Navigating Section 1202's Redemption (Anti-churning) Rules

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Section 1202 provides for a substantial exclusion of gain from federal income taxes when stockholders sell qualified small business stock (QSBS).[1] But a number of requirements, including avoidance of Section 1202(c)(3)'s anti-churning rules, must be satisfied in order to be eligible to claim Section 1202's gain exclusion. This article focuses on the potential forfeiture of QSBS status that can be triggered by poorly-timed issuances and redemptions of stock.

If Section 1202's anti-churning rules are triggered, the affected stock will forfeit its QSBS status. Presumably, Section 1202(c)(3) was enacted as an effort to block the strategy of exchanging non-QSBS for QSBS. The potential application of these rules should be considered before stock is redeemed or QSBS issued. Also, understanding how these rules work is important when vetting whether stock is QSBS.

Stock redemptions are not common occurrences for early-stage companies. But companies do occasionally redeem stock from exiting founders and early-stage employees. Later-stage companies also occasionally rely on stock redemptions as a source of liquidity for founders or investors. Understanding whether the anti-churning rules would be triggered by a redemption is a necessary part of the planning process.

This article 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 five years, the C corporation has gained favor as the entity of choice for many start-ups. Much of this interest can be attributed to the reduction in the federal corporate income tax rate from 35% to 21%, but savvy founders and venture capitalists have also focused on qualifying for Section 1202's gain exclusion. Efforts by Congress to reduce Section 1202's benefits over the past several years have failed. Additional information regarding the eligibility requirements for Sections 1202 and 1045 can be found on our ***QSBS & Tax Planning Services page****.*

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What qualifies as a stock redemption?

A stock redemption is generally the purchase of stock by the same corporation that originally issued the stock (referred to in this article as the "**Issuing Corporation**").[2] The anti-churning rules are potentially applicable regardless of whether any of the redeemed stock is QSBS.

When can you rule out the triggering of the anti-churning rules?

When there are no redemptions during a Four-Year Testing Period. With respect to a specific issuance of QSBS, the anti-churning rules are not triggered if the Issuing Corporation has not redeemed any stock during a **Four-Year Testing Period** (defined as the four-year period beginning on the date two-years prior to the applicable QSBS issuance and ending two years after such issuance). For example, if QSBS was issued on January 1, 2019, the anti-churning rules are not triggered if there was no redemption of stock during the period beginning January 1, 2017, and ending January 1, 2021.

When there are no redemptions during a Two-Year Testing Period. Again, with respect to a specific issuance of QSBS, the anti-churning rules are generally not triggered if the Issuing Corporation has not redeemed any of stock during a **Two-Year Testing Period** (defined as the two-year period beginning on the date one year prior to the applicable QSBS issuance and ending one year after the applicable issuance). A possible exception to this rule arises in the situation where QSBS has been issued to a specific stockholder, and the Issuing Corporation redeems stock from that stockholder or related persons during the Four-Year Testing Period.

When the redemption of stock is tied to termination of employment, death, divorce, etc. Redemptions incident to termination of employment, death, disability, mental incompetency or divorce are excluded for purposes of the anti-churning rules (see the discussion below).

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How to determine when the anti-churning rules are triggered

Assuming the general exceptions outlined above don't apply, Section 1202 has two separate tests for determining when the anti-churning rules are triggered:

- ***Related person redemptions***. This test involves the issuance of QSBS to a specific stockholder, and the redemption of stock from that same stockholder or a related persons during a Four-Year Testing Period bracketing that stock issuance.
- ***Significant redemptions***. This test involves any issuance of QSBS, and "significant redemptions" of stock during a Two-Year Testing Period bracketing that stock issuance.

These two tests are discussed in detail below.

The "related person" anti-churning test

Under Section 1202(c)(3)(A), the anti-churning rules can be triggered if QSBS is issued to a specific stockholder and the Issuing Corporation redeems stock from that same stockholder or related persons during the Four-Year Testing Period.[3] Whether this rule has been triggered is determined as follows:

- ***First determine if there have been applicable issuances of QSBS and redemptions of any stock (QSBS or non-QSBS) within the Four-Year Testing Period.*** With respect to the issuance of QSBS to a specific stockholder, determine if there have been any redemptions of stock from that same stockholder or a related persons during an applicable Four-Year Testing Period.[4] If so, this anti-churning test has been triggered unless either the *de minimis* exceptions or general exceptions discussed below apply. If the anti-churning test has been triggered, the subject stock forfeits its QSBS status.
- ***Next, determine whether the first de minimis exception applies.*** Determine whether the aggregate redemption consideration paid to the specific stockholder and related persons has exceeded $10,000 during the Four-Year Testing Period. Ten thousand dollars is a small dollar amount, but

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sometimes founder stock will be redeemed at its original (e.g., $0.001) issue price. If this *de minimis* exception applies, then the related persons anti-churning test has not been triggered with respect to the specific QSBS issuance.

