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*November, 2020*

## **THE LEGISLATIVE HISTORIES OF SECTIONS 1045 AND 1202**

**Section 1202 of the Internal Revenue Code provides a 100% exclusion of gain on the sale of “qualified small business stock” in limited circumstances. It is an amazing tax benefit when it applies. It was enacted in 1993 to encourage investment in small businesses. But it is a long and complex section. Section 1045 was enacted in 1997 to also encourage investment in small businesses. There are many unanswered questions about Sections 1045 and 1202, but there is not much regulatory guidance and there are few cases. This bulletin surveys the legislative history of the two sections.**

**Enactment of Section 1202 in 1993.** Section 1202 of the Internal Revenue Code was enacted in 1993 as part of the Omnibus Budget Reconciliation Act of 1993, which included the Revenue Reconciliation Act of 1993.<sup>1</sup>

**The Political Situation.** In 1992 Bill Clinton defeated H. Ross Perot and incumbent George H.W. Bush in the presidential election. In 1993 Democrats controlled the White House and both Houses of Congress. As a result of this control, Section 1202 has an unusual legislative history.

**The First Mentions.** In his first State of the Union speech in February, 1993, Mr. Clinton said:

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<sup>1</sup> Pub. L. 103-66.

“Our plan is designed to improve the health of American business through lower interest rates, improved infrastructure, better trained workers, and a stronger middle class. Because small businesses generate most of our nation's jobs, our plan includes the boldest targeted incentives for small business in history. We propose a permanent investment tax credit for small business, and new rewards for entrepreneurs who take risks.<sup>2</sup>

President Clinton's first budget used similar language:

**Business Taxes.** The investment tax credits, the corporate alternative minimum tax changes and the favorable capital gains provisions in the stimulus and investment packages will spur investment and encourage the growth of all businesses, especially small business. At the same time however, large highly profitable companies will have to pay a greater portion of their net earnings in taxes. The package increases the corporate tax rate from 34 percent to 36 percent for taxable income above \$10 million, raising \$6 billion in 1997. Of the 2.2 million corporations, only about 2,700 large corporations will be affected by this proposal in any year.<sup>3</sup>

**An Antecedent Proposal.** On April 1 Representative Clifford Stearns, a Republican from Florida, introduced a bill which included a detailed proposal to give tax breaks at the sale of “qualified small business stock.”<sup>4</sup> This may have been a template for Section 1202, or it might have been introduced as alternative approach to Section 1202, which might already have been drafted by the staff of

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<sup>2</sup> <https://www.infoplease.com/primary-sources/government/presidential-speeches/state-union-address-william-j-clinton-february-17-1993>

<sup>3</sup> *A Vision of Change for America*, President's budget proposal, February 17, 1993 at <https://fraser.stlouisfed.org/title/a-vision-change-america-5912>.

<sup>4</sup> H.R. 1636 (introduced in the 103<sup>rd</sup> Congress, 1<sup>st</sup> Session, on April 1, 1993), Title II.

the Ways and Means Committee or the Joint Committee on Taxation, or both.<sup>5</sup> This proposal is compared below to Section 1202 as enacted.<sup>6</sup>

**The President's Bill, the Legislative Process, and Enactment.** The legislative language to effect President Clinton's revenue proposals was introduced in the House on Friday, April 30, 1993.<sup>7</sup>

On May 19, 1993 the Ways and Means Committee released its "Fiscal Year 1994 Budget Reconciliation Recommendations of the Committee on Ways and Means," as submitted to the House Budget Committee.<sup>8</sup> This print fills the role of a "House Report" on the Revenue Reconciliation Act of 1993. For Section 1202, it includes a discussion of present law, the reasons for the proposed change, and an explanation of the proposed change.<sup>9</sup> It does not discuss the rationale for excluding a list of businesses from the definition in Section 1202 of an "active business."

