTATION

Attorneys should counsel their clients that both form *and* substance matter for satisfying the shareholder approval exemption from 280G. The 280G Regulations indicate that normal voting rules apply for the shareholder vote (unless they conflict with the 280G Regulations), so attorneys should advise their clients to adhere to all corporate formalities when conducting the vote. Records of the minutes, attendance, and results for the shareholder meeting should be kept, as well as all disclosure materials that were provided to the shareholders prior to the vote. Additionally, if any entities were shareholders eligible to vote in the matter, clients should keep records substantiating that the 280G Regulations shareholder approval rules for shareholder entities were satisfied.

V. CONCLUSION

280G can often be overlooked when counseling a privately held corporation through a CIC; however, because of the financial risks—not only from lost deductions or penalties but also the expense of held-up deals due to conflicts over executive compensation—lawyers should include 280G on their due diligence list for every transaction. Raising the issue to ensure the corporation is an S corpo-

ration (or eligible to be one) may quickly dispel the risk associated with 280G, and if a client fails to meet the S corporation exemption, mitigation may still be possible with a shareholder vote. Failing to address 280G proactively, however, can create tax exposure for the companies involved with the transaction, tax liability for the executives whose payments are impacted, and disrupt a successful closing and post-transaction transition.

A. PRACTITIONER'S AID

The following list is provided to aid lawyers while navigating these topics with clients during a corporate transaction involving a privately held company:

1. Is the corporation either an S corporation or eligible to be an S corporation?
 - If so, payments would automatically not be considered parachute payments under 280G.
2. Is the corporation privately held?
 - If so, the corporation may be able to exempt parachute payments with a shareholder vote.
3. Have all disqualified individuals potentially receiving parachute payments been identified?
4. Have all parachute payments for the disqualified individuals been identified and valued?
 - Reminder: Valuation is necessary for adequate disclosure of the payments to shareholders for an approval vote and includes benefits that vest at closing even if they will not be paid at closing.
5. Are the identified parachute payments greater than three times the base amount for each disqualified individual?
 - If so, then parachute payments greater than one times the disqualified individual's base amount are excess parachute payments.
6. Are any of the parachute payments contingent upon shareholder approval?
 - If so, only those payments contingent upon a shareholder vote would be eligible for the shareholder approval exception under 280G.
7. If identified parachute payments are not subject to a shareholder vote, would the disqualified individual be amenable to making any of the parachute payments contingent upon shareholder approval?
8. If any of a disqualified individual's parachute payments are contingent upon and put to a shareholder vote, have disclosures been prepared that:
 - a. Satisfy the 280G regulations' requirements for a full and truthful disclosure of the material facts for the parachute payments, including:
 - i. the event that triggers the payment(s),
 - ii. the total amount of the payments that would be parachute payments if not shareholder-approved, and
 - iii. a brief description of each payment.
 - b. Identify all parachute payments to a disqualified individual that are the subject of the shareholder vote, *even those that are not being voted upon?*
 - c. Are received by all shareholders who are entitled to vote on the matter, per the 280G regulations, as determined within the 6-month period immediately prior to the transaction?
9. If a disqualified individual's parachute payments are put to a shareholder vote, were the payments approved by more than 75% of the shareholders eligible to vote?
 - If so, then the individually approved payments are exempt from the 280G definition of a parachute payment.
 - If not, then the disqualified individual must forfeit or return the identified contingent parachute payments that were not approved.

ABOUT THE AUTHOR

Brandon P. Cross is an associate attorney in Warner Norcross + Judd LLP's Employee Benefits practice group and focuses his practice on qualified retirement plans, nonqualified deferred compensation plans, and executive compensation matters.