- ***Next, determine whether the second de minimis exception applies.*** Determine whether more than 2% of the stock (QSBS or non-QSBS) held by the specific stockholder and related persons has been redeemed during the Four-Year Testing Period. For each redemption during the Four-Year Testing Period, the percentage redeemed is determined by dividing the redemption consideration by the value of all outstanding stock held by the stockholder and related persons immediately before the redemption. For example, if the redemption consideration equals $1, and all of stock held by the stockholder and related persons at that time is valued at $100, then 1% has been redeemed. If a second redemption occurs during the same Four-Year Testing Period, $1,000 of redemption consideration is paid at a time when all of the stock held by the specific stockholder and related persons is valued at $150,000, then another .666% has been redeemed. Only 1.666% of the specific stockholder's stock has been redeemed if no additional redemptions occur during the Four-Year Testing Period and this 2% *de minimis* exception would apply.

The limited scope of the two *de minimis* exceptions discussed above suggests that when stock is redeemed from a specific stockholder or related persons, the corporation generally will not be able to issue QSBS to that same stockholder for a two-year period. Likewise, if QSBS has been issued to a specific stockholder, the corporation will most likely not be able to redeem stock from that same stockholder or related persons for a period of two years.

In addition to the two *de minimis* exceptions outlined above, there are several additional general exceptions such as redemption in connection with termination of employment, death, divorce, etc., discussed below.

The "significant redemptions" anti-churning test

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Under Section 1202(c)(3)(B), the anti-churning rules can also be triggered when there are "significant redemptions" of stock during an applicable Two-Year Testing Period (i.e., the Two-Year Testing Period applicable to a specific issuance of QSBS).[5] This test operates independently of the related party test and a particular redemption of stock could trigger the application of either or both tests. Whether this rule has been triggered is determined as follows:

- ***First, determine with respect to the QSBS issuance being tested whether there have been any redemptions of stock during the Two-Year Testing Period.***
- ***Next, determine whether the first de minimis exception applies.*** With respect to QSBS issuance being tested, determine whether aggregate redemption consideration paid during the applicable Two-Year Testing Period exceeds $10,000. If not, then the significant redemptions test has not been triggered.
- ***Next, determine whether the second de minimis exception applies.*** With respect to the QSBS issuance being tested, determine whether more than 2% of the corporation's stock was redeemed during the Two-Year Testing Period. For each redemption during the Two-Year Testing Period, the percentage redeemed is determined by dividing the redemption consideration by the value of all outstanding stock immediately before the redemption. For example, if the redemption consideration is $1, and all of the Issuing Corporation's stock is valued at $100, then 1% of the stock has been redeemed. If the consideration paid in a second redemption during the Two-Year Testing period was $1,000 at a time when all of the Issuing Corporation's stock was valued at $90,000, then more than 2% of the Issuing Corporation's stock has been redeemed during the Two-Year Testing Period and the 2% *de minimis* exception doesn't apply.
- ***Finally, if the two de minimis exceptions don't apply, determine with respect to the QSBS issuance being tested whether the aggregate redemption consideration paid during the Two-Year Testing Period exceeds an amount***

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equal to 5% of the value of the Issuing Corporation's stock as of the start-date of the Two-Year Testing Period. For example, assume the following facts: (i) QSBS was issued on January 1, 2019; and (ii) the value of all stock on January 1, 2018, was $10 million. Based on these facts, the significant redemptions test would be triggered if the aggregate consideration equaled or exceeded $500,000 during the Two-Year Testing Period.

Additional exceptions for redemptions triggered by employment termination, death, divorce, etc.

Treasury Regulation Section 1.1202(d) provides several significant additional exceptions to the anti-churning rules. If a particular stock redemption qualifies under one of the exceptions, that redemption is ignored for purposes of testing for the triggering of the anti-churning rules.

Exception for termination of services (the "Employment Termination Exception"). A redemption is disregarded if the applicable stock was issued in connection with the performance of services as an employee or director and the stock was redeemed incident to retirement or other bona fide termination of services.[6] There are two questions that must be answered affirmatively before this exception applies. First, was the stock issued in connection with the performance of services as an employee or director? Second, was the stock redeemed incident to retirement or other bona fide termination of services? Several pointers to assist in answering those questions are outlined below.

