NEW YORK STATE BAR ASSOCIATION TAX SECTION

–

REPORT ON PROPOSED REGULATIONS REGARDING THE APPLICATION TO PARTNERSHIPS OF SECTION 1045 GAIN ROLLOVER RULES FOR QUALIFIED SMALL BUSINESS STOCK

January 21, 2005

TABLE OF CONTENTS

Page

New York State Bar Association
Tax Section

Report on Proposed Regulations Regarding the Application to Partnerships of Section 1045 Gain Rollover Rules for Qualified Small Business Stock

I. Introduction

This report of the Tax Section of the New York State Bar Association[1] comments on proposed regulations promulgated under Section 1045 of the Internal Revenue Code of 1986, as amended (the "Code),[2] on the application of Section 1045 to partnerships and their partners (the "Regulations").[3] The Regulations provide rules on the deferral or "rollover" of gain on a partnership's or a partner's sale of "qualified small business stock" ("QSBS"), including by specifying the extent to which partners are eligible for rollover treatment.

Given the importance of venture capital funds and other partnership vehicles in facilitating investment in QSBS, guidance in this area is extremely valuable. We commend the Internal Revenue Service (the "IRS") and the Treasury Department for proposing rules that are clear and mechanical, drawing on the underlying principles of the statute to provide greater certainty for taxpayers.

While we generally support the approach taken in the Regulations, we have identified certain issues that could be clarified and areas where the underlying purpose for certain provisions could be more clearly articulated. We have also identified certain aspects of the Regulations that we believe are more restrictive than required by the statute, as well as certain statutory restrictions that do not appear to further any compelling policy concern. In both types of cases, we suggest that consideration be given to providing greater flexibility, either by revising the Regulations or, where appropriate, through statutory revision. Our recommendations are based on the underlying premise that unnecessarily restrictive rules could

---

[1] The principal author of this report was Janet B. Korins, with helpful comments from Kimberly S. Blanchard, William B. Brannan, David Hardy, Gary B. Mandel, Seth L. Rosen, Joel Scharfstein, Michael Schler, David R. Sicular, Lewis R. Steinberg and Michael Weinstein.

[2] Unless otherwise specified, any references made herein to the "Code" or to a "Section" refer to the Internal Revenue Code of 1986, as amended.

[3] Prop. Treas. Reg. § 1.1045-1, REG-150562-03, 69 Fed. Reg. 42370 (July 15, 2004, corrected Aug. 10, 2004).

undermine the policy objective of the statute to encourage individuals to invest in small businesses. At the same time, we are mindful that in some cases greater flexibility would require more complicated rules, so the desire for flexibility must always be balanced against the desire to avoid unnecessary complexity.

This report will briefly summarize the legislative and regulatory context of the Regulations, looking at the legislative history and underlying policies informing Section 1045, as well as at previous guidance provided by the IRS and the Treasury Department. The report then addresses specific provisions in the Regulations and contains the following recommendations:

- While we agree that the statutory framework does not treat the acquisition of a partnership interest as an acquisition of QSBS, we believe the Regulations have interpreted this rule too broadly to prohibit indirect acquisitions of replacement QSBS. This result does not appear to be required by the underlying principles of Sections 1202(f), (g), (h), (i) and (j).[4] We believe the Regulations should permit acquisitions of replacement stock in a tiered partnership arrangement or, alternatively, through a separate chain of ownership. In any event this issue should be addressed more explicitly in the Regulations.

- Consideration should be given to increasing flexibility by permitting a partner to opt out of a partnership's Section 1045 election.

- The nonrecognition limitation should be amended or clarified to account for typical, albeit more complex partnership structures.

- The application of the Regulations to disregarded entities should be clarified.

Finally, the last section of this report identifies certain aspects of the Regulations that seem unnecessarily restrictive but compelled by the statute. In those cases, consideration could be given to whether the statute should be amended to provide for additional flexibility.

---

[4] Section 1045(b)(5) provides that rules similar to the rules found in Sections 1202(f), (g), (h), (i), (j) and (k) apply to the rollover of gain from one QSBS to another QSBS. The legislative history and context of this section will be discussed in Section II below.

II. Legislative and Regulatory Context

A. Basic Statutory Framework

Section 1045 and Section 1202 provide for special treatment of gain on the sale of QSBS held by noncorporate taxpayers. The term "qualified small business stock" is generally defined in Section 1202 to mean stock of a domestic C corporation if (i) as of the date of issuance the corporation is a "qualified small business" (generally satisfied if the corporation's aggregate gross assets (measured by adjusted tax basis) do not exceed $50 million);[5] (ii) during substantially all of the taxpayer's holding period for the QSBS, the corporation meets an active business requirement (generally satisfied if at least 80% by value of the corporation's assets are used in the active conduct of one or more trades or businesses other than professional or financial services, banking or other businesses identified by statute);[6] and (iii) the stock is acquired by the taxpayer at original issuance.[7] Under Section 1202, enacted in 1993, a noncorporate taxpayer may exclude 50% of gain on the sale of QSBS from gross income if the taxpayer holds the stock for more than five years.

Section 1045, enacted in 1997, permits a noncorporate taxpayer that holds QSBS ("relinquished" QSBS) for more than six months to elect to defer recognizing gain on the sale of such stock, if the taxpayer purchases new QSBS ("replacement" QSBS) within 60 days of the sale. The taxpayer will be taxed on the gain only to the extent that the sale proceeds exceed the price of the replacement stock. Any unrecognized gain will be "rolled over" to the replacement QSBS, and the cost basis of such replacement stock will be reduced by the amount of unrecognized gain. Section 1045 does not apply to any gain treated as ordinary income.

In 1998, Section 1045 was amended to clarify that a partnership or an S corporation is eligible to roll over gain from QSBS, so that noncorporate partners and S corporation shareholders might obtain the benefits of rollover treatment.[8] This amendment was significant

---

[5] Section 1202(d).

[6] Section 1202(e).

[7] Section 1202(c).

[8] IRS Restructuring and Reform Act of 1998, P.L. 105-206, §6005(f).

because many individuals might not have access to investments in QSBS other than through ownership in a venture capital fund or similar partnership. Partnerships are eligible to elect rollover treatment even if they have some corporate partners who are not eligible for Section 1045 benefits.