ENDNOTES

- 1 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (Code), unless otherwise indicated.
- 2 *See* I.R.C. § 280G(a).
- 3 *See* I.R.C. § 280G(a).
- 4 *See* Reg. § 1.280G-1, Q/A-1(b).
- 5 *See* I.R.C. § 280G(b)(2). 280G permits some variance, but a CIC generally includes an equity sale, asset sale, or change in the controlling owners or board of directors. *See* Reg. § 1.280G-1, Q/A-27.
- 6 *See id.*
- 7 *See* § 1.280G-1, Q/A-11(a).
- 8 *See id.*
- 9 *See* § 1.280G-1, Q/A-11(c).
- 10 *See id.*
- 11 *See* § 1.280G-1, Q/A-11(b)(3).
- 12 *See id.*
- 13 *See* § 1.280G-1, Q/A-11(b)(2).
- 14 *See id.* Treasury regulations contain specific methodology for determining a parachute payment’s present value. *See* § 1.280G-1, Q/A-31-33.
- 15 *See* § 1.280G-1, Q/A-11(b)(5).
- 16 *See* *Frequently Asked Questions About Small Business, July 2024*, OFFICE OF ADVOCACY, last accessed September 9, 2025, https://advocacy.sba.gov/wp-content/uploads/2024/12/Frequently-Asked-Questions-About-Small-Business_2024-508.pdf.
- 17 *See* § 1.280G-1, Q/A-11(b)(5).
- 18 *See id.*; *see also* I.R.C. § 1361(b).
- 19 *See* I.R.C. § 280G(b)(5).
- 20 *See* I.R.C. § 280G(b)(5).
- 21 *See* I.R.C. § 280G(b)(5).
- 22 *See* I.R.C. § 280G(b)(5)(A)(ii)(II).
- 23 *See* Reg. § 1.280G-1.
- 24 *See* § 1.280G-1, Q/A-6-7 (“The shareholder approval requirements described in Q/A-7 of this section are met with respect to such payment if . . . [b]efore the vote, there was adequate disclosure to all persons entitled to vote.”) (emphasis added).
- 25 *See* § 1.280G-1, Q/A-7(c).
- 26 *See id.*
- 27 *See id.*
- 28 *See id.*
- 29 *See* § 1.280G-1, Q/A-7(a)(2).
- 30 *See* § 1.280G-1, Q/A-7(b)(1).
- 31 *See* § 1.280G-1, Q/A-7(a)(2) (“. . . of all material facts concerning all material payments which (but for Q/A-6 of this section) would be parachute payments with respect to a disqualified individual.”) (emphasis added); *see also* § 1.280G-1, Q/A-7(e), Ex. 10.
- 32 *See* § 1.280G-1, Q/A-7(b)(1) (“The vote described in paragraph (a)(1) of this A-7 must determine the right of the disqualified individual to receive the payment.”).
- 33 *See id.*
- 34 *See id.*
- 35 *See id.*
- 36 *See* § 1.280G-1, Q/A-7(b)(2).
- 37 *See* § 1.280G-1, Q/A-7(b)(4).
- 38 *See id.*
- 39 *See id.*
- 40 *See* § 1.280G-1, Q/A-7(b)(3).
- 41 *See* § 1.280G-1, Q/A-7(b)(3)(ii).
- 42 *See* § 1.280G-1, Q/A-7(b)(4). When determining ownership for purposes of “disqualified individuals,” the 280G Regulations specify that section 318(a)’s attribution rules must be considered. *See id.*
- 43 *See* § 1.280G-1, Q/A-7(b)(3)(ii).
- 44 *See id.*

Profits Interests: A Tax-efficient Way to Incentivize Employees

By Christopher Attar



Offering equity in a business can be an effective strategy for attracting and retaining top talent. It can also help incentivize employees to work toward growing the business. For businesses taxed as partnerships, granting a profits interest is one of the most tax-efficient ways to provide equity. Properly structured, a profits interest allows service providers to share in both the profits/losses of the business and any future appreciation in value of the business without an immediate tax to the recipient when the interest is granted.

This article provides an overview of profits interests, including the tax consequences to the recipient, and notes a few practical considerations. While the concept is widely recognized in practice, there is currently no statutory authority on profits interests in the Internal Revenue Code. Guidance is derived primarily from general partnership tax principles and administrative statements (Revenue Procedures).

WHAT IS A PROFITS INTEREST?

A profits interest is an interest in a business taxed as a partnership that entitles the holder to share in the current-year profits and losses of the business and any appreciation in value of the business following the grant date. Unlike with the grant of a capital interest, there is no immediate tax hit to the recipient of a profits interest.¹

In order for the interest to qualify as a profits interest when it is granted, it cannot have any current liquidation value. This means that if the business' assets were sold at fair market value (FMV) and the proceeds were distributed in complete liquidation immediately after the profits interest was granted, the profits interest holder should not share in any of the proceeds. The point is that the profits interest is designed to have no value at the time of grant, but it allows the recipient to share in future appreciation beyond the FMV as of the time of grant. FMV at the time of grant is used to set the "hurdle" value, which is an important practical consideration.

