How Sections 1202 and 1045 Can

Exclude or Defer SOME Stock Gains

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July 16, 2021

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This outline 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 outline was completed on July 1. 2021 and does not reflect developments after that date.

How Sections 1202 and 1045 Can Exclude or Defer SOME Stock Gains

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1. OVERVIEW

- Section 1202 of the Internal Revenue Code excludes up to 100% of the gain on the sale of shares, and the exclusion is not subject to the alternative minimum tax ("**AMT**").

  - California has not conformed, and there is no California counterpart.

  - There are a zillion requirements of Section 1202. One is that the stock is held for 5 years.

  - It is possible to determine after the stock is sold whether the stock qualified for the exclusion. It is better to monitor compliance annually for at least five years before a sale. The ideal is to consider Section 1202 before making the investment and to monitor is at least annually until sale.

  - A partial exclusion for regular taxes and the AMT applies for stock issued between 1993 and 2010. The 100% exclusion was an "extender" until 2014.[1] The 2017 tax act did not change Section 1202.

[1] See *The Legislative History of Sections 1202 and 1045 ("Qualified Small Business Stock")* at http://www.staleylaw.com/images/Legislative_history_of_IRC_Section_1202_and_Section_1045_100860xA938A_.PDF.

- Section 1045 allows a taxpayer to defer the gain on the sale of stock that would have qualified for the Section 1202 exclusion but for the fact that it was held more than 6 but less than 60 months. To achieve the deferral, the taxpayer must "purchase" other qualifying stock within 60 days after the sale of original stock. The taxpayer must also make an election with his or her income tax return for the year. California has not conformed.

2. REPORTING GAIN THAT IS SUBJECT TO THE SECTION 1202 EXCLUSION

2.1(a) Report the regular tax exclusion on IRS Form 8949, Part II and (if required) the AMT tax preference on IRS Form 6521.

2.1(b) See the Instructions to IRS Schedule D (Form 1040) at "Exclusion of Gain on Qualified Small Business (QSB) Stock."

2.1(c) See the Instructions to IRS Form 8949 at "You sold or exchanged qualified small business stock and can exclude part of the gain."

2.1(d) See IRS Publication 550, Investment Income and Expenses (Including Capital Gains and Losses) (2020), at page 63.

2.1(e) It is important to report the gain and then to claim the exclusion. Not reporting the gain and then losing a Section 1202 tax audit would result in more severe penalties than if the gain had been properly reported.

3. MONITORING THE SECTION 1202 REQUIREMENTS

3.1 The Section 1202 exclusion applies to gain on the sale of "qualified small business stock."[2] Much of Section 1202 is devoted to defining "qualified small business stock" or "QSBS." To be QSBS, the issuer, among other things, must be a "qualified small business."[3] To be a "qualified small business," the corporation must, among other things,

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[2] I.R.C. § 1202(a)(1).

[3] I.R.C. § 1202(c)(1)(A).

agree "to submit such reports to the [IRS] and to shareholders as the [IRS] may require to carry out the purposes of [Section 1202]."[4]

- There is no guidance about how to do this.[5]

- If the corporation adopts a resolution like the one attached as *Exhibit A*, the corporation has at least made a good faith effort to satisfy that requirement.

3.2 Section 1202 is not claimed by the corporation. It is generally claimed by the shareholder.[6]

3.2(a) A shareholder who has not been a key officer of the corporation for the entire time in which he or she held shares can't know if all of the Section 1202 requirements were met unless the corporation tells the shareholder.

3.2(b) The way a corporation tells someone "You can rely on this statement" is by providing an "officers certificate."[7] In the Officer Certificate attached as *Exhibit B*, a corporation tells its shareholders "Here are the facts that you need to know to allow your tax preparer to take the position that Section 1202 applies."

◊ The officers should use the draft officers certificate as a checklist.

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[4] I.R.C. § 1202(d)(1)(C).

[5] See *Why is Section 1202 So Unsettled After All These Years?* at http://www.staleylaw.com/images/Why_is_Section_1202_so_unsettled_100491xA938A_.PDF.

[6] It can also be claimed by the members, partners or shareholders of a passthrough entity that holds shares, or by the beneficiaries of a trust that holds shares. I.R.C. § 1202(a)(1) (applies to a taxpayer other than a corporation), (g) (pass-through entities, including S corporations, as shareholders).

[7] See, for example, Section 313 of the California General Corporation Law.