Somewhat surprisingly, the members of our committee have encountered relatively infrequent use of the Section 1045 rollover rules in practice. Since as a practical matter Section 1045 benefits will usually arise in the context of funds and other partnership arrangements, the increased clarity provided by the Regulations may encourage greater use. In addition, the recent reduction in capital gain rates[9] has increased the attractiveness of the Section 1045 deferral rules as compared with the Section 1202 gain exclusion rules. Section 1202 has become relatively less significant because gain on QSBS continues to be taxed at a 14% percent rate,[10] resulting in only a 1% rate differential under Section 1202 as compared to other capital gains transactions.

B. Application of Section 1045 to Partnerships

The 1998 amendment to Section 1045 did not set forth specific rules as to how the rollover provision would apply in the partnership context. Instead, Section 1045(b)(5) merely indicated that rules "similar to" the rules found in Sections 1202(f), (g), (h), (i), (j) and (k) would apply for purposes of the rollover rule. Those Section 1202 rules are described in more detail below and, among other things, set forth basic principles on the treatment of pass-through entities for QSBS purposes. In addition, Section 1202(k) confers explicit authority on the Treasury Department to issue regulations appropriate to carry out the purposes of Section 1202,

---

[9] Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27, §301.

[10] Gain on Section 1202 stock (QSBS) is treated as "28-percent gain" under Section 1(h)(4)(A)(ii); this treatment was not changed by the Jobs and Growth Tax Relief Reconciliation Act of 2003. Thus, when the 50% gain exclusion provisions of Section 1202 are applied against this "28-percent gain," the result is a tax rate of 14% on the sale of QSBS.

including regulations addressing the use of split-ups, shell corporations, or partnerships to avoid the purposes of Section 1202.[11]

The legislative history of the 1998 amendment provided only very limited additional guidance as to the application of Section 1045 to partnerships. According to the 1998 legislative history, the application of the cross-referenced Section 1202 rules in the context of Section 1045 means that the benefit of a tax-free rollover with respect to a sale of QSBS by a partnership flows through to a noncorporate partner if the partner held its partnership interest at all times that the partnership held the QSBS.[12] Apart from that statement, the statute and legislative history do not shed light on the parameters of Section 1045 rollover treatment in the context of partnerships. Therefore, the underlying principles must be gleaned from the analogous rules of Section 1202(f), (g), (h), (i), (j), and (k). Since the Regulations attempt to draw on the principles articulated in Section 1202, it is helpful to summarize those principles and consider their relevance in the Section 1045 context.

As a general matter, Section 1202 codifies the fundamental principle that QSBS must be held by the taxpayer from the date of original issuance. In the partnership context, that principle is addressed primarily by Sections 1202(g) and 1202(h). Under Section 1202(g), any amount included in gross income by reason of holding an interest in a pass-through entity[13] may be eligible for the benefits of Section 1202 if (but only if) (i) the amount is attributable to gain on the sale or exchange by the pass-through entity of stock which is QSBS in the hands of the entity and which was held by the entity for more than five years, and (ii) such amount is includible in gross income by the taxpayer by reason of the holding of an interest in the entity which was held by the taxpayer on the date on which such pass-through entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-through entity. In order to prevent taxpayers from increasing the available Section 1202 benefits by increasing over time their percentage ownership interests in QSBS held through a pass-through entity,

---

[11] Section 1202(k). To date, no such regulations relevant to the subject of this report have been promulgated under Section 1202.

[12] H.R. Conf. Rep. No. 105-599, 105th Cong., 2d Sess. 339-340 (1998).

[13] For the purposes of Section 1202(g), the term pass-through entity includes a partnership, S corporation, regulated investment company and common trust fund.

Section 1202(g) further provides that the gain exclusion will not apply to the extent it exceeds the amount which would have applied if the amount were determined by reference to the interest the taxpayer held in the pass-through entity on the date the QSBS was acquired.[14]

Section 1202(h) sets forth rules on tax-free and other transfers of interests in QSBS and describes the limited circumstances in which a taxpayer can acquire an interest in QSBS by transfer rather than on original issuance. Permitted transfers include transfers by gift, at death, or from a partnership to a partner of stock with respect to which requirements similar to the requirements of Section 1202(g) are met at the time of transfer (without regard to the five-year holding period requirement). Under those limited circumstances, the transferee will be treated as having (i) acquired the stock in the same manner as the transferor, and (ii) held the stock for the same period as the transferor. In other circumstances, QSBS will lose its character upon a transfer. Notably, as explicitly provided in the legislative history of Section 1202,[15] while a partner may receive QSBS on a partnership distribution, contributions of QSBS by an individual partner to a partnership are not permitted.[16]

Additional principles for the application of Section 1045 are set forth in Sections 1202(f), (i), (j) and (h), although those provisions are not directly relevant to the issues raised by the Regulations.[17]

---

[14] As discussed in more detail below, the Regulations implement the rules of Section 1202(g) by (i) requiring that the partnership entity itself, rather than the partner, acquire the original QSBS on its original issuance (subject to the exception for distributions of QSBS discussed below), and (ii) providing that if a partner's interest in QSBS held through a partnership fluctuates during the holding period for the stock, the partner is only eligible for Section 1045 benefits to the extent of its smallest percentage interest in the QSBS.

[15] H.R. Rep. No. 103-111, 103d Cong., 1st Sess. 602 (1993).

[16] As discussed below, these principles are incorporated into the Regulations, which permit distributions of QSBS to a partner but prohibit contributions of QSBS by a partner to a partnership.

[17] Section 1202(h) provides that if QSBS is exchanged in certain types of incorporation and reorganization transactions, the stock received in the exchange qualifies as QSBS and the holding period of the original stock is added to the holding period for the stock received. Similarly, Section 1202(f) provides that, if stock is acquired through a conversion of stock that is QSBS in the hands of a taxpayer, the stock so acquired will be treated as QSBS and the holding period of the original QSBS will carry over. Each of those rules under Section 1202 are relevant to Section 1045 to the extent that they affect the determination of the holding period of relinquished QSBS. However, that general issue is not addressed by the Regulations except in the limited context of a tacked holding period in connection with a distribution of QSBS by a partnership to a partner.