REVENUE PROCEDURE 93-27

The first attempt by the IRS to clarify tax treatment to a recipient of a profits interest came from Rev. Proc. 93-27, which provides that the receipt of a profits interest in exchange for services will not be a taxable event for the recipient or the issuer. Rev. Proc. 93-27 defines a profits interest as any interest other than a capital interest. A capital interest is defined as an interest that would give the holder a share of proceeds if the partnership's assets were sold at FMV and then the proceeds were distributed in a complete liquidation of the partnership.

Rev. Proc. 93-27 further clarifies, however, that a few certain circumstances would require the recipient to recognize income at the time of grant (making the tax benefit of the revenue procedure unavailable). The first is if the profits interest related to a substantially certain and predictable stream of income from partnership assets, such as high-quality debt securities or a high-quality net lease. The second is if the recipient disposes of the profits interest within two years of receipt. The third is if the profits interest is an LP interest in a "publicly traded partnership."²

REVENUE PROCEDURE 2001-43

While Rev. Proc. 93-27 provided taxpayers with welcome clarity on the general tax treatment of the receipt of a profits interest, there was still uncertainty related to profits interests with vesting schedules.

Generally, when property is granted subject to vesting, it becomes taxable upon vesting (not at the time of grant) unless an 83(b) election is filed immediately following the grant.

The IRS issued Rev. Proc. 2001-43 to clarify that, for purposes of Rev. Proc. 93-27, when a profits interest that is substantially nonvested is granted, the service provider will be treated as receiving the interest on the date of its grant, provided the partnership and service provider treat the service provider as the owner of the partnership interest from the date of its grant (i.e., service provider takes into account the distributive share of partnership income, gain, loss, deduction etc.) and no deduction is taken by the partnership when the interest becomes substantially nonvested.

The result of Rev. Proc. 2001-43 is that the IRS allows taxpayers to treat the grant of substantially nonvested profits interest as if an 83(b) election is made.

PRACTICAL CONSIDERATIONS

While the tax implications of a profits interest are relatively clear, implementation raises a few practical issues. Most important is that the grant of a profits interest, and the governing provisions, must be clearly documented. The most simple way is to build the profits interest into the business' governing agreement (e.g., operating agreement) with careful attention to the distribution provisions and the hurdle mechanics (to ensure a grant has no current liquidation value). A valuation as of the time of grant is also necessary to set the baseline value (the hurdle) for the recipient's participation in future appreciation.

With respect to the recipient, while Rev. Proc. 2001-43 provides that an 83(b) election is not necessary, it is recommended that a "protective" 83(b) election is filed to protect against scenarios where the taxpayer is, or becomes, unable to rely on the revenue procedure.

Finally, an optional add-on for employers who wish to really reward service providers is a "catch-up" provision, which would provide additional proceeds to a recipient upon a sale/liquidation event.

CONCLUSION

Profits interests remain one of the most tax-efficient ways to provide equity compensation in a business taxed as a partnership. Although the legal foundation is built on revenue procedures rather than statute, the approach is regularly relied upon by practitioners and taxpayers. With careful planning, profits interests can provide powerful alignment between owners and service providers while preserving favorable tax treatment.

ENDNOTES

- 1 The receipt of equity for services is generally taxable as ordinary income to the recipient under Sections 83 and 61. Further, the receipt of a capital interest in a partnership in exchange for services is specifically taxable as compensation under Treasury Regulation Section 1.721-1(b)(1).
- 2 As defined in Code Section 7704(b).

The Impact of OBBB's Expansion of Section 1202 on Entity Choice

By E. Murphy, Rebecca Pugliesi, and B. Jordan



THE IMPACT OF OBBB'S EXPANSION OF SECTION 1202 ON ENTITY CHOICE

In recent years, the dynamics of entity selection for businesses have shifted significantly. The federal tax rate for C corporations was permanently reduced from 35 percent to 21 percent in 2018, and the complexity associated with flow-through entities has continued to rise. As a result of these changes, an increasing number of businesses, including those backed by private equity, are opting for C corporation structures.

The One Big Beautiful Bill Act (OBBB), signed into law on July 4, 2025, further enhances the appeal of C corporation structures by significantly expanding the permanent gain exclusions available under Section 1202 for qualified investors on the sale of qualified small business stock (QSBS). These changes demonstrate the federal government's commitment to encouraging investment in small domestic corporations by making the permanent tax breaks more accessible and impactful.