The Senate passed H.R. 2264 on June 25, 1993 without the QSBS provision. Instead, the Senate version provides for "qualified small issue bonds" (Section 8121), but not "qualified small business stock."<sup>10</sup>

A Conference Committee resolved differences between the House and Senate versions of H.R. 2264, which included Section new 1202 as Section 13113 of the bill. Regarding Section 1202, the Committee Report states "Allows a taxpayer other than a corporation to exclude from gross income 50 percent of

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<sup>5</sup> If you know how Section 1202 related to the Stearns bill, I would certainly appreciate a call!

<sup>6</sup> See table *The 1993 Stearns Bill* below.

<sup>7</sup> Special Supplement - Treasury Department's Legislative Language for President Clinton's Revenue Proposals, released April 30, 1993, Daily Tax Report (BNA) No.83, Monday, May 3, 1993.

<sup>8</sup> Reprinted in Daily Tax Report (BNA) No. 96, May 20, 1993 at page L-48, captioned "Revenue-Raising provisions from Committee Print (WMCP:103-11)." I have not found another version, or an official version, of this print online.

<sup>9</sup> At page L-52 in the Daily Tax Report reprint.

<sup>10</sup> <https://www.congress.gov/bill/103rd-congress/house-bill/2264/summary/35>.

gain from the sale or exchange of qualified small business stock (called “QSBS” below) held for more than five years. Sets forth rules and limitations for such exclusion. Treats one-half of such exclusion as an item of tax preference for minimum tax purposes.”<sup>11</sup>

The bill that was reported by the Conference Committee was enacted as the Omnibus Budget Reconciliation Act of 1993, Public Law 103-66. New Section 1202 with its partial gain exclusion and AMT preference was effective for stock issued after August 10, 1993.

The staff of the JCT published an explanation of the 1993 Act.<sup>12</sup>

**The 1993 “Rollover” Scheme.** Current Section 1045, which allows qualified small business stock held for more than six months to be sold and the gain deferred to the extent that the sale proceeds were used to “purchase” other QSBS, was not enacted until 1997. But the 1993 Act provided for deferral of gain on the sale of QSBS not held for five years to the extent that the sale proceeds were used to “purchase” stock of a “specialized small business investment company” or “SSBIC.”<sup>13</sup> The stock of an SSBIC that was licensed by the Small Business Administration could be QSBS even if the SSBIC only invested in the stock of other corporation, because an SSBIC was (and is) not subject to the active business requirement of Section 1202.<sup>14</sup>

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<sup>11</sup> H. Rept. 103-213, (Title XIII: Revenue, Health Care, Human Resources, Income Security, Customs and Trade, Food Stamp Program, and Timber Sale Provisions - Chapter 1: Revenue Provisions - Revenue Reconciliation Act of 1993)

<sup>12</sup> Staff of the Joint Committee on Taxation, SUMMARY OF THE REVENUE PROVISIONS OF THE OMNIBUS BUDGET RECONCILIATION ACT OF 1993 (H.R. 2264), page 2 (JCS-11-93, August 23, 1993) <https://www.jct.gov/CMSPages/GetFile.aspx?guid=d636c680-a0dd-4193-b239-1673e60488f0>.

<sup>13</sup> I.R.C. § 1044, enacted in 1993 (Pub. L. 103-66, § 13114(a)) and repealed in 2017 as part of the Tax Cuts and Jobs Act. Pub. L. 115-97, § 13313(a). The “purchase” requirement is also found in Section 1043 (sale of assets to comply with conflict of interest rules for media companies, enacted in 1989) and 1033 (involuntary conversions, in the Internal Revenue Code of 1954; <https://www.govtrack.us/congress/bills/83/hr8300/text>).

<sup>14</sup> I.R.C. § 1202(c)(2)(B).

**1997 Senate Proposals and Section 1045 Enacted.** In 1997 Mr. Clinton, a Democrat, was still President. Both Houses of Congress now had Republican majorities. The Taxpayer Relief Act of 1997 was one of the first major pieces of legislation in the 105<sup>th</sup> Congress.<sup>15</sup> The House and Senate passed different versions of H.R. 2014.