◊ If in the "checklist" phase a statement is not true, the officers should let the tax advisor know. Some of these statements are shortcuts ("If this statement is true, we can avoid many more-detailed questions. If not, we will get into those questions.").

◊ The officers certificates take the place of a questionnaire.[8]

3.2(c) It is not certain that the active business and C corp requirements for QSBS are tested on an annual basis to determine if they were satisfied for "substantially all" of the taxpayer's holding period for such stock.[9]

◊ In the absence of guidance, it seems reasonable to test these on an annual basis. On the assumption that this is correct, I would have the officers sign an officers certificate for each fiscal year of the corporation, including short years.[10]

◊ For me, 4 out of 5 years meets the "substantially all" test. Some preparers might be happy with 4 good years out of 6.

3.2(d) Extra info is needed about the year in which the shares were issued and the following two years, to address the special

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[8] It would be possible to recast the officers certificate as a questionnaire, and then to recast the completed questionnaire as an officers certificate.

[9] See I.R.C. § 1202(c)(2)(A).

[10] Note that some statements in the list will change over the years. Examples: The issuer must be a "qualified small business" with assets under $50M only when the stock is issued. I.R.C. § 1202(c)(1)(A). In the first two years of the corporation's existence, a special working capital rule applies. I.R.C. § 1202(e)(6). The redemption tests are applied in a 4-year window centered on the date a taxpayer's shares were issued. I.R.C. § 1202(c)(3). The organization or purchase of a subsidiary will bring that subsidiary into the tests. I.R.C. § 1202(D)(3), (e)(5).

Section 1202 rules for redemptions and for investment assets not yet deployed as working capital.[11]

3.3 Original issuance –

3.3(a) The taxpayer should have sufficient documentation to show that the taxpayer acquired the shares directly from the issuing corporation or the issuing corporation's underwriter.[12]

3.3(b) Don't let your clients ignore this the way Dr. Holmes did.[13]

3.4 The partner, member or shareholder of a pass-through entity or the beneficiary of a trust might not know when the shares were issued to the entity or trust, whether it was an original issuance to the pass-through entity or trust, or whether the shares were held continuously by the pass-through entity or trust.

3.4(a) I suggest providing the partners/members/shareholders/beneficiaries with a certificate like the one attached as *Exhibit C* by which the entity or trustee provides that info to the partners/members/shareholders/beneficiaries.

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[11] I.R.C. § 1202(c)(3), (e)(6)(B).

[12] I.R.C. § 1202(c)(1)(B).

[13] "[The taxpayer] has proffered no evidence beyond his own uncorroborated testimony to establish that he acquired [replacement co.] stock at its original issue. 'Original issue' is defined as the 'first issue of securities of a particular type or series.' … [The taxpayer] offered no documentary evidence, such as stock certificates or book entries from the corporation, indicating from whom he acquired the stock on each of the 36 stipulated purchase dates. He further failed to submit evidence showing that on each of those 36 purchase dates, he purchased any of the original issue of that stock type or series. We cannot (and do not) find that petitioner acquired [replacement co.] stock at its issue; petitioner has failed to carry his burden of proof on that point." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (considering stock purchased in 1997, then sold and the proceeds rolled over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd in an unpublished opinion* 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015) ("The Tax Court did not clearly err in finding [the taxpayer] had failed to establish that he acquired the shares of [replacement co.] at original issue. [The taxpayer]'s testimony on this point was contradictory, and at one point he said that he acquired the shares from company officers.").

3.5 With the officers certificates and the certificate of secretary from the corporation that issued the shares and a separate certificate from any pass-through entity or trust that holds QSBS, the ultimate shareholders should have sufficient info to take the position on their tax return that the gain exclusion of Section 1202 applies. They should also have enough info to make an audit of the issue short and painless.

4. BUSINESS COMPUTER SOFTWARE ROYALTIES AND THE ACTIVE BUSINESS REQUIREMENT

4.1 The part of Section 1202 that has the "active business" requirement has this provision: "For purposes of [the "active business" requirement], rights to computer software which produces active business computer software royalties (within the meaning of section 543(d)(1)) shall be treated as an asset used in the active conduct of a trade or business."[14]

4.2 It does not say that the software is used in an active business ONLY if it meets the Section 543 test. So I view this provision as a safe harbor.

4.2(a) I would expect shareholders of software companies to say to management "Well, did the corporation satisfy the safe harbor in each year or not? If there is a safe harbor and we qualify, we want to use it."