- ***What constitutes the "issuance of stock in connection with the performance of services."*** There are no tax authorities interpreting Section 1202 that define when "*stock acquired by the seller in connection with the performance of services as an employee or director*." Section 83 addresses the tax consequences associated with the transfer of stock to employees in connection with the performance of services, and it seems reasonable that courts would look to this statute for guidance.[7] The courts have interpreted broadly what constitutes property transferred in connection with the

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performance of services under Section 83. The U.S. Tax Court has noted that Section 83 "*only envisions some sort of relationship between the services performed and the property transferred*." [8] Satisfaction of the first leg of this exception should be straightforward: (i) where the issuance is clearly earmarked as such; (ii) the employee files a Section 83(b) election if the stock is subject to vesting; or (iii) the employee includes the receipt of the stock as compensation on a tax return (even if the compensation amount is stated to be zero). Founders often pay a nominal cash amount (e.g., $0.001), but their stock is generally considered to be issued for a combination of the nominal cash amount and prior and future services and it seems reasonable that stock issued to them should be treated as issued in connection with the performance of services.[9] In the real world, founder stock may be issued for no money paid and without the issuance of the stock being reported as compensation. Under these circumstances, the specific facts will need to be considered in determining whether the employment termination exception should apply.

A more complicated situation arises when stock is issued to a service provider in connection with the incorporation of a partnership (LP or LLC). In many cases, units held by partners/members were originally issued as compensation for services. When the LP/LLC is incorporated, those units are exchanged under a Section 351 nonrecognition exchange for stock in the corporation. This raises the question of whether the stock would be considered as having been acquired in connection with the performance of services. There are few tax authorities that address the issue of whether LLC/LP equity issued to a service provider retains that characterization when exchanged for corporate stock in a Section 351 nonrecognition exchange. In Revenue Ruling 2007-49, Situation 2, the IRS concluded that stock held by a service provider and subject to Section 83 continued to be subject to Section 83 where there was a stock exchange governed by Section 368 (a tax-free reorganization). [10] Based on that ruling, it seems reasonable to conclude that,

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stock issued in exchange for LP/LLC interests originally issued for services should retain for purposes of Section 1202 the character of being issued for services.

- ***Redemption of stock incident to termination of employment***. The second requirement of Treasury Regulation Section 1.1202-2(d)(1) is that the redemption must be "incident to" retirement or the bona fide termination of employment. The term "incident to" is not defined in tax authorities interpreting Section 1202. In this situation, courts will often look at how a term or phrase is defined in commonly used dictionary sources and how the term or phrase is used elsewhere in the Internal Revenue Code.[11]

  Use of the phrase "incident to" is defined in commonly used dictionary sources. The Merriam-Webster online dictionary defines "incident" when used as an adjective as "*occurring or likely to occur especially as a minor consequence or accompaniment*" and "*dependent on or relating to another thing in law*." [12] Law Insider defines "incident to" in the context of medical services to mean "*something integral, although incidental, in connection with the performance of medical services and service furnished during a course of treatment*."[13] As these examples suggest, dictionary definitions appear to support a broad interpretation of what "incident to" encompasses.

  Use of the phrase "incident to" elsewhere in the Internal Revenue Code. Courts are also likely to look to how the phrase is used by tax authorities interpreting other Internal Revenue Code provisions. Section 1041 uses the phrase "incident to" in connection with determining the tax treatment of transfers of property between spouses that are associated with their divorce. Section 1041(c) provides that a transfer of property is "incident to" a divorce if the transfer occurs within one year after the date on which marriage ceases or is related to the cessation of the marriage. A property transfer is treated as being related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument. This presumption can be rebutted by showing that the

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transfer was made to accomplish the division of property owned by the former spouses at the time of the cessation of the marriage.[14]

There appears to be a strong argument that a redemption should be considered incident to termination of employment if the redemption was addressed in a separation agreement, or was originally addressed in an employment or stockholders agreement. If the redemption wasn't included as part of the separation from services, but occurs reasonably soon thereafter, the tax authorities discussed above should provide adequate support for the position that the redemption should nevertheless be considered "incident to" employment termination.[15] There are additional references in Sections 248, 204, 709 supporting the conclusion that the term "incident to" is basically treated as being interchangeable with the terms "relating to," "in connection with" or "arising out of." Based on these tax authorities, there appears to be a solid argument that for purposes of Treasury Regulation Section 1.1202-2(d)(1), all that is required for services to be "incident to" termination of employment is a plausible connection between the termination of employment and the stock redemption.[16]

- ***Redemptions incident to death, disability or mental incompetency or divorce***. Treasury Regulation Sections 1.1202-2(d)(2), (3) and (4) provide the following additional exceptions to the "anti-churning" rules for death, disability, mental incompetency and divorce.[17] These additional exceptions are fairly self-explanatory, although "disability" or "mental incompetency" are not defined in any Section 1202 tax authorities.