WHAT IS SECTION 1202 AND WHO QUALIFIED PRIOR TO OBBB?

The qualified small business stock exclusion under Section 1202 allows certain owners to permanently exclude gain on the sale or liquidation of C corporation stock from taxable income.¹ For qualified stock issued after September 2010 and prior to July 5, 2025, a shareholder can exclude 100% of the gain up to the greater of \$10 million or 10 times the shareholder's adjusted stock basis.² Gain on the sale of stock acquired between August 1993 and September 2010 is eligible for 50% or 75% gain exclusion depending on when the stock was issued.³

- Both the shareholder and the corporation must meet a number of requirements to take advantage of this tax benefit.⁴ The main qualifications prior to the OBBB changes were:
- The stock must be held by an individual, trust, or estate either directly or indirectly through a pass-through entity.⁵
- The stock must be held by the shareholder for at least five years.⁶ Ownership of stock options and instruments convertible into stock do not begin the holding period until exercised.
- The stock must be acquired via original issuance from the C corporation (i.e., the stock cannot be purchased from another shareholder). Further, it must be received in exchange for services, cash or property (but not stock),⁷ other than in certain tax-free exchanges.
- The corporation must be a domestic C corporation.⁸
- The corporation's gross assets must be less than \$50 million at the time of investment and at all times prior to the investment.⁹ The valuation of the assets is typically based on tax basis, not fair market value or even book value. As a result, many companies with a valuation far exceeding \$50 million can still meet this requirement.
- The corporation must use at least 80% of the fair value of its assets in a qualified trade or business. A qualified trade or business includes all businesses except for those excluded in the statute. The list of disfavored businesses includes professional services; banking and financing; farming; oil, gas, and mining; restaurants and hospitality; real estate; and other passive businesses. There are additional limitations on the amount of working capital, investment assets, or investment real estate.¹⁰

HOW DID OBBB CHANGE SECTION 1202?

First, the OBBB reduced the required holding period for QSBS to qualify for tax exclusions. While investments that meet the 5-year holding period requirement will still qualify for a 100% gain exclusion, there are also exclusions available for shorter investments. Investors can now benefit from a 75% exclusion for stock held for 4 years and a 50% exclusion after just 3 years of holding QSBS.¹¹ These changes are designed to stimulate investment by offering more immediate and escalating tax advantages as the duration of the investment increases.

Second, the per-taxpayer gain exclusion cap has been raised from \$10 million to \$15 million, with annual inflation adjustments.¹² This means that a qualified taxpayer investing in stock after then can now exclude, at a minimum, \$15 million of gain on the sale of QSBS from their taxable income. No change was made to the 10-times basis limitation.

Third, the “aggregate gross assets” limit for a corporation to qualify as a small business has increased from \$50 million to \$75 million.¹³ This amount will also be annually adjusted for inflation. This change allows more businesses to qualify for QSBS benefits.

The changes are effective for all QSBS issued after July 4, 2025. All prior issuances are still subject to the prior rules. This will create interesting structuring opportunities going forward for investors looking to maximize Section 1202 benefits through staged exits and new investments.

INCORPORATING SECTION 1202 INTO AN ENTITY CHOICE ANALYSIS

While Section 1202 can be a deciding factor for many businesses with the right fact patterns, it is just one consideration when undergoing an entity choice analysis. For eligible shareholders, it can provide access to the lower corporate tax rates on operations while mitigating or eliminating the effects of double taxation on exit. However, there are other tax considerations and business plans that can severely limit or completely nullify the benefits of Section 1202. Such considerations include the current and future investor group, issuance of rollover stock, expected strategies around dividends, and expected exit strategies, to name a few.

While the Section 1202 benefit can be powerful for some types of taxpayers, not all investors are eligible to receive Section 1202 benefits. It's important to consider the make-up of the current and future investor group when choosing to structure as a corporation. Individuals, trusts, and estates, as well as flowthrough entities ultimately owned by such taxpayers can be eligible. Taxpayers who are disinclined to invest in flowthrough entities, often including foreign investors and not-for-profit entities, may be aligned with Section 1202 eligible shareholders to prefer a C corporation structure. This may avoid the need for the additional complexity of having a “blocker” corporation for certain investors. However, other investors, including taxable C corporation investors, may incur less tax efficiency by investing in a C corporation compared to a flowthrough investment. Additionally, even qualifying types of investors must invest while the corporation meets the small business requirements and hold the stock for at least 3 years to even partially qualify. Early investors may be more advantaged than subsequent investors, who may be subjected to the downsides of C corporation ownership without Section 1202 benefits.

