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subject: Section 1202 and Brokerage Services

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Corporation =

Taxpayer =

ISSUES

Does a business that facilitates the leasing of property between lessors and lessees constitute a business involving the performance of services in the field of brokerage services within the meaning of § 1202(e)(3)(A) of the Internal Revenue Code?

CONCLUSIONS

A business that facilitates the leasing of property between lessors and lessees constitutes a business that involves the performance of services in the field of brokerage services within the meaning of § 1202(e)(3)(A).

FACTS

Taxpayer sold stock in Corporation. Corporation operates a website on which potential lessees may use the website to make nonbinding reservations for the use of certain facilities at specified rental rates from facility lessors that are included in the website data base. Corporation has no authority to enter into or sign leases on behalf of the potential lessors or lessees. A legally binding rental agreement for the use of a facility does not arise until the potential lessor and the potential lessee enter into a lease agreement. Corporation's website will show a user that is considering leasing one or more facilities in a particular location the facilities in that area that are included in the website data base.

Potential lessees do not pay any fee to Corporation for the use of Corporation's website. In its "Terms of Service" for lessees, Corporation states that it has no control over the facilities to be leased and does not guarantee the accuracy of any listings. Nor does Corporation guarantee that a lessee will actually be able to lease a facility listed in its database.

The lessors are responsible for all payments to Corporation. As a condition of being listed in Corporation's public, searchable database, lessors agree to compensate Corporation. Specifically, Corporation charges lessors a recurring periodic fee for simply being listed in the database, and a contingent fee based on a percentage of rent paid by a lessee actually leasing a facility from a lessor through a search of Corporation's database. Corporation requires lessees to pay the rent for the leased facility through Corporation's website.

The facilities listed for lease on Corporation's website include real property. In Corporation's "Terms of Service," Corporation represents to potential lessees that its

" Corporation states that it is not responsible for, and does not engage in, brokering, selling, purchasing, exchanging, or leasing posted properties. Although it may hold a real estate broker license in one or more states, Corporation asserts that it is not a broker with respect to the leasing of the facilities. Further, a lessee's use of the website constitutes an acknowledgement that Corporation has pre-negotiated rental rates with the lessors included on its website, part of which will be retained by Corporation as compensation for its services.

Corporation may also provide other services to lessors. For example, Corporation may charge a lessor a monthly fee to build and host a website for the lessor to be used in conjunction with the leasing of the lessor's facility. Liability for this monthly fee is not contingent on the lessor successfully leasing its facility to potential lessees.

LAW AND ANALYSIS

A. Section 1202

For taxpayers other than corporations, under § 1202(a), gross income shall not include a certain percentage of any gain from the sale or exchange of qualified small business stock (QSB stock) held for more than 5 years. The gain exclusion is 100% for QSB stock acquired after September 27, 2010, 75% for QSB stock acquired after February 17, 2009 and before September 28, 2010, and 50% for QSB stock acquired on or before February 17, 2009.

Section 1202(c) provides that, in general, QSB stock means any stock in a C corporation which is originally issued after the date of enactment of the Revenue Reconciliation Act of 1993 (Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, § 13113(a)) if: 1) on the date of the stock's issuance such corporation is a qualified small business; and 2) such stock is acquired by the taxpayer at its original issue in exchange for money or other property or as compensation for services.

Section 1202(c)(2)(A) requires that in order to be treated as QSB stock, during substantially all of the taxpayer's holding period for such stock, the corporation issuing the stock must satisfy the active trade or business requirement of § 1202(e). This requires the corporation to use at least 80 percent of its assets (by value) in the active conduct of one or more qualified trades or businesses.

Generally, an active trade or business is any trade or business other than trades or businesses expressly listed in § 1202(e)(3). Section 1202(e)(3)(A) specifically provides that a trade or business involving the performance of services in various fields, including brokerage services, is not an active trade or business under § 1202(e)¹.

B. Brokerage Services

There are two primary possibilities for characterizing the services provided by Corporation. First, it is simply providing advertising services. Second, Corporation's services extend beyond passive advertising and constitute the provision of brokerage services.