4.3 "Active business computer software royalties" are excluded from royalties that are generally personal holding company income.[15] The officers certificate attached as *Exhibit D* has many statements that are in the nature of "If this statement is true, we can skip many other questions."

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[14] I.R.C. § 1202(e)(8).

[15] I.R.C. § 543(a)(1)(D).

5. "SECTION 1202 BASIS"

5.1 Generally, when property is contributed to a corporation in a Section 351 transaction, the transferor gets a carryover basis in the shares received.[16]

5.2 But for Section 1202 purposes, the "Section 1202 basis" is the fair market value of the property contributed to the corporation.[17]

5.3 Example: An existing S corp transfers its business assets worth $9M to a new C corporation in exchange for all of the stock of the C corporation. The S corporation had a $1M basis in those business assets at the time of the transfer and the C corporation took a $1M basis in those assets. The Section 1202 basis of the S corporation in the C corporation stock would be $9M. So if the C corporation stock was sold five years later for $20M, the S corporation would have $19 of gain ($20M realized - $1M tax basis), and the S corporation would exclude $11M under Section 1202 ($20M amount realized - $9M Section 1202 basis).[18]

6. GETTING THE MOST OUT OF SECTION 1202

6.1 The amount of federal gain eligible for the exclusion is the greater of $10 million or 10 times the "Section 1202 basis." Let's call this "$10M or 10x" rule the "**10/10 limit**." The limits are applied per issuer, so one taxpayer could use the Section 1202 exclusion for several sales of stock in one year, as long as the stock was issued by different corporations.

6.2 If the taxpayer contributes to the issuing corporation more than $1M in cash (or assets with a "Section 1202 basis" of more than $1M), or a

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16 I.R.C. § 358(a)(1).

17 I.R.C. § 1202(i).

18 Those S corporation shareholders who held their shares continuously from the time the s corporation acquired the C corporation stock until it sold it would benefit from the exclusion. I.R.C. § 1202(g).

combination of the two totaling more than $1M, then the $10M limit on gain is increased to ten times the Section 1202 basis of the contributed assets.

6.3 The exclusion is applied on a per taxpayer and a per corporation basis. Note that the 10/10 limit appears to apply per "taxpayer" realizing the gain – not per issuee.

6.4 Example: Founder starts the business with a $10,000 capital contribution in his garage. He gives 20% of his shares to each of his four children. The stock sells for $50M. He and each of his children has a $2,000 basis in his or her shares, and each uses the $10M limit.[19] All $50M of gain is excluded.

6.5 Using the Section 1202 basis for the 10-times-basis limit 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.

7. USING SECTION 1045

7.1 If QSBS is held for more than 6 months but less than 5 years, Section 1045 can be used to defer the gain on the sale by buying new QSBS in another company.

7.2 The replacement QSBS must be "purchased" within 60 days after the original QSBS is sold.[20]

7.2(a) A transaction is a "purchase" only if results in a cost basis.[21]

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[19] I.R.C. § 1202(h).

[20] I.R.C. § 1045(a)(1).

[21] I.R.C. § 1045(b)(2). Note the similarity to the definition in Section 1033(a)(2)(A)(ii). Also note GCM 39742, April 19, 1988 addressing whether cash contributed to a corporation in a Section 351 transaction was "purchased" for purposes of Section 1033 (involuntary conversions).

7.2(b) Replacement stock is QSBS only if acquired in an original issuance by the corporation.[22] It follows that replacement stock cannot be already-issued shares purchased from a shareholder.

7.3 The election to defer gain is made by reporting the gain on Form 8949, entering code "R" and backing out the deferred gain as an adjustment.[23]

7.4 Section 1045 was enacted in 1997. It originally applied only to individual taxpayers. In 1998 it was amended to apply to all noncorporate taxpayers.[24] In 2004 the IRS and Treasury proposed regulations on how Section 1045 applied to shares owned by partnerships.[25] Those regs were made final in 2007.[26] They cover:

7.4(a) Rules for partnerships that elect to apply section 1045,

7.4(b) Rules for taxpayers other than C corporations and for partners that elect to apply Section 1045,

7.4(c) The limitation on the amount of gain that an eligible partner can defer under Section 1045,

7.4(d) Rules for partnership distributions of QSBS stock to eligible partners, and

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[22] I.R.C. § 1045(b)(1) (applying the Section 1202 definition of QSBS); I.R.C. § 1202 (c)(1)(B) (requiring an original issuance).