Section 1202 is a gain exclusion provision and not a rollover provision. Accordingly, Section 1202 offers little guidance about the requirements for the investment in replacement QSBS. Significantly, Section 1202 provides no direct guidance on whether replacement QSBS may be acquired by a partner rather than a partnership, or by a partner indirectly through its interest in a separate partnership. The Regulations address these issues by drawing on the Treasury Department's interpretation of Section 1045(b)(5). While the Regulations provide useful guidance in this area, certain limitations imposed by the Regulations do not appear to be mandated by the statute. For example, as discussed more fully below, the acquisition of replacement QSBS by a partner through a separate partnership is prohibited by the Regulations, even though the situation is not explicitly covered by the statute or legislative history.

C. Subsequent Guidance

Since the time of the 1998 statutory revisions to Section 1045, the only guidance on the application of Section 1045 to partnerships has been Revenue Procedure 98-48,[18] which set forth election procedures for rollover treatment in the partnership context. Specifically, the Revenue Procedure explained that a pass-through entity may make a Section 1045 election with regard to a reinvestment of the proceeds from the sale of QSBS, as long as the holding period requirements are met and the replacement QSBS is purchased within 60 days of the sale. In such a scenario, the rollover benefits flow through to the noncorporate partners.

In addition, according to the Revenue Procedure, if a partnership disposes of QSBS and does not make a Section 1045 election, a noncorporate partner may personally make a Section 1045 election and reinvest its distributive share of gain on the partnership's sale of QSBS in replacement QSBS, provided that the holding period and 60-day repurchase requirements are met. While this latter rule was not directly addressed in the statute or

---

Section 1202(i) sets forth rules for determining the basis of QSBS acquired on a contribution of property other than money or stock to, or on a subsequent contribution to capital of, a corporation. Section 1202(j) states that a taxpayer cannot exclude gain from the sale of QSBS if the taxpayer (or a related person) held an offsetting position with respect to that stock at any time before the five-year holding period is satisfied. If the taxpayer (or a related person) acquires an offsetting short position with respect to QSBS after the five-year holding period is satisfied, then the taxpayer must elect to treat the acquisition of the offsetting short position as a sale of the QSBS in order to exclude any gain from that stock. The Regulations do not discuss whether or to what extent the offsetting position rules are applicable in the Section 1045 context.

[18] 1998-2 C.B. 367 (Sept. 21, 1998).

legislative history,[19] it was consistent with the underlying principles to permit individual partners to take advantage of rollover treatment even if the partnership failed to do so.

Beyond these two factual scenarios, Revenue Procedure 98-48 did not provide further guidance regarding Section 1045 elections in the partnership context. Accordingly, it remained unclear whether and to what extent Section 1045 elections not contemplated by the Revenue Procedure could be made, either at the partnership or at the partner level.

As noted in the preamble to the Regulations (the "Preamble"), the IRS and Treasury Department received inquiries regarding the application of Section 1045 to partners and partnerships after the publication of Revenue Procedure 98-58. For example, in a letter to the Treasury Department in May 2001, Senators Susan Collins, Charles Schumer, Orrin Hatch, and Joseph Lieberman asked the Treasury Department to issue clear guidance on the application of Section 1045 when a partnership disposes of relinquished QSBS and reinvests the proceeds in replacement QSBS and when a partner personally reinvests in replacement QSBS through a separate partnership.[20] In response to this and other inquiries, the IRS and Treasury Department issued the Regulations in July 2004.

III. The Regulations

The Regulations provide welcome guidance in the application of Section 1045 at both the partnership and at the partner level, specifically addressing issues related to who is eligible to

---

[19] Although the partner-level election was not discussed in the legislative history to the 1998 amendment, practitioners raised this issue along with many others in response to the development of the statutory language that would eventually become Section 1045(b)(5). For example, in a letter arguing for the availability of QSBS rollover treatment for partnerships with corporate partners, the Western Association of Venture Capitalists proposed allowing QSBS rollover benefits to flow through to partners in the same way that qualified gain flows through to partners under Section 1202(g). One consequence of such an approach, according to the letter, was that the flow-through of benefits would necessitate partner-level elections. *See, e.g.*, "Venture Capitalist Association Calls For Revising Stock Rollover Rules," Tax Notes, March 5, 1998, 98 TNT 43-22, footnote 4; *see also* "Attorneys Urge Replacing Small Business Stock Rollover Provision," Tax Notes, April 16, 1998, 98 TNT 73-22. These practitioner responses did not specifically consider the issue of partner elections as an alternative possibility when the partnership chose not to make a Section 1045 election. In any event, the specific election procedures provided in Revenue Procedure 98-48, and subsequently incorporated in the Regulations, appear to endorse a permissive interpretation of the existing law.

[20] *See* "Senators Urge Treasury To Issue Guidance On Qualified Small Business Stock," Tax Notes, May 9, 2001, 2001 TNT 115-28.

make the election, the timing and manner of making the election, and the specific requirements of replacement QSBS. Although we have some specific concerns, we believe that the Regulations are generally clear, helpful, and appropriate in both scope and content.

A. Application of Section 1045 to Sales or Acquisitions of Partnership Interests

Section 1.1045-1(a)(1) of the Regulations states that QSBS has the meaning provided in Section 1202(c) and does not include an interest in a partnership that purchases or holds QSBS. This rule is intended to enforce the basic requirement that QSBS must be held from the date of original issuance. The only exceptions are those provided in Section 1202(h) for transfers by death, gift or upon a partnership distribution.

Accordingly, the Regulations do not treat an acquisition of a partnership interest as an acquisition of QSBS. The Preamble explains that an acquisition of a partnership interest cannot be treated as an acquisition of QSBS in light of the clear statutory language of Section 1202(c). Section 1202(c) states that except as provided in Section 1202(f) and (h), QSBS must be "acquired by the taxpayer at its original issuance." The exception in Section 1202(h) permits a taxpayer to acquire QSBS by a partnership distribution. If the acquisition of a partnership interest were treated as an acquisition by the partner of the underlying QSBS, then Section 1202(h) would presumably be unnecessary. We therefore agree that the statute does not permit the acquisition of a partnership interest to be treated as an acquisition of QSBS.

However, the implications of this rule and how broadly it should be interpreted are not entirely clear. In some cases, treating an acquisition of a partnership interest holding QSBS as an acquisition of QSBS would clearly violate the basic principle of Section 1202(g), which requires that a partner hold a continuous interest in QSBS from the date of issuance through the date of sale. If a partner acquired an interest in a partnership that already held QSBS, then the partner would not have indirectly held an interest in the QSBS from the date of issuance. In those circumstances it is clear that the partner should not be treated as having acquired QSBS.