1. Statutory and Regulatory Definitions for Federal Tax Purposes

As stated above, the term "brokerage services" is not defined in § 1202 nor is it explained in the legislative history to § 1202, which simply repeats the term without any elaboration on its meaning. See H.R. Rep. No. 111, 103d Cong., 1st Sess. 601 (1993). Outside of § 1202(e)(3)(A), several other Code sections and Federal income tax regulations discuss the definition of "brokerage services". Because § 1202(e) does not

¹ Section 1202(e)(3) also provides that certain other trades or businesses are not qualified trades or businesses. This list includes, among others, any farming business, operation of a hotel, motel or restaurant, and any banking, insurance, financing, leasing, investing or similar business.

contain a definition of the terms used, it is instructive to look to other Code sections. Specifically, we look to §§ 6045, 448 and 199A for guidance.²

For information reporting purposes, § 6045(a) requires every person doing business as a broker to file information returns regarding the person's customers in accordance with regulations issued by the Secretary. Section 6045(b) also requires the person doing business as a broker to provide a statement to the customer. The term broker is broadly defined in the statute without any restriction to a particular type of business. Specifically, § 6045(c)(1) provides that the term broker includes—(A) a dealer, (B) a barter exchange, and (C) any other person who (for a consideration) regularly acts as a middleman with respect to property or services.

Treas. Reg. § 1.6045-1 similarly broadly defines the term “broker” to include “any person (other than a person who is required to report a transaction under section 6043), U.S. or foreign, that, in the ordinary course of a trade or business during the calendar year, stands ready to effect sales to be made by others.” Notwithstanding this broad statutory and regulatory definition of broker, in promulgating the regulations under section 6045, Treasury chose to limit the types of assets, the sale of which would be subject to broker reporting. Specifically, Treas. Reg. § 1.6045-1(a)(9) defines a “sale” as dispositions of securities, commodities, options, regulated futures contracts, securities futures contracts, or forward contracts, and includes redemptions of stock, retirements of debt instruments, entering into short sales for cash, and in the case of an option, a regulated futures contract, a securities futures contract, or a forward contract, a sale includes any closing transaction. Notwithstanding that the definition of sale in Treas. Reg. § 1.6045-1(a)(9) effectively limits the types of “brokers” who will have an obligation to make information reports, the statutory and regulatory definition of broker nonetheless remains broad enough to apply to Corporation's website operations.

In 1986, Congress added real estate transactions to the types of transactions for which broker reporting is required under section 6045. See § 6045(e). Recognizing that many people may be involved in facilitating real estate transactions, however, Congress provided a specific ordering rule to ensure that only one person would be treated as the “broker” with the obligation to report on the real estate transaction. See § 6045(e)(2). Specifically, the “real estate reporting person” to be treated as a broker includes the following persons (in order): the person responsible for closing the transaction, the mortgage lender, the seller's broker, the buyer's broker, or such other person designated in the regulations. This reporting regime for real estate brokers shows that Congress understood that the term broker had an expansive meaning, certainly broad enough in this context to apply to Corporation's lease facilitation operations.

Section 448(a) generally requires C corporations and partnerships that have a C corporation as a partner to use the accrual method of accounting if such entities meet a gross receipts test³. However, § 448(b)(2) treats a qualified personal service

² While other Code sections may discuss brokers or brokerage services, §§§ 448, 6045(a) and 199A are the most applicable to § 1202 as they provide the clearest guidance as to the definition.

³ Section 448(a) also requires tax shelters to use the accrual method of accounting.

corporation (QPSC) as an individual, thereby creating an exception to the accrual method requirement for such C corporations and partnerships whose only C corporation partners are QPSCs. Section 448(d)(2) requires that substantially all of the activities of the corporation involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. These activities also constitute a subset of the trades or businesses that fail to meet the test for a qualified trade or business under § 1202(e)(3)(A).

