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DO SHARES ISSUED TO EMPLOYEES QUALIFY FOR THE SECTION 1202 GAIN EXCLUSION WHEN THE SHARES ARE SOLD?

Corporate employers often issue share to employees pursuant to incentive compensation plans. When do those shares qualify for the Section 1202 gain exclusion?

Section 1202 Overview

Certain gain on the sale of shares can be completely excluded from income for both regular and alternative minimum tax purposes under Section 1202. There are limits on the use of the funds received in the sale. There is no requirement to reinvest. It is a spectacular tax benefit. But it is an exceedingly complex area of tax. To get the tax benefit, many rules must be satisfied before the sale of the shares. It is like a coupon with tons of fine print on the back. Unfortunately, even an overview of Section 1202 is complex.

The 100% gain exclusion is available for shares issued after September 27, 2010.[1] The shares must be held for five years.[2] Stock that meets all of the requirements of Section 1202 is called "qualified small business stock" or "QSBS," whether or not it meets the five-year holding requirement.[3]

The shares must be issued by a C corporation.[4]

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1 I.R.C. § 1202(a)(4), enacted on September 27, 2010. Pub. L. No. 111-240, § 1 (September 27, 2010). A partial exclusion, with an alternative minimum tax preference, is available for shares issued after August 10, 1993 and before September 28, 2010. I.R.C. §§ 57(a)(7), 1202(a)(2), (3).

2 I.R.C. § 1202(a)(1).

3 This is because the term "QSBS" is also used in Section 1045, which allows a deferral of gain and requires only a 6-month holding period.

4 I.R.C. § 1202(a)(1). A few "tacking" rules apply to the holding period.

The "value" of the corporation at all times after August 10, 1993 and immediately after the share issuance cannot exceed $50 million[5]

The shares must be acquired from the issuer for money, property (not stock), or as compensation for services.[6] Shares purchased from another shareholder will not qualify for the exclusion.[7] The taxpayer cannot exchange the non-QSBS of another corporation for QSBS.[8]

The issuing corporation must not redeem more than a *de minimis* amount of its shares from *the taxpayer* for *two years* before or after the QSBS is issued.[9] Redemptions of stock *from others* within *one year* before or after the stock issuance can prevent Section 1202 from applying.[10] Transfers of shares from shareholders to service providers are treated as redemptions under Section 83 but not for the no-redemption rules of Section 1202.[11] Redemptions at termination of employment, death, disability or divorce are disregarded for the no-redemption rules of Section 1202.[12]

During substantially all of the taxpayer's holding period for the shares, (1) the corporation must be a C corporation and not a DISC, a regulated investment company, a REIT, a REMIC or a co-op,[13] and (2) at least 80% of the assets of the issuing corporation must

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5 I.R.C. § 1202(d)(1). "Value" is really adjusted tax basis in the corporation's assets. If one corporation owns more than 50% of the stock of another, they are aggregated for this test. I.R.C. § 1202(d)(2), (3).

6 I.R.C. § 1202(c)(1)(B). Exceptions apply for reorganizations, gifts and stock acquired from a decedent or distributed from a partnership to a partner. *Id.*

7 But shares acquired from an underwriter at the original issuance of the shares can qualify. *Id.*

8 If the taxpayer exchanges QSBS for other stock in a Section 351 or Section 368 transaction, the benefits of Section 1201 follow the new shares. I.R.C. § 1202(h)(4). If the taxpayer sells QSBS and would recognize gain, the taxpayer can defer the gain by buying new QSBS. I.R.C. § 1045. But it is not possible to transfer non-QSBS stock in exchange for new QSBS. I.R.C. § 1202(c)(1)(B).

9 I.R.C. § 1202(c)(3)(A). Attribution rules apply.

10 I.R.C. § 1202(c)(3)(B). A *de minimis* rule applies. *Id*; Treas. Reg. § 1.1202-2(b)(2). Transactions treated as redemptions from the issuer under Section 304 are treated as redemptions for these redemption rules. I.R.C. § 1202(c)(3)(C).

11 Treas. Reg. §§ 1.83-6(d), 1.1202-2(c).

12 Treas. Reg. § 1.1202-2(d).

13 I.R.C. § 1202(c)(2)(A), (e)(1)(B), (e)(4).

be used in the active conduct of one or more "qualified businesses."[14]

Note that this test requires data for every year of the holding period.[15] And the data needed will not necessarily be found in the Form 1120. For some data, the best evidence will be *declarations* signed by the president and CFO for the year.

The exclusion under Section 1202 does not apply to all gain on the sale of the QSBS.