The situation posited in Example 1 of the Regulations is entirely different. In that case, an individual A recognizes gain in connection with a disposition of QSBS that will be eligible for

rollover treatment, assuming a proper investment in replacement stock. Rather than reinvesting directly in replacement stock, A contributes cash to acquire an interest in partnership ABC that in turn uses the cash to acquire QSBS. Even though the stock is QSBS in the hands of the partnership, and even though individual A held an interest in the partnership at the time of the acquisition of QSBS, the QSBS is not treated as replacement QSBS acquired by the partner. The rationale for the conclusion in the Regulations is that "A's acquisition of the additional partnership interest is not treated as a purchase of replacement QSB Stock."

We do not think this result is required by the statute. The Example purports to describe a situation where a taxpayer treats the acquisition of a partnership interest as an acquisition of QSBS – which we agree is prohibited by the statute. But we think the facts could properly be characterized as an indirect acquisition by individual A of replacement QSBS through an interest in a partnership. We see nothing in the statute to require that the acquisition of replacement QSBS must be a direct acquisition. This issue is discussed in Section F below. In any event, the Regulations and the related Example should more clearly distinguish between these factual situations.

The Regulations also conclude that the sale of a partnership interest is not treated as a sale of QSBS. The treatment in the Regulations of a sale of a partnership interest appears mandated by Section 1202(g), which provides that a partner is eligible for Section 1202 benefits only if, among other things, the partner recognizes gain attributable to "the sale or exchange by the pass-thru entity" of QSBS. In addition, Section 1202(g)(2)(B) specifically refers to the disposition of QSBS "by [the] pass-thru entity." In light of the statutory language, we agree that Section 1202 principles should apply to distinguish between a direct disposition of QSBS and the sale of an interest in a partnership holding QSBS. However, as discussed in Section IV A below, this might be an area where statutory change would be appropriate.

B. Contributions

Under the Regulations, an individual who holds QSBS (or replacement QSBS) may contribute such QSBS to a partnership under Section 721 without triggering recognition of any previously deferred gain. However, upon such contribution, the contributed stock will lose its

QSBS character, and neither the partnership nor the contributing partner will be eligible for Section 1045 benefits on a subsequent sale of the stock.

We agree with the IRS and Treasury Department that this result is required by the applicable statutory language, specifically the requirement in Section 1202(c)(1)(B) that QSBS be acquired at original issuance. In fact, the legislative history to Section 1202 states specifically that while a partnership may distribute QSBS to a partner, if QSBS is contributed by a partner to a partnership, any gain from the disposition will not be eligible for the exclusion. Again, however, as discussed in Section IV B below, we question the rationale for this rule and believe that this is an area where statutory change might be warranted.

C. Definition of Eligible Partner

Under the Regulations, only an "eligible partner" may defer gain recognized by a partnership on the sale of QSBS. "Eligible partner" is defined in Section 1.1045-1(a)(2) of the Regulations to mean a taxpayer other than a corporation who holds an interest in a partnership on the date the partnership acquires the QSBS and at all times thereafter before the partnership sells or distributes the QSBS. The requirement that the partner hold a continuous interest in the partnership from the date of issuance until the date of sale is based on the statutory language of Section 1202(g)(2)(B). In addition, consistent with Section 1202(h), a taxpayer who acquires from an eligible partner by gift or at death an interest in a partnership that holds QSBS is treated under the Regulations as having held the acquired interest in the partnership during the period the eligible partner held the interest in the partnership.

The Regulations provide a special rule for QSBS held through a tiered partnership arrangement. If an upper-tier partnership holds an interest in a lower-tier partnership that holds QSBS, then for purposes of determining whether a partner is an eligible partner, the upper-tier partnership's interest in the lower-tier partnership is ignored, and each partner of the upper-tier partnership is treated as owning directly the interest in the lower-tier partnership. The partner of the upper-tier partnership is treated as owning the interest in the lower-tier partnership during the period in which both (i) the partner of the upper-tier partnership held an interest in the upper-tier partnership, and (ii) the upper tier partnership held an interest in the lower-tier partnership. Similar principles apply if QSBS is held through multiple tiers of partnerships.

The tiered partnership rules provide a reasonable approach that is consistent with the underlying policies of the QSBS provisions in the Code and Regulations. However, we believe that the rule is crafted too narrowly, leading to some unnecessarily restrictive results. For example, as the Preamble points out, under the tiered partnership rule an upper-tier partnership cannot make a Section 1045 election with respect to QSBS sold by a lower-tier partnership. More generally, the tiered partnership rule is described in the Preamble as a look-through rule that applies to determine whether a partner is eligible for the benefits of Section 1045, and it is included as part of the section of the Regulations that addresses eligibility. It is not clear whether this tiered partnership rule is intended to apply more broadly. We think the Regulations should be amended to clarify that it does apply more broadly to the acquisition of replacement QSBS in a tiered partnership structure, as discussed in Section F below.

D. Election Requirements and Procedures

Generally, we believe consideration should be given to providing greater flexibility to (i) permit partners to opt out of a partnership's Section 1045 election and (ii) designate which QSBS will be treated as replacement QSBS.

1. Partner Elections. Consistent with Revenue Procedure 98-48, if an election to roll over gain from QSBS is made by a partnership, then no separate election is required at the partner level. In addition, the election is binding on all of the partners. An election at the partner level is permitted only in the absence of a partnership election.

There may be situations where a partner would prefer to make the Section 1045 election at the partner level, even if a valid election is also made at the partnership level. For example, because of expectations about the timing of future sales of QSBS and the expected future valuation of that stock, a partner might prefer to designate directly acquired stock as replacement QSBS, rather than participate in the Section 1045 election at the partnership level. The partner might also prefer a direct reinvestment in replacement QSBS if the partner were contemplating a future sale of its interest in the partnership. Direct reinvestment would also provide greater certainty that a partner's Section 1045 benefits would not be diluted by the subsequent addition of new partners to the partnership.

On the other hand, a partner might prefer to opt out of a partnership's Section 1045 election and recognize gain if the partner has expiring losses or expects to be in a lower tax bracket in the current year.

