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WHY IS SECTION 1202 SO UNSETTLED AFTER ALL THESE YEARS?

WHERE ARE THE SECTION 1202 REGULATIONS?

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. There are many unanswered questions about Section 1202. There should have been technical corrections by legislation and a lot more regulations and other IRS guidance. What happened?

In a nutshell, taxpayers did not use Section 1202 very often until after 2017, so there was not much demand for regulations, and then the Internal Revenue Service and the Department of Treasury were busy with guidance on the 2017 tax act.

Why didn't taxpayers use Section 1202 much before 2017? To use Section 1202 effectively, a taxpayer must start planning when a business entity is organized or an investment is made. The shares must be issued to the taxpayer (not bought from an existing shareholder) and held for five years.[1] The issuing corporation must be a C corporation.[2]

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[1] I.R.C. § 1202(a), (c).

[2] I.R.C. § 1202(c)(1)(A), (d)(1).

Until 2015 the possible tax benefits of the Section 1202 exclusion were not worth giving up other tax benefits (discussed below). Then in 2015 and 2016 it seemed unlikely that Section 1202 would survive the tax reforms proposed by candidates for president of the U.S. Until Section 1202 survived the 2017 tax act (known as the "Tax Cuts and Jobs Act" or "TCJA"), few taxpayers planned their businesses around Section 1202. Only after the TCJA did the 100% exclusion of Section 1202 seem like a permanent part of federal tax law.

TCJA created many new tax laws that required the attention of the Internal Revenue Service and the Department of the Treasury. So there was not a groundswell of demand for guidance on Section 1202 issues until the TCJA guidance was out, which took years.[3]

The Early Years – An Overview. Some tax provisions start out simple and become complex over the years. Section 1202 was "born" complex in 1993.[4] But from 1993 to 2010, the tax benefits provided by Section 1202 were much less than today. The exclusion was partial and half of the excluded amount was a tax preference for the alternative minimum tax. When the tax rate on long-term capital gain dropped to 20% in 1997, the gain that was not excluded by Section 1202 stock was still taxed at 28%.[5]

By the end of 2010, the exclusion was no longer partial and the AMT preference was gone for newly issued shares.[6] But from 2010 through 2014, 100% exclusion under Section 1202 was an "extender" that Congress extended for one year at a time.[7]

[3] 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 but not repealing it).

[4] Omnibus Budget Reconciliation Act of 1993 (which included the Revenue Reconciliation Act of 1993), Pub. L. 103-66, § 13113.

[5] Taxpayer Relief Act of 1997, Pub. L. 105-34, § 311. The AMT preference was reduced from 50% to 42% of the excluded amount to 42%.

[6] Creating Small Business Jobs Act of 2010, Pub. L. 111-240, § 2011, September 27, 2010.

[7] For example, the 100% exclusion with no AMT preference in Section 1202(a)(4) as added in 2010 applied "In the case of qualified small business stock acquired after the date of the enactment

In 2015 the 100% exclusion became permanent,[8] but both candidates for president called for tax reform, and Section 1202 seemed like low-hanging fruit for tax reformers. But, as noted above, Section 1202 survived the 2017 TCJA.

The Opportunity Cost and Risks of Planning to Use Section 1202. To get the tax benefit of Section 1202, the stock must be issued by a C corporation and the issuing corporation must be a C corporation for most of the time that the taxpayer holds the shares. But selling a business owned by a C corporation or distributing the profits of a C corporation to its shareholders generally subjects the profits to two levels of tax – at the corporate level and again at the shareholder level. Business owners could avoid the second level of tax by using an S corporation or a limited liability company. If a C corporation sold its *assets* and then liquidated, Section 1202 would, at best, eliminate the shareholder-level tax. Only if the *shares* of the C corporation were sold would Section 1202 exclude all tax on the sale of the business.

So for a business that generated positive cash flow that could be distributed to the shareholders as dividends (rather than paying down debt), using a C corporation to get the possible benefit of Section 1202 in a stock sale meant paying the year-in-year-out cost of a double tax. And that double tax could be avoided by using an S corporation or an LLC instead of a C corporation.