[23] Rev. Prov. 98-48, § 3.02, 1998-2 C.B. 367; Instructions to 2020 Form 8949 at pages 2 and 9; Instructions to 2020 Schedule D at page D-9.

[24] See *The Legislative History of Sections 1202 and 1045 ("Qualified Small Business Stock")* at http://www.staleylaw.com/images/Legislative_history_of_IRC_Section_1202_and_Section_1045_100860xA938A_.PDF.

[25] 69 Fed. Reg. 42370, July 15, 2004.

[26] T.D. 9353, 2007-2 CB 721.

7.4(e) Rules for contributions of QSBS or replacement QSBS to a partnership.[27]

[End of outline.]

[27] Treas. Reg. § 1.1045-1.

Exhibit A

Certificate of Secretary re Corporate Resolutions

ABCD, INC.

Certificate of Secretary

The undersigned hereby certifies that:

I am the duly elected, qualified and acting secretary of ABCD, Inc., a Delaware corporation.

The following is a true copy of a resolutions duly adopted by the Board of Directors of the corporation at a meeting duly called, noticed and held on may _____, 2021, the minutes of which appear in the minute book of the corporation:

> WHEREAS, this corporation wishes to facilitate the use by its shareholders of the gain exclusion in Section 1202 of the Internal Revenue Code;
>
> NOW, THEREFORE, BE IT RESOLVED: That this corporation agrees to submit reports to the Internal Revenue Service and to the shareholders of this corporation, in each case as the Internal Revenue Code may require to carry out the purposes of Section 1202.

The foregoing is in conformity with the Certificate of Incorporation and Bylaws of this corporation, has never been modified or repealed, and is now in full force and effect.

IN WITNESS WHEREOF, the undersigned has signed this Certificate this _____ day of____, 2021, pursuant to the authority granted by the Bylaws of the corporation.

_____

John Jones, Secretary

William C. Staley 818-936-3490

Exhibit B

Officer Certificate (Issuer)

OFFICERS CERTIFICATE
ABCD, INC.

For 2017

SARAH SMITH and JOHN JONES certify that they are the President and Secretary of ABCD, Inc., a Delaware corporation ("**ABCD**"), and that:

1. We served as officers and directors of ABCD for all of 2017.

2. ABCD did not purchase, directly or indirectly, any of its shares in 2017.[1]

3. At no point in 2017 did one shareholder or family own 50% or more of the outstanding ABCD shares.[2]

4. At no point in 2017 did any group of ABCD shareholders own 50% or more of the outstanding stock of ABCD and at least 50% of the outstanding stock of another corporation.[3]

5. The value of ABCD's cash plus the value of its assets did not exceed $50 million at any time in 2017.[4]

6. At no point in 2017 was ABCD a member of a chain one of or more other corporations connected through stock ownership with a common parent, except that ABCD (via its wholly-owned subsidiary EFGH, LLC) acquired all of the outstanding shares of IJKL, Inc. [5]

7. During 2017 ABCD did not engage in any of the following:

   7(a) Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial

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

2 I.R.C. § 1202(c)(3)(C).

3 I.R.C. § 1202(d)(3).

4 I.R.C. § 1202(d)(1).

5 I.R.C. § 1202(d)(1).

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,

7(b) Any banking, insurance, financing, leasing, investing, or similar business,

7(c) Any farming business (including the business of raising or harvesting trees),

7(d) Any business involving the production or extraction of products of a character with respect to which a depletion deduction is allowable, or

7(e) Any business of operating a hotel, motel, restaurant, or similar business.[6]

8. ABCD was a C corporation for federal income tax purposes for all of 2017.[7]

9. At no point in 2017 was ABCD for federal income tax purposes a DISC or former DISC, a regulated investment company, real estate investment trust, or REMIC, or a cooperative.[8]

10. At no point in 2017 did 10% or more of the value of the assets, if any, of ABCD consist of real property that ABCD did not use in the active conduct of its business.[9]

11. During all of 2017 at least 80% of the assets of ABCD (by value) were used in the active conduct of one or more businesses.[10] For this purpose:

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6 I.R.C. § 1202(e)(3).