The House bill reduced the maximum tax rate on long-term capital gain (held for more than 18 months) from 28% to 20%. If Section 1202 applied to exclude some gain, the maximum rate on the un-excluded gain remained 28%.

“The Senate amendment struck all of the House bill after the enacting clause and inserted a substitute text.”<sup>16</sup> What the Senate inserted had been S.949, the proposed “Revenue Reconciliation Act of 1997.” The Senate bill would have:

- Allowed corporations to use Section 1202 for stock held for investment, but not for the stock of members of an affiliated group;
- Repealed the AMT preference for the Section 1202 exclusion;
- Allowed the 20% tax rate to apply to the un-excluded portion of the gain;
- Increased the maximum assets of the issuing corporation from \$50M to \$100M;
- Repealed the \$10M/10x limitation on the amount of gain that could be excluded;
- Extended from two to five years the time to deploy cash in the active conduct of a trade or business;

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<sup>15</sup> Wikipedia, 105<sup>th</sup> United States Congress.  
[https://en.wikipedia.org/wiki/105th\\_United\\_States\\_Congress](https://en.wikipedia.org/wiki/105th_United_States_Congress).

<sup>16</sup> Joint Explanatory Statement of the Committee on Conference, H.R. Rep. 105-220, July 30, 1997.

- Repealed the limit on the amount of an issuing corporation's working capital; and
- A redemption of stock with a business purpose would not have prevented Section 1202 from applying.

The Senate version of the bill also included new Section 1045.

The Senate Finance Committee published a report on S. 949.<sup>17</sup> It listed the following as its reasons for proposing changes to Section 1202:

The Committee believes it is important to maintain a larger exclusion for stock in small, start-up enterprises. Such enterprises are inherently risky and may not have easy access to the capital necessary to launch a new venture. The Committee believes that it is important to foster such entrepreneurial activities and believes targeted reduction in capital gains taxation will help provide access to needed capital.

The Committee also understands that the present law restrictions on working capital may often be inappropriate in the context of a venture start up enterprise.

The law changes in the Senate version (other than the maximum size of the issuing corporation and the application to corporate investors) would have been effective as of the 1993 date of enactment of Section 1202.

The two versions of the bill were resolved by a Conference Committee, which generally followed the House bill. In addition, it reduced the AMT preference from 50% to 42% of the excluded gain. The Conference Committee included new Section 1045 in its version of the bill.<sup>18</sup> Neither the Senate Report

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<sup>17</sup> S. Rep. 105-33, June 20, 1 997.

<sup>18</sup> Section 1045 was amended once to make its deferral available to "a taxpayer other than a corporation" and not just to "individuals. IRS Restructuring and Reform Act of 1998, Pub. L. 105-206, § 6005(f)(1)(A), (B). It has not been amended since then.

nor the Conference Report stated why Section 1202 applies to new issuances of stock, but Section 1045 applies to purchases of stock.<sup>19</sup>

President Bill Clinton signed the Taxpayer Relief Act of 1997 on August 5, 1997 (and exercised his line item veto on two provisions not relevant here on September 3, 1997).

In December, 1997 the staff of the Joint Committee on Taxation published an explanation of the Taxpayer Relief Act of 1997.<sup>20</sup> Here is what the staff said about Section 1045:

### **Present and Prior Law**

The Revenue Reconciliation Act of 1993 provided individuals a 50-percent exclusion for the sale of certain small business stock acquired at original issue and held for at least five years. In order to qualify as a small business, when the stock is issued, the gross assets of the corporation may not exceed \$50 million. The corporation also must meet an active trade or business requirement.

### **Reasons for Change**

The Congress hoped that by providing deferral of gain recognition for funds reinvested in qualifying small businesses that investors will make more capital available to the new, small businesses that are important to the long term growth of the economy.