Because Section 1045 is intended to provide incentives for taxpayers to invest in small businesses, we believe the Regulations should be flexible to the extent consistent with the statute and its underlying purpose. Therefore, we recommend that the Regulations be amended to permit a partner opt-out election in cases where a partner wishes to elect out of Section 1045 entirely, or, alternatively, wishes to invest in replacement QSBS outside the partnership. In either case, the partner would need to notify the partnership of the opt-out election so that the partnership could make the appropriate basis adjustment to the replacement QSBS. In the case of a partner electing to opt out of a partnership election and instead purchase replacement QSBS at the partner level, both the partnership and the electing partner would make appropriate basis adjustments. The rules in the existing Regulations requiring partnership basis adjustments for partners that are not eligible for Section 1045 benefits could be adapted to account for a partner who elects out of a partnership's Section 1045 election. Therefore, the opt-out election can be crafted in a manner that would create minimal additional complexity and that would provide an incentive for partners to consider a number of alternative investments in QSBS.

We considered the mechanics and timing of an opt-out election and whether a partner should be required to file an opt-out election within 60 days of the sale of the QSBS (i.e., during the reinvestment period). As an alternative, consideration could be given to permitting the election to be made on the partner's federal income tax return for the year in which the corresponding gain is reflected. We recognize that permitting the opt-out election to be deferred until the partner files its return could create additional complications if the partner and the partnership have different taxable years and the partnership needs to file its tax return or otherwise determine its tax basis in the replacement QSBS before the partner's tax return has been filed. It is not clear whether the benefit of increased flexibility would be offset by the burden of creating a situation where a partnership has to amend its tax return to account for a subsequent partner election. Perhaps a rule could be crafted to provide for the election to be made no later than the close of the partnership's taxable year.

The advantages of a partner opt-out election cannot be realized unless the partner has prompt notice of the realization of gain with respect to QSBS. This creates an issue similar to the question whether a partnership must notify a partner that the partnership does not intend to reinvest in QSBS, so that the partner can directly acquire replacement QSBS within the required 60-day period. The Regulations reflect a judgment that this issue is best left to negotiations among the parties. We agree with that judgment and likewise believe that if an opt-out election were available, the Regulations should not require a partnership to notify a partner of this opportunity. Of course, the parties could negotiate to include this term in the partnership agreement.

2. Elections Regarding Replacement QSBS. The Regulations provide that the basis reduction for QSBS in connection with a rollover at the partnership level is made to replacement QSBS "in the order acquired" by the partnership.[21] Similarly, if a partner purchases replacement QSBS directly, the basis of the replacement stock is also reduced "in the order acquired."[22] Under these provisions, if the partnership (or a partner) acquires during the replacement period two tranches of stock that potentially qualify as replacement stock, the first acquired tranche will be treated as the replacement QSBS. In other words, the Regulations do not appear to permit a partnership (or a partner) to elect which stock to treat as replacement QSBS. This result seems required by the statutory language of Section 1045(b)(3), which provides that if gain from a sale of QSBS is deferred, then such gain shall be applied to reduce "in the order acquired" the basis of the replacement QSBS acquired during the replacement period. However, as discussed in Section IV C below, we believe this is another area in which the restriction does not appear to serve a compelling policy objective and consideration could be given to statutory change.

E. Nonrecognition Limitation

Under the Regulations, the amount of gain that an eligible partner can roll over under Section 1045 is subject to a nonrecognition limitation, which is the product of the partnership's realized gain from the sale of the relinquished QSBS and the eligible partner's smallest

---

[21] Prop. Treas. Reg. § 1.1045-1(b)(3)(ii).

[22] Prop. Treas. Reg. § 1.1045-1(c)(3)(ii).

percentage interest in the partnership's income, gain, or loss with respect to the relinquished QSBS. An analogous rule applies for purposes of determining the distribution nonrecognition limitation, which limits a partner's entitlement to Section 1045 benefits with respect to QSBS distributed by a partnership to a partner. As the Preamble explains, these limitations ensure that deferral of gain under Section 1045 applies only to gain that relates to the partner's continuous economic interest in the relinquished QSBS. The limitation is also consistent with Section 1202(g)(3), which limits the gain exclusion benefits of that section based on the interest held by the taxpayer on the date that the QSBS was purchased, and Section 1202(g)(2)(B), which limits the gain exclusion based on the interest held by the taxpayer continuously throughout the required holding period.

We agree that a partner should be entitled to the benefits of Section 1045 only to the extent that it has a continuous ownership interest associated with its investment in QSBS through a partnership. Without a nonrecognition limitation, a partner could preserve its Section 1045 benefits with respect to a specific investment while shifting the benefits of ownership or risk of loss associated with that investment to other investors.

The Regulations set forth a reasonable rule that is easy to administer and that makes sense in the context of a simple pro rata partnership arrangement. However, the rule is less clear in the context of many common but more complex partnership arrangements. For example, it is unclear whether and to what extent the nonrecognition limitation would apply to a limited partnership where the general partner is entitled to a 20% profits interest after the limited partners have received a return of and a priority return on their initial capital contributions. It is possible to interpret the Regulations to say that 20% of the benefits of the QSBS are forfeited, because the smallest share of income attributable to the limited partners is 80% and the smallest share of income attributable to the general partner is 0%. As a result, in a typical venture capital fund structure where the general partner has a carried interest, a portion of the Section 1045 benefits would automatically be eliminated. In some cases, depending on the structure of the partnership, it is possible that the entire benefit could at least arguably be eliminated under a

technical reading of the Regulations.[23] We think that result is clearly inconsistent with the purpose of the statute, particularly in a case where the partners and partnership agreement remain unchanged over the term of the investment.

While we believe the Regulations are overly stringent in this context, we do not have a specific recommendation for an alternative rule. We have considered several possibilities. As a general matter, we are in favor of flexibility to further the underlying policy objectives of Section 1045. We believe the loss of rollover benefits under the example above is unnecessarily restrictive in a regime designed to promote investment by individuals in small businesses. However, we are mindful of the fact that increased flexibility will likely give rise to more complicated rules. The desire for flexibility will therefore need to be weighed against the desire to avoid undue complexity.

Perhaps the simplest approach would be for the nonrecognition limitation to be based on how the gain on the sale of the QSBS is actually allocated. Benefits under Section 1045 would be allocated in that same ratio, assuming that the partners have remained unchanged throughout the holding period and that the partnership allocations have not been modified during that period. Under that approach, the general partner would be eligible for 20% of the Section 1045 benefits in the foregoing example.