Even if the business remained a C corporation and the business was sold in a stock sale, the complexity of Section 1202 means that there are many ways to lose the tax benefit. Most business owners would not spend much on assuring that Section 1202 applied until *after* the closing of a sale of the C corporation's assets or stock. There was often bad news about Section 1202 at that point. Consequently, many tax advisers recommended that clients use S corporations or limited

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).

[8] Protecting Americans From Tax Hikes Act of 2015, Pub. L. 114-113, § 126, April 24, 2105.

liability companies rather than C corporations.

The TCJA lowered the federal corporate tax rate, so it lowered the inside tax component of the double tax and thus lowered the risk of planning to use Section 1202.

The Early Years – More Detail. The original 50% exclusion was increased to 75% in 2009, but the excluded gain was still subject to the AMT.

In 2010 the exclusion was increased to 100% and the gain was not subject to the AMT – for investments made that year. The provision became one of a group of annual "extenders," none of which were ever certain to be extended.

In 2015 the 100% exclusion from both the regular tax and the AMT was made permanent.

Beyond the Statute. Three cases, one regulation and a few letter rulings provide a bit of guidance on Section 1202.

Case Law. In 2012 three cases apply Section 1202.[9] All of them have facts that wildly favor the IRS. The taxpayers lost all three cases.

The "Redemption" Regulations. In June, 1996 Treasury published proposed regulations on the types of redemptions of shares that would prevent Section 1202 from applying. Curiously, those regs included a table of contents, something done only when a long, complex set of regulations are anticipated. The table of contents is the "-0" reg and the redemption reg is the "-2" reg. There is no "-1" reg! This indicates that the IRS had planned to issue more guidance, but never did.

Other Published Guidance. There are no revenue rulings or revenue procedures interpreting Section 1202.

[9] Natkunanathan v. Commissioner, 99 T.C.M. 1071 (2020), *aff'd in an unpublished opinion,* 2012-2 U.S.T.C. ¶50,456, (9th Cir. Jul. 12, 2012) (the taxpayer had no chance at the Section 1202 exclusion, but claimed it anyway in amended returns and represented himself in Tax Court). Two Tax Court memorandum opinions were decided on Section 1202 issues, even though they arose in the context of an attempted deferral of gain under Section 1045. Owen v Comm'r, 103 T.C.M. 1135 (2012) (not an active business); Holmes v. Comm'r, 104 T.C.M. 250 (2012) (not enough evidence to show that rollover stock "qualified small business stock"). Section 1045 allows a taxpayer to defer gain on Section 1202 stock held for at least six months.

IRS Publication 550, *Investment Income and Expenses (Including Capital Gains and Losses) (April 3, 2020)*, contains a two-page summary of Sections 1202 and 1045, and addresses how to report excluded gain.

The instructions to IRS Forms 8949 (income tax) and 6251 (for an AMT preference) cover reporting gain on "qualified small business stock."[10]

Letter Rulings. The IRS has issued a few private letter rulings interpreting Section 1202. Some involve the conversion of the issuing corporation into an LLC classified as a corporation for income tax purposes (a good Type F reorg) and two address whether businesses in the health care field can be active trades or businesses for Section 1202 purposes.[11] The oldest applies Section 1202 in a Section 355 tax-free split-up.[12]

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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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[10] "Qualified small business stock" is stock that meets all of the Section 1202 requirements except the five-year holding period. I.R.C. § 1202(c)(1).

[11] PLR 2017-17-010, January 23, 2017 (lab reports); PLR 2016-36-003, June 1, 2016 (F reorg); PLR 2016-03-010 to -014, October 07, 2015 (F reorg); PLR 2014 36 001, May 22, 2014 ("Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, which is certainly a component of the health industry, Company does not perform services in the health industry…").

[12] PLR 98-10-010, December 31, 1997 (stock of controlled corporation received in a Section 355 split-up was QSBS with tacked holding period).