- Generally, gain for tax purposes is the excess of the amount realized over the tax basis. The tax basis of shares is generally the cost, plus adjustment to the basis, such as legal fees paid to defend title to the shares. To determine the gain to which Section 1202 applies, a special definition of "tax basis" is used for the shares sold. "Section 1202 stock basis" is the value of property transferred to the corporation by the taxpayer in exchange for shares on the date of that exchange -- even if the basis for other tax purposes is less.[16]

- The amount of federal gain eligible for the exclusion for the taxable year is the greater of $10 million or 10 times the "Section 1202 stock basis."[17] If the taxpayer contributes to the issuing corporation more than $1 million in cash (or

[14] I.R.C. § 1202(c)(2)(A). (e)(1)(A). The following are not "qualified businesses" for this purpose: "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), any business involving the production or extraction of products of a character with respect to which a [depletion] deduction is allowable …, and any business of operating a hotel, motel, restaurant, or similar business." I.R.C. § 1202(e)(3). Too much real estate or investment assets not used for working capital could prevent the corporation from meeting the active business requirement for the period. I.R.C. § 1202(e)(5)(B), (e)(7).

[15] I.R.C. § 1202(c)(2)(A). The active business tests are applied "for any period." I.R.C. § 1202(e)(1).

[16] I.R.C. § 1202(i)(1). After the stock is issued, contributions of property to the capital of the corporation increase the "Section 1202 stock basis" of previously issued stock by the value of the property on the date of the contribution. I.R.C. § 1202(i)(2).

[17] I.R.C. § 1202(b)(1).

assets with a "Section 1202 stock basis" of more than $1 million), or a combination of the two totaling more than $1 million, then the $10 million limit on gain is increased to 10 times the "Section 1202 *asset* basis" of the contributed assets.[18] Let's call this "$10M or 10x" rule the "$10M/10x limit."[19]

The exclusion is available to taxpayers that are not C corporations.[20]

Section 83 Overview

Section 83 provides that when property (including stock of an employer) is "transferred" in connection with the performance of services, the recipient has income in an amount equal to the excess of the value of the property received over the amount that the service provider pays for it. (Let's call that excess the "spread.")

Property (including stock of an employer) is "transferred" to an employee (or other service provider) when the employee has the right to benefit fully from the increase in value of the shares and when the employee also has the full risk of loss from a decrease in the value of the shares. Restrictions that will never lapse (those that apply at the termination of employment of the employee, for example) are considered in determining whether a "transfer" has occurred. Restrictions that will lapse (holding the shares for a specified amount of time, or meeting a specified milestone) are not considered for this purpose.[21]

Section 83 establishes when the spread is calculated and taken into income.[22] If there are no "lapse

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[18] The "Section 1202 *asset* basis" is the value of property transferred to the corporation by the taxpayer in exchange for shares, even if the basis for other tax purposes is less. This has the effect of limiting the amount of gain which Section 1202 excludes, but increasing the maximum amount that can be excluded – if all of the requirements of Section 1202 are satisfied.

[19] The "$10M/10x limit" is sometimes called the "Per Issuer" limitation.

The $10M/10x limit is per "taxpayer" realizing the gain - not per issuee. The $10M limit is cumulative for each taxpayer. I.R.C. § 1202(b)(1)(A). The 10x limit is applied each year -- even if the taxpayer has maxed out on the $10M limit -- but the 10x limit uses the Section 1202 stock basis of the shares being sold in that year. I.R.C. § 1202(b)(1)(B), (i).

[20] I.R.C. § 1202(a)(1). Special rules apply to QSBS held by partnerships, S corporations, regulated investment companies and common trust funds (presumably, as defined in Section 584). I.R.C. § 1202(g).

[21] Treas. Reg. § 1.83-3(a).

[22] Amounts taken into income for this purpose are subject to wage withholding at

restrictions" (like "golden handcuffs"), this occurs when the property is transferred. If there are lapse restrictions, this generally occurs when the restrictions lapse or the property becomes transferrable by the employee.[23] However, the employee can elect (a) to ignore the tax effect of the lapse restrictions and (b) to calculate the spread and take it into income when the property is transferred. This election is called a "Section 83(b) election" and must be filed with the Internal Revenue Service within 30 days after the transfer.[24]

The transfer date has two functions. If there are no lapse restrictions, the transfer date determines when the spread is calculated and when it is taken into income. If there are lapse restrictions, the transfer date determines when a Section 83(b) election can be made.

If lapse restrictions apply to shares and the employee may not transfer them, the shares are "nonvested[25]." If there is no lapse restriction, the shares may be transferred by the employee, or if the lapse restrictions have lapsed, the shares are "vested."