It could be argued that any allocation of Section 1045 benefits to the general partner with respect to a carried interest is inappropriate because the general partner has not made an economic investment in the QSBS and bears no risk of loss. In addition, we recognize that there might be situations where the general partner is allocated 100% of the gain with respect to a disposition of QSBS, even though it has not contributed any capital with respect to the investment, because the general partner is entitled to a "catch up" allocation relating to a prior preferred return allocation to the limited partners. In either situation, it could be argued that it is

---

[23] In other words, it could be possible that the general partner's carried interest would be ineligible for deferral and also that at least 20% and perhaps 100% of the limited partners' gain would also be ineligible for deferral. For example, assume the facts in the text but also assume that the general partner receives a "catch-up" allocation of gain to match the limited partners' preferred return. In that situation, both the limited partners and the general partner could be viewed as having a smallest share of income equal to 0%. Under that view, no partner would be entitled to rollover benefits.

more appropriate to allocate the tax benefits to the limited partners who invested the capital used to acquire the QSBS. Accordingly, an alternative, simple approach would be to allocate 100% of the benefits to the limited partners in the foregoing example.

There are other alternatives, which one might view as more theoretically appropriate but which are at the same time more complicated. For example, the nonrecognition limitation could be based on a partner's cumulative percentage of income or gain during the required holding period. Thus, assume the facts described above where the limited partners invest 100x and are entitled to a 10% annual return before profits are split on an 80/20 basis. Assume further that the QSBS generates 10x in dividend income in year 1, 10x in dividend income in year 2, and then is sold at the beginning of year 3 for 110x. The cumulative profit associated with the QSBS over the holding period is 30x, which is allocated 28x to the limited partners and 2x to the general partner. It would seem reasonable to allocate 2/30 of the QSBS benefits to the general partner and 28/30 to the limited partners.[24] This approach would allow a general partner whose carried interest does not become relevant until after several years of the partnership's operation to receive rollover benefits under Section 1045 consistent with the partner's economic interest over the life of the investment.

Finally, we considered whether the Regulations could draw by analogy on the principles underlying the allocation of "tier three" partnership nonrecourse liabilities under Treasury Regulation Section 1.752-3. That section provides some degree of flexibility to allocate excess nonrecourse liabilities based on the manner in which the partnership allocates profits, taking into account all facts and circumstances relating to the economic arrangement. The allocation may be specified in the partnership agreement as long as the allocations are reasonably consistent with the allocation of some other significant item of partnership income or gain, and alternative approaches are available.[25] The Regulations could draw on this analogy, for example, by providing that QSBS benefits must be allocated in the same proportions as the Section 752 tier three allocations. Alternatively, the Regulations could provide that QSBS benefits may be

---

[24] Therefore, under this approach the limited partners could defer 28/30ths of their allocated gain on disposition of the QSBS, and the general partner could defer 2/30ths of its allocated gain.

[25] Treas. Reg. § 1.752-3(a)(3).

allocated under any method that would be permitted under Section 752 principles. Finally, the Regulations could permit allocations using any reasonable method, with a presumption that the partnership's Section 752 method (or any permissible Section 752 method) is reasonable.

Ultimately, however, the Section 752 analogy might not provide sufficient guidance to address all of the issues in the Section 1045 context. For example, in the typical carried interest situation described above, depending on the facts, it might not be clear for any given year whether the general partner's percentage could be specified as 20%, and it is possible that the appropriate percentage could change from year to year.[26]

With any of the possibilities discussed above, rules would have to be crafted to address the scope of the "continuous ownership requirement" and account for (i) subsequent divestment or increased investment by existing partners, either as a result of a capital contribution or an amendment to the partnership agreement that reallocates income, and (ii) the impact of a subsequent admission of a new partner.

For example, with regard to subsequent divestment or increased investment by existing partners, the nonrecognition limitation would have to be crafted in such a way that rollover treatment would only be allowed to the extent of a partner's interest as reflected in the economic arrangement of the partnership on the date when the QSBS was purchased. Either in the explicit regulatory language or in a descriptive example, the rule could provide that "a partner's interest as reflected in the economic arrangement of the partnership" includes an interest in a complex partnership arrangement as of the date of purchase of the QSBS, such as the carried interest example described above, that may not entitle the partner to a current distributive share of the income or gain associated with the QSBS as of the date of purchase. While the carried interest does not represent an entitlement to the QSBS on a "liquidation" basis as of the date of purchase, it does represent a current interest in the future profits associated with the investment and

---

[26] For example, there could be a year in which income is allocated 100% to the limited partners with respect to their preferred return, and no income is available to allocate to the general partner. In that year, a 20% allocation to the general partner of excess nonrecourse liabilities might not be respected. A 20% allocation to the same general partner might be appropriate in later years when there is sufficient income available to allocate on an 80/20 basis. If the allocation of excess nonrecourse liabilities were relied on to determine the allocation of rollover benefits under Section 1045, it is not clear what the impact would be of these possible variations in the allocations from year to year.

therefore is a real economic interest in the QSBS. This situation would have to be distinguished, for example, from an amendment to the allocations during the term of the investment reflecting a change in percentage ownership of the indirect investment in the underlying QSBS.

With regard to the impact of a subsequent investment in the partnership, the nonrecognition limitation should prohibit a subsequent investor in the partnership from availing itself of rollover benefits with respect to the partnership's previously-purchased QSBS. In addition, the Regulations would need to address the impact of the dilution of a historic partner's interest resulting from the subsequent investment in the partnership by a new or existing partner. Specifically, the Regulations would need to address the impact of a book-up and "reverse" Section 704(c) allocations.

On this point, the Executive Committee is divided. Some members believe that the historic partner's share of gain attributable to the QSBS as of the date of the subsequent investment should be preserved and tracked through "reverse" Section 704(c) principles. Under this view, that amount of gain should be eligible for rollover benefits at the time of an actual sale of the QSBS by the partnership.[27]

Other members of the Executive Committee disagree with that analysis. These members view the dilution of a historic partner's interest in the partnership resulting from a subsequent capital contribution as economically equivalent to a divestment of QSBS, similar to a sale by an individual of a portion of QSBS acquired upon issuance. While gain allocations to the historic partner are preserved under Section 704(c) principles, as an economic matter the historic partner is sharing with the new investor the risk of loss and the opportunity for gain. Under this view, permitting the historic partner to retain full Section 1045 benefits is inconsistent with the continuous ownership requirement of Section 1202(g)(2)(B), as made applicable by Section 1045(b)(5). These members therefore believe that a historic partner should not be entitled to Section 1045 benefits with respect to the entire amount of its "reverse" Section 704(c) gain with

---

[27] As an alternative, at least theoretically it might be possible to create a regime where, upon the election of the partnership, the "reverse" section 704(c) gain is immediately recognized upon the subsequent investment and book-up, but eligible for deferral under Section 1045. We do not recommend that approach because it seems complicated and fundamentally inconsistent with subchapter K and basic realization principles that generally defer recognition until an actual disposition.

respect to the relinquished QSBS. Instead, the amount eligible for benefits upon the disposition of the relinquished QSBS should be reduced to reflect the dilution.

