Determining the Applicable Section 1202 Exclusion Percentage When Selling Qualified Small Business Stock

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When Section 1202 was enacted in 1993, a 50% gain exclusion applicable to the sale of qualified small business stock (QSBS), with the remaining 50% of the gain taxed at a 28% rate.[1] Not surprisingly, operating as business through a C corporation for the purpose of qualifying for Section 1202's gain exclusion was not particularly attractive for most businesses. After Congress increased the gain exclusion to 75% for QSBS issued after February 17, 2009, and then 100% for QSBS issued after September 27, 2010, qualifying for Section 1202's gain exclusion became a viable planning goal. In most cases, determining the applicable exclusion percentage is a straightforward exercise. But as discussed below, there are a couple of factors that can complicate this determination.

This is one in a series of articles and blogs addressing planning issues relating to QSBS and the workings of Sections 1202 and 1045. During the past several years, there has been an increase in the use of C corporations as the start-up entity of choice. Much of this interest can be attributed to the reduction in the federal corporate income rate from 35% to 21%, but savvy founders and investors have also focused on qualifying for Section 1202's generous gain exclusion. Legislation proposed during 2021 sought to curb Section 1202's benefits, but that legislation, along with the balance of President Biden's Build Back Better bill, has stalled in Congress, perhaps permanently. More background information regarding qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Internal Revenue Code is available on our website.

Proposed legislation could roll back the exclusion percentage to 50% for most stockholders

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Legislation was proposed during the last quarter of 2021 that would have rolled the exclusion percentage back from 100% to 50% for trusts and estates and individuals with adjusted gross income (AGI) of $400,000 or more. Most sellers of QSBS will have AGI exceeding $400,000, since QSBS gain is an above the line item in determining AGI.[2] The legislation has stalled, however, along with the balance of President Biden's Build Back Better bill. At this point, it is unclear whether the legislation will be revived during the Biden administration.

How the exclusion percentage is determined under current law:

- *A 100% gain exclusion is generally applicable for QSBS issued after September 27, 2010*.
  If QSBS is issued for cash or services after September 27, 2010, the holder will be able to claim a 100% gain exclusion if Section 1202's eligibility requirements are met. If QSBS is issued in exchange for contributed property after September 27, 2010, and that property has a holding period in the hands of the contributor that commenced after September 27, 2010, the holder will be able to claim a 100% gain exclusion if Section 1202's eligibility requirements are met. Note that it is not 100% clear what exclusion percentage is applicable if QSBS is issued after September 27, 2010, in exchange for contributed property, where the contributed property's holding period commenced prior to September 28, 2010 (i.e., when the 50% or 75% gain exclusion was applicable). This issue is discussed in detail below.
- *A 50% or 75% or 50% gain exclusion is generally applicable for QSBS issued on or before September 27, 2010*.
  If QSBS is issued after August 10, 1993, but prior to February 18, 2009, the holder will generally be able to claim a 50% gain exclusion. If QSBS is issued after February 17, 2009, but on or before September 27, 2010, the holder will generally be able to claim the 75% exclusion. Note that is not 100% clear what exclusion percentage would applicable if QSBS is issued after February 17, 2009, but on or before September 27, 2010, in

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consideration of contributed property, where the contributed property's holding period commenced prior to February 18, 2009 (when the 50% gain exclusion was applicable). This issue is discussed in detail below.

- *No gain exclusion is available for stock issued prior to August 11, 1993.*
- *When is stock "issued" for federal income tax purposes?* Stock would be considered issued for federal income tax purposes if it is issued and is not subject to any restrictions under Section 83 (generally, no applicable vesting requirements). Stock subject to substantial risk of forfeiture under Section 83 would not be considered "issued" until the vesting requirements lapse, unless a Section 83(b) election is made. If the Section 83(b) election is made, the stock would be considered "issued" on the initial date of issuance. Stock is not considered "issued" with respect to options until stock is issued upon the exercise of the options (with the stock then potentially subject to the Section 83 vesting rules). Convertible debt is generally not considered to be stock "issued" until the debt is converted into stock. SAFE instruments are often treated as being the equivalent of issued stock, but that treatment is not supported in a blanket fashion by tax authorities.

A complicating factor in determining the applicable exclusion percentage potentially arises when a stockholder's holding period for property contributed to a corporation in exchange for QSBS dates back to a time when a lower exclusion percentage was applicable:

As outlined above, determining the applicable exclusion percentage is usually quite straightforward. But Section 1202's so-called "Flush Language" has introduced some uncertainty. This Flush Language follows Sections 1202(a)(3) and (4) (addressing applicable exclusion percentages), and has earned its name by being unnumbered clauses flush against the left margin immediately following Sections

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1202(a)(3) and (4). The Flush Language reads as follows:

> "[i]n the case of any stock which would be described in the preceding sentence (but for this sentence), the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223."[3]

There have been two schools of thought regarding how to interpret the meaning of the Flush Language. Some believe that the language is intended to address the exclusion percentage applicable when property with a holding period dating back in the hands of the contributor to a period when a lesser exclusion percentage was applicable is contributed to a corporation in exchange for QSBS. Others believe that the Flush Language addresses the exclusion percentage applicable when shares of QSBS are exchanged for stock under Sections 351, 368 or 1045.

As quoted above, the Flush Language provides that the acquisition date for purposes of determining the applicable exclusion percentage is the first day the QSBS was held by the taxpayer determined after the application of Section 1223. This reference, if read in isolation, would appear to support the conclusion that Congress was referring to either or both of (i) property contributed to a corporation or (ii) stock exchanged for other stock in transactions falling within the scope of Sections 351, 368 or 1045.

