Section 1202.—50 Percent Exclusion for Gain From Certain Small Business Stock

26 CFR 1.1202–2: Qualified small business stock; effect of redemptions.

T.D. 8749

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Qualified Small Business Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the 50-percent exclusion for gain from certain small business stock. The final regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1993 and provide guidance to the issuers and owners of the stock of certain small businesses.

DATES: This regulation is effective December 31, 1997. For dates of applicability of these regulations, see §1.1202–2(e).

FOR FURTHER INFORMATION CONTACT: Catherine A. Prohofsky of the Office of the Assistant Chief Counsel (Income Tax and Accounting) at 202-622-4930 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

Section 1202 of the Internal Revenue Code allows a taxpayer (other than a corporation) to exclude 50 percent of certain gain from the sale or exchange of qualified small business stock held for more than 5 years. This document contains amendments to the Income Tax Regulations (26 CFR part 1) that provide guidance relating to the effect of redemptions on the availability of this exclusion.

On June 6, 1996, the **Federal Register** published a notice of proposed rulemaking (IA–26–94), 61 F.R. 28821, relating to the effect of certain redemptions on the 50-percent exclusion of gain from the sale or exchange of qualified small business stock under section 1202. The proposed regulations provide that these redemptions are disregarded in determining whether the anti-churning rules of section 1202(c) are violated.

Four comments responding to this notice were received. A public hearing was held on October 3, 1996. After consideration of the comments, the proposed regulations under section 1202 are adopted as modified by this Treasury decision.

Summary of Comments and Modifications

The notice of proposed rulemaking requested comments on how to determine when an independent contractor has terminated services. One commentator suggested that the determination of whether services of an independent contractor were terminated should be based on all the facts and circumstances, with termination conclusively presumed if no further services were provided for six months. The IRS and Treasury Department have not adopted this suggestion, but are continuing to study this issue and request additional comments.

Commentators suggested an additional exception for all redemptions occurring in the ordinary course of business or for legitimate business reasons. The final regulations do not incorporate this suggestion. The exceptions in the final regulations relate to redemptions that are incident to certain events affecting a shareholder. Because of the extraordinary nature of these events and the fact that they are generally not within the control of the issuing corporation, the exceptions are unlikely to lead to avoidance of the requirement that qualified small business stock be purchased at original issue. The IRS and Treasury are concerned, however, that a much broader exception for redemptions that arise out of the ordinary business needs and purposes of the issuing corporation, and are not incident to extraordinary events affecting its shareholders, would be much more likely to undermine the original issue requirement.

Two commentators requested that the final regulations be effective for stock purchases by an issuing corporation at any time after August 10, 1993. The effective date has been modified in response to this suggestion. The final regulations will apply to stock issued after August 10, 1993. Thus, regardless of the date on which a redemption occurs (or on which the redeemed stock was issued) the redemption is treated as provided in the final regulations for purposes of determining whether stock issued after August 10, 1993, is qualified small business stock.

The Chief Counsel for Advocacy of the Small Business Administration recommended the inclusion of an exception for redemptions occurring in connection with the divorce of a shareholder. This suggestion has been adopted. The final regulations provide that redemptions of stock occurring incident to the divorce of a shareholder are disregarded in determining whether redemptions exceed de minimis amounts.

The Chief Counsel for Advocacy also requested that the IRS and Treasury Department analyze the current use of section 1202. No exclusion under section 1202 can be claimed until 1998 because stock must be issued after August 10, 1993, to be qualified small business stock, and must be held for more than 5 years to qualify for the exclusion. Thus, the available tax return data do not provide the information necessary to analyze the current use of section 1202.

Minor clarifying changes in the regulatory language have also been made.

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Catherine A. Prohofsky, Office of the Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1202–2 is also issued under 26 U.S.C. 1202(k). * * *

Par. 2. Sections 1.1202–0 and 1.1202–2 are added to read as follows:

§1.1202–0 Table of contents.

This section lists the major captions that appear in the regulations under §1.1202–2.

§1.1202–2 Qualified small business stock; effect of redemptions.

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(a) *Redemptions from taxpayer or related person*—(1) *In general.* Stock acquired by a taxpayer is not qualified small business stock if, in one or more purchases during the 4-year period beginning on the date 2 years before the issuance of the stock, the issuing corporation purchases (directly or indirectly) more than a *de minimis* amount of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b)) to the taxpayer.

(2) *De minimis amount.* For purposes of this paragraph (a), stock acquired from the taxpayer or a related person exceeds a *de minimis* amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of the stock held by the taxpayer and related persons is acquired. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(b) *Significant redemptions*—(1) *In general.* Stock is not qualified small business stock if, in one or more purchases during the 2-year period beginning on the date 1 year before the issuance of the stock, the issuing corporation purchases more than a *de minimis* amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of the issuing corporation's stock as of the beginning of such 2-year period.

(2) *De minimis amount.* For purposes of this paragraph (b), stock exceeds a *de minimis* amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of all outstanding stock is purchased. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of

the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

(c) *Transfers by shareholders in connection with the performance of services not treated as purchases.* A transfer of stock by a shareholder to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is not treated as a purchase of the stock by the issuing corporation for purposes of this section even if the stock is treated as having first been transferred to the corporation under §1.83–6(d)(1) (relating to transfers by shareholders to employees or independent contractors).

(d) *Exceptions for termination of services, death, disability or mental incompetency, or divorce.* A stock purchase is disregarded if the stock is acquired in the following circumstances:

(1) *Termination of services*—(i) *Employees and directors.* The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services;

(ii) *Independent contractors.* [Reserved];

(2) *Death.* Prior to a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and—

(i) The stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and

(ii) The stock is purchased within 3 years and 9 months from the date of the decedent's death;

(3) *Disability or mental incompetency.* The stock is purchased incident to the disability or mental incompetency of the selling shareholder; or

(4) *Divorce.* The stock is purchased incident to the divorce (within the meaning of section 1041(c)) of the selling shareholder.

(e) *Effective date.* This section applies to stock issued after August 10, 1993.

Michael P. Dolan,
Deputy Commissioner of
Internal Revenue.

Approved December 22, 1997.

Donald C. Lubick,
Acting Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on December 30, 1997, 8:45 a.m., and published in the issue of the Federal Register for December 31, 1997, 62 F.R. 68165)