F. Replacement QSBS

Although the Regulations provide welcome guidance on the application of Section 1045 to partners and partnerships, more specific guidance is needed with regard to the treatment of replacement QSBS. In particular, we believe that the reinvestment rules for QSBS should be revised to permit replacement QSBS to be acquired by a partnership that owns or is owned by the partnership selling the relinquished QSBS (i.e., in a tiered ownership structure), and also by a partnership separately owned by an eligible partner. We believe this result is consistent with the statute and the underlying policy objectives. In that regard, we note that, as discussed above, there is no statutory authority directly addressing this issue, because the statutory rules in Section 1202, which in turn provide the basis for the Section 1045 Regulations, do not set forth any particular requirements for acquisitions of replacement QSBS (since the reinvestment concept does not apply in the context of Section 1202).

The potential inconsistencies that result from the reinvestment rules as currently formulated in the Regulations are illustrated by the following two examples.

Example A. Partner A owns a 99% interest in Partnership A. Partnership A owns a 99% interest in Partnership B. Partnership B sells relinquished QSBS. If Partner A individually purchases replacement QSBS, then s/he may make a Section 1045 election. However, if Partnership A purchases the replacement stock, a Section 1045 election appears to be precluded, even though the relationship between Partner A and Partnership B is more attenuated than the relationship between Partnership A and Partnership B.

Example B. Partner A owns a 99% interest in Partnership A. Separately, Partner A owns a 99% interest in Partnership B. Partnership A sells relinquished QSBS. If Partner A individually purchases replacement QSBS, then s/he may make a Section 1045 election. However, if Partnership B purchases the replacement stock, Partner A is precluded from making the Section 1045 election under the Regulations. (See Example 1 of the Regulations.)

At a minimum, we believe that the tiered partnership rules should be expanded to encompass the situation described in Example A. In the Preamble, the IRS and Treasury Department specifically request comments on the tiered partnership rules. We support those rules because they provide flexibility by collapsing various tiers of partnerships and treating them as one entity. However, as currently formulated in the Regulations, the tiered partnership rules apply only to the narrow question of who is an eligible partner. We believe that a broader application of the tiered partnership rules to permit the purchase of replacement QSBS in a tiered arrangement would provide internal consistency within the Regulations and would further implement the underlying policies of the Regulations, Section 1045, and Section 1202.

Example 3 in the Regulations discusses the treatment of eligible partners of a tiered partnership, but neither that example nor the other examples explain the impact of a tiered partnership arrangement on investments in replacement QSBS. Example 3 involves individuals A and B who contribute cash to an upper-tier partnership, which in turn forms a lower-tier partnership with individual C. The lower-tier partnership purchases QSBS. On a later date, individual D contributes cash to the upper-tier partnership. The lower-tier partnership then sells the QSBS. The example concludes that A, B and C are eligible partners for Section 1045 benefits.

Using the facts of Example 3, after the sale by the lower-tier partnership of QSBS, suppose the upper-tier partnership invested in QSBS. Can that QSBS be treated as replacement QSBS from the upper-tier partner's perspective even though the reinvestment is by a different entity? The example does not address this question.

We believe a partner should be viewed as participating indirectly in the transactions engaged in through tiers of partnerships, as long as the partner is an eligible partner during the relevant time periods. Therefore, in the example described above, an upper-tier eligible partner should be treated as having reinvested in the QSBS acquired by the upper-tier entity and should be eligible to make a rollover election with respect to the sale of the QSBS by the lower-tier entity.

More broadly, we believe the reinvestment rules should be revised to treat a partner as reinvesting in QSBS acquired not only through a tiered partnership arrangement, but also

through separate chains of ownership. This situation is illustrated in Example B above. Under those facts, we believe the acquisition of QSBS by the separate Partnership B should be treated as an indirect acquisition of replacement stock by Partner A, eligible for rollover treatment. For that reason, as we discuss in Section IIIA above, we disagree with the conclusion of Example 1 in the Regulations.[28]

We have considered that the rationale for preventing indirect acquisitions of replacement stock through a separate partnership might be related to the statutory rule preventing a partner from acquiring QSBS and contributing it to a partnership. Permitting a partner to contribute cash to a partnership which in turn uses the cash to purchase QSBS might in some sense be viewed as a way for taxpayers to avoid this prohibition on QSBS contributions. However, as noted below we do not understand the purpose of the rule prohibiting contributions, and in any event we do not think that either that rule or the other statutory provisions preclude the Treasury Department from respecting an indirect acquisition of replacement QSBS. At a minimum, the Regulations should directly address and clarify these issues.

G. Miscellaneous Issues

We assume that a single member entity treated as disregarded from its owner under the "check-the-box" regulations[29] would also be disregarded for the purposes of the Regulations. Therefore, for example, QSBS could be contributed by a partnership to a single-member LLC without violating the prohibition on partnership contributions or the requirement that QSBS must be held by the same entity from the date of issuance until the date of sale. While we think this result is clear and consistent with the underlying principles of the statute and the Regulations, the Regulations should make this result explicit to avoid any uncertainty.

---

[28] For the same reason, we disagree with the implications of Example 8. In Example 8, a partnership sells QSBS and purchases replacement QSBS, but does not make the required Section 1045 election. Partner A, on the other hand, makes an election under Section 1045, but does not directly acquire replacement QSBS. The Example states that no person is eligible for rollover treatment. Under our approach, Partner A would be permitted to make a Section 1045 election with respect to the acquisition of replacement QSBS at the partnership level.

[29] *See* Treas. Reg. § 301.7701-3(a).

IV. Issues for Possible Statutory Amendment

In some cases the Regulations adopt rules that are required by the statute but that seem overly restrictive absent a compelling policy rationale. Consideration could be given to whether these issues should be addressed by statutory amendment.