Notably absent from the list of activities that can qualify a C corporation as a QPSC under § 448(d)(2) are the performance of activities in the field of brokerage services. Nevertheless, the § 448 regulations provide that consulting services do not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. See Treas. Reg. § 1.448-1T(e)(4)(iv)(A). The regulations provide that whether a person's services are sales or brokerage services, or economically similar services is based on all the facts and circumstances of that person's business, including the manner in which the taxpayer is compensated for the services (e.g., whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect). *Id.* Treas. Reg. § 1.448-1T(e)(4)(iv)(B) provides several examples of the application of this rule, which has the corollary effect of providing some indication as to what constitutes sales services, brokerage services, or services economically similar to brokerage services. The examples distinguish consulting from sales services, as well as brokerage services and economically similar services. What triggers the taxpayer's right to compensation appears to be a major factor in making this determination. It appears that if the taxpayer is compensated for advising and counseling the client, the services constitute consulting⁴. If, no matter how much effort the taxpayer expends advising and making recommendations to the client, the taxpayer is only compensated if the client engages in specific transactions, the services are not for consulting.

For instance, in Example 5, the taxpayer executes transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. The taxpayer also provides clients with economic analyses and forecasts of conditions in various industries and businesses, and based on these analyses, the taxpayer recommends that the taxpayer engage in certain transactions involving securities and/or commodities. However, the taxpayer's compensation is typically based on actual trades made by clients. Example 5 concludes that the taxpayer is providing brokerage services.⁵

⁴ The consulting examples do not expressly provide that the taxpayer is compensated based on hourly billing rates or some other metric not based on commissions for executed transactions. However, notably absent from the consulting examples are any indications that the taxpayer's compensation is commission based.

⁵ Although Example 10 concludes that the taxpayer is engaged in the performance of brokerage or sales services, it does not state whether the taxpayer's services are in the nature of brokerage or sales services. In that example the taxpayer sells insurance, annuities, and other similar insurance products. The taxpayer studies the client's financial situation, business and personal insurance risks, and

The regulation's goal is to provide guidance as to what constitutes the performance of services in the field of consulting. As brokerage services are not consulting services under the regulation, the examples do not provide enough facts or criteria to allow a reader to distinguish between sales services⁶, brokerage services, and services economically similar to brokerage services.⁷

Finally, § 199A(d)(2)(A) references § 1202(e)(3)(A) in its list of trades or businesses that are specified service trades or businesses. In 2019, Treasury issued regulations that expressly define the performance of brokerage services in the context of § 199A. However, these regulations only apply for purposes of § 199A.⁸

anticipated future economic and financial needs. Based on this study, the taxpayer recommends various insurance products to the client. The client then may purchase various insurance products through the taxpayer. The taxpayer's compensation for its services is typically based on the purchases made by the clients. The example does not make clear whether the taxpayer is a dedicated sales agent for a particular insurance company, in which case we would consider the taxpayer to be providing sales services, or if the taxpayer is an independent insurance agent that could obtain insurance contracts for the client from multiple insurance companies, in which case we would consider the taxpayer to be an insurance broker.

⁶ In Example 6 the taxpayer studies a client's data processing needs and makes recommendations to the client regarding the design and implementation of data processing systems. The client then may order computers and other data processing equipment through the taxpayer based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the equipment orders made by the clients. Example 6 concludes that the taxpayer is providing sales rather than consulting services. The example does not specify whether the taxpayer is also the party that provides the computers and data processing equipment, is a dedicated sales agent for a single manufacturer or distributor of computers and other data processing equipment, or works as an independent agent on behalf of clients to arrange a sales transaction between the client and one or more manufacturers or distributors of computers and data processing equipment. Our assumption is that the taxpayer is a sales agent for one manufacturer or distributor of computers and other data processing equipment.

⁷ In Example 7 the taxpayer assists clients in meeting their personnel needs by referring job applicants to the clients with hiring needs in a particular area. The taxpayer's compensation for its services is typically based on the job applicants, referred by the taxpayer to the clients, who accept employment positions with the clients. In Example 9 the taxpayer assists clients in placing advertisements for their goods and services. The taxpayer analyzes the conditions and trends in the client's particular industry, and then makes recommendations to the client regarding the types of advertisements which should be placed by the client and the various types of advertising media (e.g., radio, television, magazines, etc.) which should be used by the client. The taxpayer's compensation for its services is typically based on orders for advertisements which the client makes. In both examples the regulations conclude that the taxpayers are engaged in the performance of services economically similar to brokerage services. The regulations provide no criteria for distinguishing brokerage services from services economically similar to brokerage services.