### **Explanation of Provision**

The Act allows an individual [reference to footnote 86] to roll over gain from the sale or exchange of small business stock held more than

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<sup>19</sup> H.R. Rep. 105-220, July 30, 1997.

<sup>20</sup> Staff of the Joint Committee on Taxation, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, <https://www.congress.gov/committee-print/105th-congress/joint-committee-print/45107?q=%7B%22search%22%3A%5B%22105-34%22%2C%22105-34%22%5D%7D&s=2&r=35>.

six months where the taxpayer uses the proceeds to purchase other qualifying small business stock within 60 days of the sale of the original stock. For purposes of this provision, the replacement stock must meet the active business requirement of section 1202 for the six-month period following the purchase. The holding period of the replacement stock generally will include the holding period of the stock sold, except that the replacement stock itself must be held for more than six months to do another tax-free rollover.

[Footnote 86] Title VI (sec. 605(f)) of H.R. 2676, the Tax Technical Corrections Act of 1997, as passed the House on November 5, 1997, provides that a partnership or S corporation can roll over gain from small business stock held more than six months if (and only if) all the interests in the partnership or S corporation are held by individuals or estates at all times during the taxable year. The term “estate” is intended to include both the estate of a decedent and the estate of an individual in bankruptcy.

**The 75% Exclusion.** The American Recovery and Reinvestment Tax Act of 2009, Public Law 111-5, added a new 75% exclusion for stock acquired after February 7, 2009.

**The 100% Exclusion.** By the end of 2010, the exclusion was no longer partial and the AMT preference was gone for newly issued shares.<sup>21</sup> But from 2010 through 2014, 100% exclusion under Section 1202 was an “extender” that Congress extended for less than two years at a time.<sup>22</sup>

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<sup>21</sup> Creating Small Business Jobs Act of 2010, Pub. L. 111-240, § 2011, September 27, 2010.

<sup>22</sup> For example, the 100% exclusion with no AMT preference in Section 1202(a)(4) as added in late September, 2010 applied “In the case of qualified small business stock acquired after the date of the enactment of the Creating Small Business Jobs Act of 2010 [on 9-27-10] and before January 1, 2011....” American Taxpayer Relief Act of 2012, Pub. L. 112-240, January 2, 2013, § 324 (extension for stock acquired through December 31, 2013); Tax Increase Prevention Act of 2014, 113-295, § 135 December 1, 2014, (extension through 2014); Consolidated Appropriations Act, 2016, Pub. L. 114-113, § 126 (December 18, 2015) (making the 100% exclusion permanent with no AMT preference).

The 2017 Tax Cuts and Jobs Act referred in two places to Section 1202, but, to the surprise of many, did not amend or repeal Section 1202.<sup>23</sup>

**The 1993 Stearns Bill.** On the next five pages is a comparison of the 1993 Stearns bill (*which was not enacted*) with Section 1202 as enacted:

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<sup>23</sup> An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (aka the “Tax Cuts and Jobs Act of 2017” or “TCJA”), Pub. L. 115-97, December 22, 2017, §§ 11011(a), 13823(a) (referring to Section 1202).

<b>THE 1993 STEARNS BILL</b>		
<b>Issue</b>	<b>Stearns Bill (<i>not enacted</i>)</b>	<b>Section 1202 as enacted</b>
Tax benefit	Deduction to determine adjusted gross income (“above the line”)	Exclusion
100% deduction	Allowed for gain on investments in corporations worth less than \$5M when the investment was made, with the deduction percentage increasing from 50% to 100% the longer the stock was held	No 100% exclusion until 2010
Effect on tax rates	In addition to the deduction, the tax rate for non-corporate taxpayers on gain on qualified stock would not exceed 14% for the regular income tax. The tax rate for corporations on this gain would be 17%, or half of the 34% rate.	No reduction on tax rate for the half of the gain that was not excluded. Resulted in an effective rate of 14% on the total gain for regular tax.
Losses netted against gains before tax benefit calculated?	Yes, for stock of companies with equity of more than \$5M at the issue date	No. Losses on other QSBS do not reduce the amount of the exclusion.
AMT preference?	For deduction but not for lower tax rate on gain/ /	Yes, for half of excluded amount