A. Sale of Partnership Interest as Sale of QSBS.

As discussed in Section III A, the Regulations follow the statute and provide that the sale of a partnership interest cannot be treated as a sale of QSBS. A partner can achieve rollover benefits only in the case of either a direct sale of stock by the partnership or a distribution of the stock and direct sale by the partner. We question the rationale for this rule and believe that the statute places unnecessary emphasis on the fact that the same entity must acquire and sell the QSBS.

Consideration could be given to whether and to what extent the sale of a partnership interest should appropriately be treated as a sale of QSBS. Such a rule would not create a duplication of QSBS tax benefits, because the acquiring partner would clearly not be an eligible partner entitled to benefits under Section 1045. Possibly the rationale for the statutory rule is to avoid the added complexity of having to allocate the amount realized for the partnership interest between gain attributable to QSBS and other assets. In any event, this might be an area to consider for future statutory change.

B. Contribution Limitation.

As discussed in Section III B above, the statute and legislative history clearly indicate that stock contributed by a partner to a partnership loses its character as QSBS. The policy rationale behind this rule is not clear. Furthermore, the rule can lead to arbitrary results. For example, if two individuals contribute money to a partnership on Day 1, and on Day 2 the partnership purchases QSBS, both individuals are eligible partners for purposes of Section 1045 and both can enjoy the corresponding tax benefits. In contrast, if the same two individuals separately purchase identical QSBS on Day 1, but on Day 2 they decide to form a partnership to hold their aggregate QSBS investment, they are precluded from enjoying the benefits of Section 1045 or Section 1202. In our view, this rule result creates an unnecessary trap for the

unwary and gives undue emphasis to the order of steps in a regime designed to create incentives for investments by individual taxpayers in small businesses. We therefore believe that, at a minimum, the contribution limitation should not apply in situations where each individual partner contributes identical QSBS and maintains the same percentage interest in the QSBS, although owned indirectly after contribution to the partnership.[30] However, in light of the clear statutory language, we believe a legislative change would be required.

The Executive Committee cannot reach unanimity on whether the contribution limitation should be eliminated entirely. Some members believe that the rule is not theoretically justified and that it creates an unfair penalty against a partner who reorganizes his or her ownership of QSBS but retains a substantial ownership interest in the stock. For example, if an individual holds 100 shares of QSBS and sells 50 of those shares, the individual will retain 50% of the total Section 1045 benefits held before the sale of stock. If, on the other hand, the individual does not sell any shares of QSBS but rather contributes all 100 shares to a partnership in consideration for a 99% partnership interest, the individual will lose 100% of the Section 1045 benefits associated with the stock. That result seems rather harsh, since the individual retains a 99% indirect ownership interest in the stock.

Other members of the Executive Committee do not view the contribution limitation as necessarily inconsistent with the overall purposes of Section 1045 and believe that the additional complexities required by a change in the rule outweigh the benefits of allowing partner-to-partnership contributions of QSBS. In their view, the contribution limitation is a simple way to prevent the "sharing" of Section 1045 benefits through partnership transactions that function as "disguised sales" of the QSBS benefits. In addition, as a practical matter QSBS is likely to be acquired by a partnership rather than directly by individuals, and therefore perhaps the impact of the contribution limitation may not be significant in practice.

Even those who support eliminating the contribution limitation acknowledge that the implementation of such a change would require additional complexity. The existing Regulations

---

[30] In that case, we believe each partner should retain full rollover benefits, rather than being treated as having "disposed" of an interest in 50% of the contributed QSBS and "acquired" an interest in 50% of the QSBS contributed by the other partner.

do provide a framework for handling some of the issues. For example, they contain detailed rules for tracking a partner's continuing economic ownership in QSBS. In addition, the Regulations contain rules for providing appropriate basis adjustments depending on whether partners qualify for Section 1045 treatment and whether elections are made at the partner or partnership level.

However, additional rules would be needed to ensure that the amount of Section 1045 benefits available to the contributing partner accurately reflects the decreased ownership percentage of the contributing partner in the QSBS. For example, if A contributes 100 shares of QSBS to Partnership in exchange for a 50% partnership interest and B contributes cash for a 50% partnership interest, A should only be entitled to 50% of the previously available Section 1045 benefits, because ownership of the QSBS after contribution is shared 50/50 with B. Accordingly, the rules might provide that only 50% of any Section 704(c) built-in gain should qualify for benefits,[31] and if the QSBS subsequently appreciates in value, A should be entitled to Section 1045 benefits only with respect to 50% of the appreciation. In addition, in a situation where a partnership sold two tranches of QSBS, contributed by different partners, ordering rules would presumably be needed to determine whether a reinvestment is allocable to a particular tranche (and thus a particular partner).

While we understand that the IRS and Treasury Department are bound by the statute and legislative history of Sections 1202 and 1045 with regard to the limitations on the contribution of QSBS to a partnership, consideration should be given to whether this aspect of the underlying law would be an appropriate subject for a future statutory amendment and if so how best to address the technical issues noted above to minimize additional complexity.

---

[31] The Executive Committee is not in agreement on how the Section 704(c) amount should be handled. The issue is similar to the question of whether a historic partner should retain 100% of rollover benefits with respect to "reverse" Section 704(c) gain upon a subsequent capital contribution to the partnership and corresponding "book-up" event. As noted above, the Executive Committee is divided on that issue. See Section III E above. For similar reasons, we disagree whether it would be appropriate to preserve 100% of the Section 704(c) built-in gain for rollover treatment in connection with a partnership contribution of QSBS.

C. Election to Designate Replacement QSBS

As noted in Section III D 2 above, Section 1045(b)(3) provides that if gain from a sale of QSBS is deferred, then such gain shall be applied to reduce "in the order acquired" the basis of the replacement QSBS acquired during the replacement period. The treatment of replacement QSBS in the Regulations is consistent with this statutory requirement. The legislative history provides no guidance with respect to this requirement.

It is possible that a partnership or a partner could make more than one acquisition of QSBS during the 60-day replacement period, and we see no policy reason why only the first-acquired QSBS should count as replacement QSBS. Consideration could be given to a statutory change that would allow the partnership or the partner to elect out of the rule that the first-acquired QSBS must be treated as the replacement QSBS. This election could be made (within the 60-day period) by designating which QSBS the partnership or partner wishes to treat as the replacement QSBS. Absent an election, the existing "first acquired" rule would apply. Such a provision would be consistent with the general purpose of the statute while allowing greater investment planning flexibility for partnerships and partners.