Should a complete liquidation be treated as a redemption for purposes of the anti-churning rules?

There may be unusual circumstances where a taxpayer rolls the proceeds from the sale of QSBS into replacement QSBS under Section 1045, and the corporation issuing the replacement QSBS liquidates within two years after issuance of the replacement QSBS.

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Generally, a liquidating distribution is considered a stock redemption for federal income tax purposes. This treatment raises the question of whether the anti-churning rules might apply even in circumstances where a stockholder has a combined five-year holding period for the original and replacement QSBS. Since the holding period for replacement QSBS is deemed under Section 1045 to relate back to the date the original QSBS was issued, it seems more than reasonable to conclude that this rule should also apply with respect to the possible application of the anti-churning rules. [18]

Secondary sale issues

Section 317 defines "redemption of stock" as follows: "*For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock*." Our assumption is that this definition of redemption applies for purposes of the anti-churning rules of Section 1202(c)(3). A secondary sale is generally defined as a sale of stock to a third party (i.e., a purchaser other than the corporation). The tax consequences of a third-party purchase are often different than those triggered by a redemption of shares, which must run the gauntlet of Section 302 in order to determine whether the redemption is treated as a taxable exchange (eligible for Section 1202 treatment) or dividend treatment (not eligible for offsetting by Section 1202's gain exclusion). A secondary sale (i.e., third party purchase), on the other hand, is generally treated as a taxable sale, which avoids triggering Section 1202(c)(3)'s anti-churning rules, and the potential for dividend treatment under Section 302. Business owners familiar with buy-sell/stockholder agreements see the distinction between secondary sales and redemptions when considering the differences between redemption agreements and cross-purchase agreements (i.e., where stockholders buy out shares from other stockholders upon the occurrence of death, termination of employment or other triggering events). Obviously, secondary sales are a useful planning tool when stock is QSBS.

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There can be situations where a transaction structured as a secondary sale is treated as a "redemption" for purposes of the anti-churning rules under Section 1202(c)(3) and Section 302 (dividend versus exchange treatment). The potential recharacterization can be significant in two respects. First, if the sale is treated as a redemption, the payment could be treated as a dividend under Section 302 and not be eligible for Section 1202's gain exclusion. Second, the deemed redemption could trigger the application of the anti-churning rules, tainting the QSBS status of stock issued in proximity to the redemption.

Under Section 304(a)(1), if a secondary sale involves the purchase of QSBS by a stockholder controlling both the corporation that issued the QSBS and the purchasing corporation, the purchase can be treated as a redemption rather than a purchase. In general, a secondary sale that doesn't involve a purchase by an affiliated corporation should be respected as a purchase by the applicable individual, trust or partnership rather than redemption, so long as the facts don't support that conclusion that, for federal income tax purposes, the purchaser acquired the QSBS on behalf of the issuing corporation. Some secondary sales include a purchase of common stock by an investor, followed by the exchange of the common stock for preferred stock. It is unclear whether, when looking at the transaction as whole (i.e., the secondary sale of common followed by the exchange of common for preferred), there is an argument that the transaction should be recharacterized as an issuance of preferred and a redemption of common for purposes of Sections 1202(c)(3) and 302, or whether the form of the transaction should be respected.

Treasury Regulation Section 1.1202-1(c) clears up one potential issue involving secondary sales of stock. The provision states that "*A transfer of stock by a shareholder to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is not treated as a purchase of the stock by the issuing corporation for purposes of this section even if the stock is treated as having first been transferred to the corporation under §1.83-6(d)(1) (relating to transfers by shareholders to employees or independent contractors).*" This provision clarifies that the sale by