The only tax authority that sheds direct light on the Flush Language is the 112th Congress' General Explanation of Tax Legislation prepared by the Committee on Taxation (the "General Explanation"). [4] The General Explanation commented when discussing the Flush Language that *"the provision clarifies that in the case of any qualified small business stock acquired (determined without regard to the tacked-holding period) after February 17, 2009, and before January 1, 2014, the date of acquisition for purposes of determining the exclusion percentage is the date of the holding period for the stock begins. Thus, for example, if an individual (i) acquires qualified small business stock at its original issue for $1 million on July 1, 2006, (ii) sells the stock on March 1, 2012, for $2 million in a transaction in which gain is not recognized by reason of section 1045, (iii) acquires qualified replacement stock at its original issue*

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on March 15, 2012, for $2 million, and (iv) sells the replacement stock for $3 million, 50 percent (and not 100 percent) of the $2 million gain on the sale of the replacement stock is excluded from gross income."[5] The General Explanation further explains that the Flush Language "is not intended to change the acquisition date under section 1202(i)(1)(A) for certain stock exchanged for property."

Section 1202(i)(1)(A) provides that QSBS issued in exchange for property (other than money or stock) is treated as having been acquired by the taxpayer on the date of such exchange. The General Explanation states that the Flush Language is not intended to affect the holding period of QSBS issued for property (the holding period commences when the stock is issued), leaving the language to apply to holding period in instances where QSBS issued for stock (i.e., exchanges of stock for stock under Sections 351, 368 and 1045).

Based on the guidance in the General Explanation, we believe that the scope of the language is intended to be limited to direct and indirect exchanges of stock under Sections 351, 368 and 1045. In each of those instances, if QSBS was issued when the exclusion percentage was less than 100%, that lesser exclusion percentage would carry over to the stock issued to the stockholder in an exchange governed by Sections 351, 368 or 1045 (providing for reinvesting QSBS sales proceeds into replacement QSBS). The Flush Language would not affect the percentage exclusion applicable to situations where a stockholder contributes property to a qualified small business in exchange for QSBS. While this may not be the most taxpayer favorable reading of the Flush Language, it does seem logical that Congress would focus on preventing taxpayers from modifying the applicable exclusion percentage through various exchanges of stock.

The applicable exclusion percentage when QSBS is exchanged for replacement QSBS (or non-QSBS) under Sections 351, 368 or 1045

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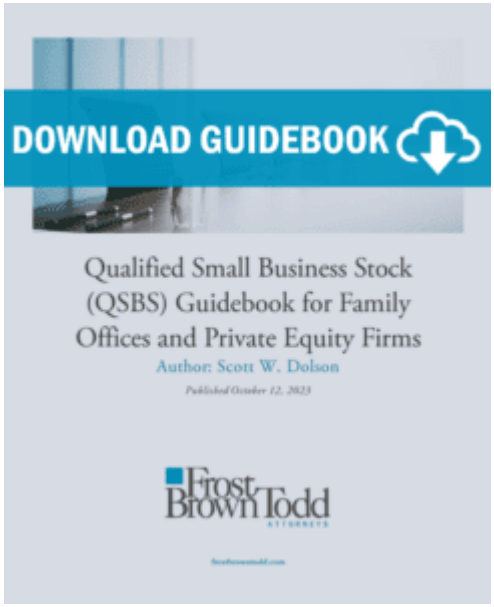
As discussed in the preceding section, we believe that when a stockholder's original QSBS is exchanged for replacement QSBS under Section's 351, 368 or 1045, the Flush Language supports the conclusion that the exclusion percentage applicable to the original QSBS carries over to be the exclusion percentage applicable to the replacement QSBS.

More Resources

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with QSBS planning. Venture capitalists, founders and investors who want to learn more about QSBS planning opportunities are directed to several articles on the Frost Brown Todd website:



- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion

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- Can Stockholders of Employee Leasing Companies Claim Section 1202's Gain Exclusion?
- Determining the Applicable Section 1202 Exclusion Percentage When Selling Qualified Small Business Stock
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- How Corporations May Run Afoul of the Accumulated Earnings Tax – A Section 1202 Planning Brief
- How Section 1202's $50 Million Aggregate Gross Assets Test Works
- Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Dissecting 1202's Active Business and Qualified Trade or Business Qualification Requirements
- Recapitalizations Involving Qualified Small Business Stock
- The 21% Corporate Rate Breathes New Life into IRC § 1202

View all QSBS Resources

Contact Scott Dolson if you want to discuss any Section 1202 or Section 1045 issues by video or telephone conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[1] See Section 1(h)(4)(B)(ii) for reference to the 28-percent gain rate. References in this article to "Section" are to sections of the Internal Revenue Code, as amended.

[2] The portion of gain eligible for Section 1202's gain exclusion would be excluded as an above-the-line amount, but the remaining 50% to apply against the $400,000 threshold, which means that

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many taxpayers selling QSBS would be limited to the 50% gain exclusion.

[3] The flush language in Sections 1202(a)(3) and (4) provides that "[i]n the case of any stock which would be described in the preceding sentence (but for this sentence), the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after the application of section 1223."

[4] General Explanations of tax legislation prepared by the Joint Committee on Taxation are referenced in Treasury Regulation Section 1.6662-4(d)(3)(iii) as authority for purposes of determining whether there is substantial authority for the tax treatment of an item.

[5] The General Explanation of Tax Legislation Enacted in the 112th Congress at footnotes 490 and 491. The reference to 2014 is no longer applicable due to the permanent extension of the 100% gain exclusion.

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