⁸ Treas. Reg. § 1.199A-5(b)(2)(i) provides that the rules of § 1.199A-5(b)(2) apply solely for purposes of § 199A and therefore may not be taken into account for purposes of applying any provision of law or other regulation other than § 199A and the regulations thereunder, except to the extent such provision expressly refers to § 199A(d) or Treas. Reg. § 1.199A-5.

Treas. Reg. § 1.199A-5(b)(2)(x) provides that for purposes of § 199A(d)(2) and Treas. Reg. § 1.199A-5(b)(1)(ix) only, the *performance of services in the field of brokerage services* includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in § 475(c)(2)) for a commission or fee, including stock brokers and other similar professionals but does not include services by real estate agents and brokers, or insurance agents and brokers.

2. Dictionary Definitions

We have found no case law that addresses the issue of what constitutes “brokerage services” for federal income tax purposes. However, in the absence of evidence to the contrary, words in a statute are assumed to bear their ordinary, contemporary, common meaning. *Pioneer Investment Services Co. v. Brunswick Associates Ltd. Partnership*, 507 U.S. 380, 388 (1993). To ascertain the meaning of statutory terms, courts often take into account the definitions of those terms in dictionaries. See e.g. *Walters v. Metropolitan Educational Enterprises, Inc.*, 519 U.S. 202, 207 (1997); *Metro One Telecommunications, Inc. v. Commissioner*, 704 F.3d 1057, 1061 (9th Cir. 2012).

One popular dictionary definition of broker defines the term similar to the definition of broker under § 6045. Specifically, Merriam-Webster defines “broker” as “one who acts as an intermediary: such as a: an agent who arranges marriages b: an agent who negotiates contracts of purchase and sale (as of real estate, commodities, or securities).” Additional, less common, meanings are “power broker” and “one who sells or distributes something.” Broker, Merriam-Webster.com, <https://www.merriam-webster.com/dictionary/broker> (last visited Jan. 7, 2021).

BLACK’S LAW DICTIONARY (11th ed. 2019) provides a more elaborate definition of broker, stating, “One who is engaged for another, usually on a commission, to negotiate contracts to property in which he or she has no custodial or proprietary interest, or an agent who acts as an intermediary or negotiator, especially between prospective buyers and sellers.”

Another definition of ‘broker’ provides that the most important factor determining whether a person is a broker is whether the party is dealing for itself or for another. Further, a broker must be acting for compensation and on behalf of someone else. See 12 Am. Jur. 2d *Brokers* § 1 (1997).

There are all kinds of parties who are referred to as brokers. A few examples include aircraft brokers, freight brokers, real estate brokers, business brokers, yacht brokers, ship brokers, stockbrokers, commodities brokers, insurance brokers, broker-dealers, auto transport brokers, mortgage brokers, list brokers (for direct mail), intellectual property brokers, produce brokers, customs brokers, and pawnbrokers.

The latter two types of brokers are not brokers as defined above. A pawnbroker functions as a dealer in used property but its primary business is that of a secured

lender that takes possession of the collateral securing the loan. With respect to importing goods into the United States, a customs broker generally aids parties in complying with import laws and regulations.

Thus, the mere fact that a party is referred to as a broker does not in and of itself mean that the party is a broker within the scope of the definitions set forth above. Likewise, the fact that a party is not commonly referred to as a broker does not, in and of itself, foreclose the possibility that the party is a broker within the scope of the definitions set forth above.

C. Is Corporation providing Brokerage Services Under § 1202(e)(3)(A)

Section 61(a) provides a broad definition of gross income, stating that except as otherwise provided, gross income means all income from whatever source derived. The Supreme Court, in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955), emphasized the sweeping and encompassing nature of § 61(a). See also *United States v. Burke*, 504 U.S. 229, 233 (1992); *Helvering v. Clifford*, 309 U.S. 331, 334 (1940).

As a corollary to the idea that gross income should be broadly construed, exclusions from gross income must be narrowly interpreted. See *Commissioner v. Schleier*, 515 U.S. 323, 328 (1995); *United States v. Burke*, 504 U.S. at 248 (Souter, J. concurring in judgment); *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 583-584 (1991); *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949).