<b>Issue</b>	<b>Stearns Bill (<i>not enacted</i>)</b>	<b>Section 1202 as enacted</b>
50% exclusion for gain on “qualified small business” stock held for more than 5 years	Issuer could be capitalized with from \$5M to \$100M at stock issuance, including accumulated but undistributed profits	Issuer can be worth up to \$50M (at tax basis) at stock issuance
Indexed limits for “small” business?	Yes	No
Only for newly issued share	Yes	Yes
Issuer must be a C corp	No	Yes
Tax benefit allowed for corporate taxpayers	Yes	No
Dollar limit on amount of tax benefit?	No	\$10M/10x limit per taxpayer
Redemptions before or after the stock issuance kill the tax	Only if the new stock is issued in exchange for stock that is not small business stock	Yes, kills the benefit if within 1 year of issuance for anyone within 2 years for issuee and related parties
Active business requirement for issuer? /	Yes	Yes

Issue	Stearns Bill ( <i>not enacted</i> )	Section 1202 as enacted
List of prohibited businesses?	No	Yes
How long must the business be active	First 5 years after stock issued	Substantially all of the taxpayer's holding period for the stock
Portion of the corporation's assets that must be used in the active conduct of the business	Substantially all	Substantially all
Start-up activities and R&D count as active business even though no revenue?	Yes	Yes
More than 10% of assets in portfolio stock is too much to be active?	Yes. Crossing this line once kills the tax benefit.	Yes, but only affects the "period" in which there is too much portfolio stock
More than 10% of assets in investment real estate is too much to be active? / /	Yes. Crossing this line once kills the tax benefit.	Yes, but only affects the "period" in which there is too much portfolio stock

Issue	Stearns Bill ( <i>not enacted</i> )	Section 1202 as enacted
Investments held for R&D or future working capital needs are treated as active?	Yes.	Yes, for current working capital. Must be used within 2 years for future R&D or working capital. After the corporation has existed for 2 years, no more than half of its assets can qualify as active by being held for future deployment.
Use personal holding company rules to see if rights to computer software are active?	Yes	Yes
Holding period of stock includes holding period of options and warrants exercised to acquire the stock?	Yes, but only if the option or warrant was issued for services provided to the issuer.	No.
Holding period of stock includes holding period of convertible debt exercised to acquire the stock? /	Yes. Unpaid principal and interest treated as payment for shares.	No.

Issue	Stearns Bill ( <i>not enacted</i> )	Section 1202 as enacted
Holding period of stock includes holding period of stock exchanged in a tax-free reorg??	Yes	Yes
Preferred converted into common tacks holding period of the preferred? /	Yes	Yes
Stock acquired by gift or inheritance can still get the tax benefit (and holding period tacks)?	Yes	Yes
If carryover basis, then new stock or transferee gets the tax benefit and holding period tacks	Yes, with market value basis for this purpose. Less strict rules for S corps and partnerships.	Explicit rules for stock issued or transferred to S corporations or partnerships; market value basis for section 1202 purposes
Special rules for short positions?	No	Yes
Change section 1244 stock limit of \$1M?/ /	Yes, raised maximum to \$5M with indexing.	No provision.

<b>Issue</b>	<b>Stearns Bill (<i>not enacted</i>)</b>	<b>Section 1202 as enacted</b>
Tax benefit effective for stock issued after what date?	12-31-93, but a taxpayer could elect to recognize gain to that date and have the tax benefit for appreciation in value after the effective date.	Date of enactment

\* \* \*

I regularly advise shareholders, accountants and attorneys about Sections 1202 and 1045. Please contact me if you would like to discuss your situation.

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