Issuance vs Transfer vs Vested

Stock will not be QSBS for Section 1202 unless the stock is "acquired by the taxpayer at its original issue (directly or through an underwriter)."[26] The date on which the taxpayer acquired the stock is important for several purposes. To get the benefit of Section 1202, QSBS must be "held for more than 5 years."[27] The active business requirement must be met by the corporation (which must be a C corporation) for substantially all of the taxpayer's holding period.[28]

If stock is transferred to an employee and there are no lapse restrictions, or if there are lapse restrictions and a Section 83(b) election is made, the holding period for the property begins on the date of transfer.[29]

If stock is issued to an employee with lapse restrictions and no Section 83(b) election is made, the holding period of the property begins on the first

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the same time. Treas. Reg. § 35.3405-1T, Q&A 18.7

23 I.R.C. § 83(a).

24 I.R.C. § 83(b).

25 Treas. Reg. § 1.83-3(b), (c).

26 I.R.C. § 1202(c)(1)(B).

27 I.R.C. § 1202(a)(1).

28 1202(c)(2)(A).

29 I.R.C. § 83(f); Treas. Reg. § 1.83-4(a).

to occur of the restrictions lapsing or the property becoming transferable.[30]

For shares issued to an employee by an employer corporation, it seems reasonable to apply these Section 83 rules to determine when the shares are "issued" by the corporation to the employee.

So for shares issued to an employee with no lapse restrictions, or for shares issued with lapse restrictions for which a Section 83(b) election was made, the issuance date would be the transfer date for purposes of Section 83. Advisers should confirm that the employee had both the full right to the upside if the shares appreciated and the full risk of loss in the shares on that date. Any buy-back or share issuance agreements in effect at that time should be reviewed.[31]

For shares issued subject to a lapse restriction when no Section 83(b) election is made, the employee's holding period(s) would begin, and the shares should be treated as issued for purposes of Section 1202, as the restrictions lapse or the shares become transferrable. For example, if shares are not transferrable and must be forfeited back to the employer if the employee's employment terminates, but on each anniversary of the issuance the forfeiture restriction lapses as to 20 of the initial block of 100 shares, after five years the employee would have five different holding periods for each block of 20 shares.[32] To determine if Section 1202 applied to a block of 20 shares, the corporation would need to be a C corporation and satisfy the

30 *Id.*

31 Note that for shares issued to an employee with the purchase price paid by a promissory note and the note secured by a pledge of the purchased shares, the transaction will be treated as an option to purchase if the pledge is nonrecourse. A pledge would be nonrecourse if on default the holder of the note could foreclose on the pledged shares, but could not reach the other assets of the employee. Treas. Reg. § 1.83-3(a)(2). If the arrangement is treated as an option, a portion of the shares are probably treated as transferred as each payment of principal is made on the note.

32 At the end of year six, the employee would have a five-year holding period in first block of 20 shares that was released from the forfeiture restriction, a four-year holding period in the second block, a three-year holding period in the third block, a two-year holding period in the fourth block, and a one-year holding period in the last block. If all of the shares were sold in the sixth and all of the shares were QSBS, Section 1202 would *exclude* only the gain on the sale of the first block because only that block satisfied the five-year holding period requirement. The gain on the other blocks could be *deferred* if the employee rolled the sale proceeds over into other QSBS and met the other requirements of Section 1045.

$50 million "value" test when that block "vested." To determine if the corporation met the active business test in substantially all of the taxpayer's holding period, it would be necessary to test separately the holding period for each block of 20 shares.

Whether the shares are vested or nonvested, and when they become vested, does not determine when the share are considered issued for Section 1202 purposes, because it does not take into account the possibility that a Section 83(b) election was made for the shares.

Transfer from Shareholder to Employee

Section 83 generally applies when the service recipient (the employer) transfers property to the service provider (the employee). Section 83 also applies when a shareholder transfers shares to an employee of the corporation.

The transferor shareholder would often like to characterize the transaction as a gift, subject to the annual gift tax exclusion, and have the employee exclude the gift from income.[33] This would be a great planning tool if it worked. But it does not work. The transfer from the shareholder to the employee will rarely be a gift.[34] And an exception to the gift exclusion for transfers to employees has been in the Internal Revenue Code since 1986.[35]

The regulations under Section 83 address the situation of a shareholder transferring shares to an employee "in consideration of services performed for the corporation."[36] The shareholder is generally treated as contributing the shares to the capital of the

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[33] I.R.C. §§ 102(a) (general exclusion from income of gifts and inheritances), 2503(b) (gift tax exclusion).