7 I.R.C. § 1202(c)(2)(A).

8 I.R.C. § 1202(e)(4).

9 I.R.C. § 1202(e)(7).

10 I.R.C. § 1202(e)(1)(A).

11(a) The assets of EFGH, LLC, a limited liability company, are treated as the assets of ABCD;[11]

11(b) Any assets that are held as part of reasonably required working capital needs of the business are treated as an asset used in the business;[12]

11(c) Assets held for investment but reasonably expected to be used within two years to finance R&D for the business are treated as an asset used in the business;[13] and

11(d) Assets held for investment but reasonably expected to be used within two years to increase the working capital needs of the business are treated as an asset used in the business.

12. At no point in 2017 did 10% or more of the value of the assets of ABCD consist of stock or securities in other corporations.[14] For this purpose, stock or securities held for working capital and R&D needs as described in 11(b), 11(c) and 11(d) above are not "stock or securities in other corporations."[15]

We declare that the matters set forth in this certificate are true and correct of our own knowledge.

Signed on _____, 2021.

_____
Sarah Smith, President

_____
John Jones, Secretary

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11 Treas. Reg. § 301.7701-3(b)(1)(ii).

12 I.R.C. § 1202(e)(6)(A).

13 I.R.C. § 1202(e)(6)(B).

14 I.R.C. § 1202(e)(5)(A).

15 I.R.C. § 1202(e)(5)(B). Note that stock of certain subsidiaries is also excluded.

Exhibit C

Pass-Through Entity Certificate

EFGH, LLC

Certificate of Manager

The undersigned hereby certifies that I am the manager of EFGH, LLC, a Delaware limited liability company ("**EFGH**"), and that:

1. EFGH acquired shares of ABCD, Inc., a Delaware corporation, on _____, 2016 by original issuance.

2. EFGH held its shares of ABCD, Inc. continuously until EFGH sold the shares on _____, 2023.

3. EFGH is a classified as a partnership for income tax purposes, and has been so classified at all times since EFGH acquired its shares of ABCD, Inc.

I declare that the matters set forth in this certificate are true and correct of my own knowledge.

Signed _____, 2023.

_____

_____, Manager

Exhibit D

Officer Certificate – Software Royalties

OFFICERS CERTIFICATE
ABCD, INC.

Active Business Computer Software Royalties - 2017

SARAH SMITH and JOHN JONES certify that they are the President and Secretary of ABCD, Inc., a Delaware corporation ("**ABCD**"), and that:

1. We served as officers and directors of ABCD for all of 2017.

2. In 2017 ABCD (via EFGH, LLC) received royalties in connection with licensing computer software (the "**Royalties**").[1]

3. In 2017 ABCD (via EFGH, LLC) was engaged in the active conduct of the business of developing, manufacturing or producing computer software (the "**Software Business**").[2]

4. The Royalties were attributable to computer software which:

   4(a) Was developed, manufacture or produced by ABCD (via EFGH, LLC) in connection with its Software Business, or

   4(b) Was directly related to the Software Business.[3]

5. For 2017 the Royalties constituted at least 50% of the ordinary gross income of ABCD. [4]

6. For 2017 the sum of the following did not exceed 10% of the ordinary gross income of ABCD: dividends received, interest income, copyright or other

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1 I.R.C. § 543(d)(1)(A).

2 I.R.C. § 543(d)(2)(A).

3 I.R.C. § 543(d)(2)(B).

4 I.R.C. § 543(d)(3.

royalties (other than software royalties), income from annuities, rental income and royalties from mineral, oil and gas projects. [5]

7. In 2017 ABCD did not receive any payments with respect to an interest in a film for the use of, or right to use, such film. In 2017 ABCD did not actively participate in the production of a film.[6]

8. For 2017, A/B exceeded 25%, where:

8(a) "A" equals the sum of the federal income tax deductions for 2017 for ordinary business expenses (but not state taxes, charitable contributions or certain compensation), R&D deductions (not credits) and deductible start-up expenses; and

8(b) "B" equals the ordinary gross income of ABCD for 2017.

8(c) The compensation excluded from "A" is the compensation for personal services rendered by the 5 individual shareholders holding the largest percentage (by value) of the outstanding ABCD stock in 2017, disregarding anyone with less than 5% (by value) of ABCD stock.[7]

We declare that the matters set forth in this certificate are true and correct of our own knowledge.

Signed on _____, 2021.

_____
Sarah Smith, President

_____
John Jones, Secretary

5 I.R.C. § 543(d)(5).

6 I.R.C. § 543(d)(5).

7 I.R.C. § 543(d)(4).