Section 1202 excludes from gross income all or a portion of the gain from the sale of QSB stock. Section 1202(e)(3) provides a list of activities that do not satisfy the active business requirement of a qualified trades or business, including brokerage services. These activities limit the scope of the § 1202 exclusion. Precedent, therefore, supports the Service in interpreting the term “brokerage services” broadly, so as to provide a narrow construction of the exclusion.

We may, in our discretion, look to other Code sections and commonly understood definitions to help define the terms used in § 1202(e), including “brokerage services.” In § 199A, for example, the definition of who is a broker is quite narrow, extending only to include those who deal with securities. In § 199A, interpreting “broker” narrowly furthers the overall purpose of the provision to provide nonincorporated businesses with a lower effective rate of tax following the reduction of the corporate rate. For § 199A, tax policy is furthered by narrowly limiting the definition of “broker” to one who only deals in securities. Using a similarly narrow definition of brokerage services would not, however, further the tax policy goals of § 1202.

In contrast, the definition of broker in § 6045 is quite broad and includes any person who regularly acts as a middleman with respect to property or services (including real estate) that the Secretary determines should be subject to reporting. In contrast to § 199A, tax policy is furthered by an expansive definition of ‘broker’ under § 6045 because limited third-party information reporting to the IRS is an important factor

contributing to the tax gap—which is the difference between taxes legally owed and taxes actually paid. GAO, *Tax Gap: Multiple Strategies Are Needed to Reduce Noncompliance*, GAO-19-558T at 6 (Washington, D.C.: May 9, 2019).

Section 448(d)(2) excludes “qualified personal service corporations” from required use of the accrual method, whereas § 1202(e)(3)(A) denies the tax benefits of § 1202 to stockholders of businesses that do not satisfy the definition of qualified trades or businesses. However, both statutes define the applicable businesses in terms of the services that the businesses perform. While the § 448 regulations do not specifically define “brokerage services”, they do differentiate between consulting services (a qualified business for § 448(d)(2) purposes) which involve advising and counseling clients, from services similar to brokerage services, which involve compensation for the client engaging in a specific transaction.

We conclude that Corporation should be classified as a broker under the common meaning of the term and as it is defined under § 6045, rather than the more narrow definition that applies for purposes of § 199A.⁹ While Corporation states that it does not provide brokerage services but instead provides advertising services, it is our view that the actions and services provided by Corporation support our position that Corporation is a broker for purposes of § 1202(e)(3)(A).

A broker serves as an intermediary between a buyer and a seller, and Corporation does this. Corporation does not just passively publish advertisements on its website that are provided to it from potential lessors desiring to lease property. Unlike a search engine that provides content to users and also sends targeted advertisements to those users based on their search history, Corporation’s website is solely devoted to effectuating agreements between potential lessors and potential lessees of certain property.

Corporation charges a minimum flat fee to lessors irrespective of whether a potential lessor succeeds in entering into lease agreements as a result of the use of Corporation’s website. However, Corporation is also compensated on a commission basis based on leasing transactions that are entered into as the result of the use of Corporation’s website.

Corporation does not have the authority to enter into leasing agreements on behalf of lessors that use its services. Corporation only provides a vehicle for potential lessees to transmit non-binding reservation requests to potential lessors. Only the potential lessor and lessee have the authority to enter into a binding lease agreement. However, brokerage activity can include simply bringing a potential buyer and seller together to work out the transaction. See *American West Hotel Brokers v. Wu*, 697 P.2d 34, 36 (Colo. 1985).

⁹ It is important to emphasize that the §199A regulations’ narrow interpretation of what constitutes brokerage services by its terms only applies for purposes of § 199A and no other Code section. Further, the examples in the section 448 regulations confirm the common meaning of the term brokerage services.

The fact that Corporation's services are provided by software created by people rather than directly by people does not change the functional nature of the services. Because Corporation provides brokerage services within the meaning of § 1202(e)(3)(A), taxpayer is not entitled to exclude any of the gain from the sale of stock in Corporation under § 1202.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]



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