

**CAN AN INTEREST IN THIS BUSINESS
GET THE SECTION 1202 GAIN EXCLUSION?
DECISION TREE**

William C. Staley, Attorney
www.staleylaw.com

Is it a **disqualified business**? If more than 20% by value of the assets of the entity will be used in a disqualified business for more than 80% of the years in which the taxpayer will hold the shares or interest in the entity, no 1202. If not, proceed.¹

Disqualified businesses: Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees, any banking, insurance, financing, leasing, investing, or similar business, any farming business (including the business of raising or harvesting trees), business involving the production or extraction of products of a character with respect to which a depletion deduction is allowable, or any business of operating a hotel, motel, restaurant, or similar business. Any other business is a “**qualified trade or business**.”

Is it an **ineligible corporation**? If so, probably no 1202 unless the corporation will be an ineligible corporation for less than 20% of the years in which the taxpayer holds the shares. If not, proceed.²

Ineligible corporations: a DISC or former DISC, a RIC, REIT, REMIC or a cooperative.

Will the **assets of the entity exceed \$50 million in value** (at adjusted basis) after the shares are purchased by the tax payer from the entity? If so, no 1202. If not, proceed.³

For an existing corporation, **have the assets exceeded \$50 million in value** (at adjusted basis) at any time since 1993? If so, no 1202. If not, proceed.⁴

¹ I.R.C. § 202(e)(3). Here “80%” is a conservative proxy for “during substantially all of the taxpayer’s holding period for [the] stock” in the statute.

² I.R.C. § 1202(e)(4). Here “20%” is a conservative proxy for the inverse of “during substantially all of the taxpayer’s holding period for [the] stock” in the statute.

³ I.R.C. § 1202(d)(1).

For purposes of the two preceding tests, all of the assets of a corporation of which the entity will own at least 50% of the stock are treated as assets of the entity.⁵

Will more than 10% of the value of the entity's assets (in excess of liabilities) consist of **stock or securities** in other corporations which are not subsidiaries of such corporation, are not held as working capital and will not be liquidated and deployed in the business within 2 years? If so, no 1202. If not, proceed.⁶

Will more than 10% of the total value of the entity's assets consist of **real property** which is not used in the active conduct of a "qualified trade or business" (see above)? . (For this purpose owning, dealing in, or renting of real property is not treated as the active conduct of a "qualified trade or business.") If so, no 1202. If not, proceed.⁷

For an existing corporation, has any transaction in the last year been treated for tax purposes as a redemption under **Section 304**?

For an existing corporation, has the corporation **redeemed shares** from **any shareholder** within the past year? If so, go to Past Redemptions below. If not, go to Next Year below.

Past Redemptions: Have 1 or more purchases or deemed purchased (under Section 304) of its stock within the last year had an aggregate value (as of the time of the respective purchases) **exceeded 5%** of the aggregate value of all of its stock? If not, proceed. If so, no 1202.⁸

Next Year: Can the corporation **commit for the next year** to not redeeming any shares from **any shareholder** and not engaging in any Section 304 transactions that would be deemed distributions from the corporation? If so, go to Taxpayer's Section 304 Transactions below. If not, go to Future Redemptions below.

Future Redemptions: During the **2-year period** beginning on the date 1 year before the issuance of the stock, would the corporation make 1 or more purchases or deemed purchases (under Section 304) of its stock from **any**

⁴ I.R.C. § 1202(d)(1).

⁵ I.R.C. § 1202(d)(3).

⁶ I.R.C. § 1202(e)(5) and (6).

⁷ I.R.C. § 1202(e)(7).

⁸ I.R.C. § 1202(c)(3)(B) and (C).

shareholder with an aggregate value (as of the time of the respective purchases) **exceeding 5%** of the aggregate value of all of its stock as of the beginning of such 2-year period. If so, no 1202. If not, proceed.⁹

Taxpayer's Section 304 Transactions: For an existing corporation, has any transaction in the last year been treated for tax purposes as a redemption under **Section 304** of shares owned by the **taxpayer** or any related person? If so, no 1202. If not, proceed..¹⁰

For an existing corporation, has the corporation **redeemed shares** from the **taxpayer** or any related person within the past two years? If so, no 1202. If not, proceed..¹¹

Can the corporation and the taxpayer commit for the **next 2 years** to not redeem any shares from the tax payer or any related shareholder and to not engage in any Section 304 transactions that would be deemed distributions from the corporation to the **taxpayer** or any related shareholder? If so, proceed. If not, no 1202..¹²

Can the entity be a **C corporation** when the shares are **issued**? If so, proceed. If not, no 1202..¹³

Will the taxpayer **hold the shares for at least 6 months**? If so, a Section 1045 deferral and rollover might be possible, so go to Holding Period below. If not, no 1045 or 1202..¹⁴

Will the taxpayer hold the shares (or qualified small business stock acquired in a Section 1045 rollover) for at least **5 years**? If so, proceed. If not, no 1202..¹⁵

Holding Period: Will the corporation be a **C corporation** for at least **80% of the years** that the taxpayer's holds the shares? If so, proceed. If not, probably no 1202..¹⁶

⁹ I.R.C. § 1202(c)(3)(B) and (C).

¹⁰ I.R.C. § 1202(3)(A) and (C).

¹¹ I.R.C. § 1202(3)(A).

¹² I.R.C. § 1202(3)(A) and (C).

¹³ I.R.C. § 1202(c)(1).

¹⁴ I.R.C. § 1045(a). To get the Section 1045 deferral and rollover, the taxpayer, the stock and the issuing corporation must satisfy all of the Section 1202 rules except the 5-year holding period.

¹⁵ I.R.C. § 1202(b)(2).

For at least 80% of the years in which the taxpayer will hold the shares, will 80% (by value) of the corporation's assets be used in the **active conduct of 1 or more "qualified trades or businesses"**? If so, proceed. If not, probably no 1202.¹⁷

Will the corporation be an "**ineligible corporation**" for none or less than 20% of the years in which the taxpayer holds the shares? If not, probably no Section 1202.¹⁸ If so, gain from the sale of the share is likely to qualify for the Section 1202 exclusion, but several other requirements must be satisfied and the taxpayer must scrupulously document that the taxpayer and the corporation have met the requirements during "substantially all" of the years in which the taxpayer holds the shares. If not, probably no 1202.

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This is not meant as a complete list of the requirements to qualify for the Section 1202 exclusion. There is no corresponding exclusion for California income tax purposes. See my detailed outline:

[Stock Transactions - Tax Issues \(including the Gain Exclusion under Section 1202, Documenting a Section 1202 Exclusion or a Section 1045 Rollover, the Section 1045 Gain Exclusion and Rollover, and Section 1244 capital losses recharacterized as ordinary losses\)](http://www.staley.com/eventsandoutlines.html) at <http://www.staley.com/eventsandoutlines.html>.

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This chart should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.

This chart was completed on February 14, 2018 and does not reflect developments after that date.

¹⁶ I.R.C. § 1202(c)(2)(A). Here "80%" is a conservative proxy for "during substantially all of the taxpayer's holding period for [the] stock" in the statute.

¹⁷ I.R.C. § 1202(c)(2)(A), (e)(1)(A). Here "80%" is a conservative proxy for "during substantially all of the taxpayer's holding period for [the] stock" in the statute.

¹⁸ I.R.C. § 1202(e)(4). Here "20%" is a conservative proxy for the inverse of "during substantially all of the taxpayer's holding period for [the] stock" in the statute.