Many businesses plan to expand through acquisitions, offering sellers a rollover investment opportunity with a goal to fund the acquisitions and incentivize growth. However, C corporations can provide less flexibility when it comes to structuring “tuck-in” acquisition transactions with an equity rollover. Tax deferral for a rollover into a corporation typically relies on Section 351, which requires that the contributing shareholders (including cash contributors) control at least 80 percent of the vote and value of the corporation issuing the equity. As a result, compared to an entity structured as a partnership, it may be more challenging to structure a transaction that obtains tax deferral for rollover investors, particularly if the cash purchase price is funded by debt rather than additional equity contributions.

Dividend distributions do not produce taxable income qualified for the Section 1202 exclusion. Even if C corporation stock is qualified for Section 1202, if the owners of a business plan to regularly distribute earnings out of the company, they will be required to pay double tax on those distributions. Dividend distributions can create a compounding adverse effect for qualified shareholders. Not only will the shareholders face double taxation on those distributions, but the distributions also reduce the value of the C corporation, potentially reducing the benefit of Section 1202 achieved on an eventual exit. A tax-savvy qualified corporation may seek strategies to reinvest earnings, building value for a larger exit, rather than issue dividend distributions. However, such corporations will need to be wary of the sting of the accumulated earnings tax if the retained capital exceeds the reasonable needs of its business.¹⁴

Finally, upon exit, the tax benefits from Section 1202 are most powerful when a buyer is willing to buy the stock of the C corporation from the shareholders. If the sellers require a stock sale, the pool of buyers interested in acquiring the business may shrink or the value received on sale may decrease, particularly in markets where asset sales are expected. Section 1202 can still be reduced or eliminate the investor-level gain for shareholders if the C corporation sells its assets and then liquidates, but the transaction will still incur an entity-level gain on the sale of assets. Worse, if the corporation is unable to liquidate and the distribution is taxed as a dividend, the investor-level taxable income would eliminate the Section 1202 benefit on the proceeds.

FINAL THOUGHTS

In light of the OBBB's expansion of Section 1202, QSBS benefits will be more widely available and should be considered as one component of a holistic entity choice analysis that also takes into account future business plans related to investors, M&A activity, shareholder distributions, and exit strategy. The coordination of Section 1202 requirements with an eye on the long-term business strategies cannot be overstated.

Furthermore, the evolving regulatory landscape and potential changes in tax laws should also be factored into the decision-making process. Business owners need to stay informed about legislative developments that could impact the benefits of Section 1202 and other tax provisions. During the Biden administration, Congress proposed legislation to severely restrict the benefits of Section 1202 based on the adjusted gross income of the shareholder.¹⁵ This proposal would have affected not only stock issued after enactment, but also stock sold after enactment that had been issued historically and otherwise met Section 1202 qualifications. It is always possible that legislative changes could decrease or eliminate the benefit on the sale of QSBS during a shareholder's holding period.

While Section 1202 offers substantial tax benefits for certain investors in qualified small business stock, it is essential to consider it within the broader context of the business's long-term goals, tax strategy, and regulatory environment. A comprehensive and informed approach to entity choice analysis will ensure that business owners make decisions that best support their growth and success. Engaging with tax professionals and legal advisors can provide valuable insights and help business owners navigate the complexities of entity choice analysis.

ENDNOTES

- 1 All references to "Section" or "§" relate to the Internal Revenue Code (U.S. Code: Title 26).
- 2 § 1202(b)(1).
- 3 § 1202(a).
- 4 § 1202(c)-(j).
- 5 § 1202(a)(1).
- 6 *Id.*
- 7 § 1202(c)(1).
- 8 §§ 1202(d)(1); 1202(c)(2)(A).
- 9 § 1202(d)(1)(A).
- 10 §§ 1202(c)(2)(A); 1202(e)(1)(A).
- 11 § 1202(a)(1)(B).
- 12 § 1202(b)(4)(B).
- 13 § 1202(d)(1)(A).
- 14 § 533.
- 15 On September 15, 2021, the House Ways and Means Committee approved a version of the Build Back Better Act that included limitations and restrictions for Section 1202.