[34] Comm'r v. Duberstein, 363 U.S. 278 (1960). The Supreme Court noted that "[W]here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it. A gift in the statutory sense, on the other hand, proceeds from a detached and disinterested generosity, out of affection, respect, admiration, charity or like impulses." (Citations omitted.) The Court concluded that "despite the characterization of the transfer of the Cadillac by the parties [as a gift] and the absence of any obligation, even of a moral nature, to make it, it was at bottom a recompense for [the service provider's] past services, or an inducement for him to be of further service in the future." Consequently, the service provider was required to include the Cadillac in income.

[35] I.R.C. § 102(c)(1) (The gift exclusion from income does not apply to "any amount transferred by or for an employer to, or for the benefit of, an employee."), enacted as Section 122(b) of the Tax Reform Act of 1986, Pub. L. 99-514 (1986).

[36] Treas. Reg. § 1.83-6(d).

corporation. In many cases the shareholder receives no payment for the shares. But if the shareholder receives any payment for the shares from the employee. the payment is treated as if the employee paid it to the corporation and the corporation then paid it to the shareholder for the shares. (Yes, it is very convoluted. But it generally works, tax-wise, since the employer is required to handle the withholding and employment taxes for the transfer.)

The deemed payment by the corporation to the shareholder is treated as a redemption.[37] Stock generally will not be QSBS if a redemption of an unrelated shareholder occurs within a year before or after the shares are issued.[38] However, this general rule for QSBS is turned off for payments that are treated as redemptions under the Section 83 rule for transfers by shareholders to employees.[39]

If the shares are transferred from a shareholder to an employee and the Section 83 rules recharacterize the transaction, is the stock treated as issued by the corporate employer for Section 1202 purposes? The Section 83 reg provides "the transaction shall be considered to be a contribution of [the shares] to the capital of such corporation by the shareholder, and immediately thereafter a transfer of [the shares] by the corporation to the employee … under paragraphs (a) and (b) of this [regulation]."[40] Paragraph (a) deals with the employer's deduction. Paragraph (b) deals with the employer recognizing gain on the transferred property, which would not apply when the corporation issued its own shares.[41] Does the word "under" in this context mean "for purposes of paragraphs (a) and (b) only, and for no other purpose"? Or does it mean "for purposes of the Internal Revenue Code, including paragraphs (a) and (b)"? If the former, the shares could never be QSBS. If the latter, the shares could be QSBS for purposes of Section 1202. As a policy matter, the latter should be the rule, so that the fiction created by the Section 83 rule would apply for all purposes of the Code and not clash with other parts (like Section 1202). As a matter of statutory interpretation, the Section 83 regs tell us how to apply the Section 83 rule for purposes of the employer's deduction, the employer's gain, if any, on the transfer to the employee, the deemed redemption and the

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37 *Id.* (It is "considered to be … a distribution to which Section 302 applies.") Section 302 applies "If a corporation redeems its stock….".

38 I.R.C. § 1202(c)(1). (c)(3)(B), Treas. Reg. § 1.1202-2(b)(1).

39 Treas. Reg. § 1.1202-2(c).

40 Treas. Reg. § 1.83-6(d).

41 Treas. Reg. § 1.1032-1(a).

employment tax consequences of the transaction. If they don't tell us that the Section 83 rule applies for Section 1202, the inference is that it does not apply for Section 1202.

Cautious advisers would not rely on the Section 83 rule applying to treat as an original issuance by the employer corporation a transfer of shares from a shareholder to an employee.[42] Instead, cautious advisers will arrange for the corporation to issue the shares. If the impetus for the shareholder transfer was the shareholder's need for cash, the adviser should recall that a redemption just before or soon after a share issuance can prevent the issued shares from ever being QSBS.

Buy-Backs

The general Section 1202 rule for redemptions is also turned off by regulation when an employee's shares were acquired by the employee in a Section 83 transaction and the employee later sells the shares back at termination of the employee's employment.[43]

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I regularly advise companies on incentive compensation arrangements. I also advise shareholders on whether Section 1202 can apply to their transactions. Contact me if you would like to discuss your situation.

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[42] In my practice I try to avoid the situation except when the shareholder really wants a cash payment from the employee. When a shareholder transfers shares to an employee, it is difficult for the parties to remember the various tax fictions involved and ultimately can be a source of confusion. The incentive effect of issuing the shares is probably reduced by the confusion.

[43] Treas. Reg. § 1.1202-2(d)(1). The redemption rule is also turned off in other circumstances, no matter how the shareholder acquired the shares: a purchase incident to the divorce of a shareholders or incident to the death, disability or mental incompetence of a shareholder. Treas. Reg. § 1.1202-2(d)(2), (3), (4).