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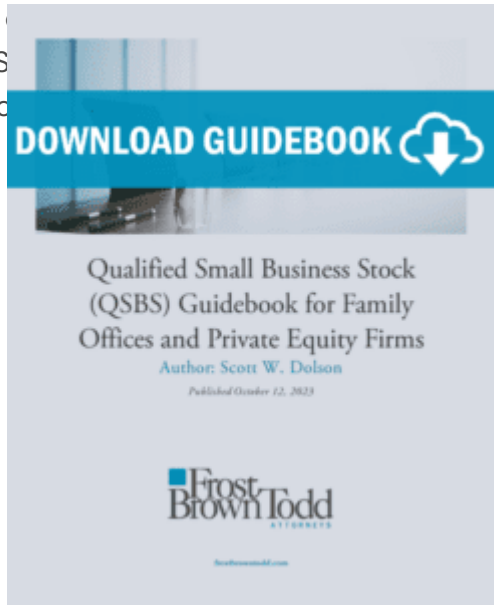
a stockholder of QSBS to an employee won't trigger the application of the "anti-churning" rules under Section 1202(c)(3), but doesn't necessarily address the issue of whether structuring the transaction as a secondary sale to an employee avoids the potential recharacterizing of the transaction as a redemption for Section 302 purposes. If a majority stockholder sells stock to a new employee for consideration, Treasury Regulation Section 1.83-6(d)(1) can be cited as authority for the position that the redemption consideration should be treated as having been paid by the corporation to the selling stockholder in exchange for redeemed stock, which under Section 302's rules would be accorded dividend rather than sale treatment (so no Section 1202 gain exclusion for the deemed redemption treated as dividend for federal income tax purposes).[19] Further, the Section 1202 regulations do not address the tax treatment associated with the deemed issuance by the corporation of the purchased stock (e.g., a below fair market value purchase price triggering compensation).

More resources

Despite the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Section 1202 and Section 1045 planning. Venture
who want to learn more about S
planning opportunities are direc



the Frost Brown Todd website:

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- 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)
- A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion
- 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?
- 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

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

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[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. Each taxpayer can exclude at least $10 million of gain upon the sale of a particular C corporation's QSBS, provided all of Section 1202's eligibility requirements are satisfied. Many but not all states follow the federal income tax treatment of

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QSBS.

[2]*See* Section 304. Section 304's reach can extend to brother-sister redemption transactions and parent-subsidiary redemption transactions. Section 317(b) provides that "*stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock*." A purchase of stock by a third party is generally not a redemption, with the exception of certain purchases involving commonly-controlled corporations. For purposes of the scope of whether a transaction is a "redemption," the purchase of stock by a successor to the original Issuing Corporation would typically fall within the scope of a redemption (e.g., when the stock of an Issuing Corporation is involved in a Section 351 nonrecognition exchange or the Issuing Corporation is a party to a Section 368 tax-free reorganization). Under Section 1202, a transfer by of stock to a service provider is not treated as a redemption by the corporation (which is not always true for other purposes under the Internal Revenue Code).

[3] Treasury Regulation Section 1.1202-2(a) provides that:

- ***In general***. *Stock acquired by a taxpayer is not qualified small business stock if, in one or more purchases during the 4-year period beginning on the date 2 years before the issuance of the stock, the issuing corporation purchases (directly or indirectly) more than a de minimis amount of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b)) to the taxpayer.*
- ***De minimis amount***. *For purposes of this paragraph (a), stock acquired from the taxpayer or a related person exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of the stock held by the taxpayer and related persons is acquired. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly)*

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by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase. [3]

[4] For purposes of determining who is a "related person," Sections 267(b) and 707(b) includes family members and certain affiliations among business entities and their owners or certain parties to a trust.

[5] Treasury Regulation Section 1.1202-2(b) provides that:

- ***In general**. Stock is not qualified small business stock if, in one or more purchases during the 2-year period beginning on the date 1 year before the issuance of the stock, the issuing corporation purchases more than a de minimis amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of the issuing corporation's stock as of the beginning of such 2-year period.*
- ***De minimis amount**. For purposes of this paragraph (b), stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of all outstanding stock is purchased. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.*

[6] Treasury Regulation Section 1.1202-2(d)(1)(ii) reserves the application of this exception to independent contractors.

[7] Treasury Regulation Section 1.83-3(f) provides that *"[p]roperty transferred to an employee or an independent contractor (or beneficiary thereof) in recognition of the performance of, or the refraining from performance of, services is considered transferred in connection with the performance of services within the meaning*

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of section 83. The existence of other persons entitled to buy stock on the same terms and conditions as an employee, whether pursuant to a public or private offering may, however, indicate that in such circumstances a transfer to the employee is not in recognition of the performance of, or the refraining from performance of services. The transfer of property is subject to section 83 whether such transfer is in respect of past, present, or future services."

[8] *Montelepre Systemed, Inc. v. Commissioner,* T.C. Memo 1991-46, *aff'd* 920 F.2d 1335 (7th Cir. 1990) at 91-171. The IRS has argued that four factors should be considered: (1) whether the property right is granted at the time the employee or independent contractor signs his employment contract; (2) whether the property restrictions are linked explicitly to the employee's or independent contractor's tenure with the employing company; (3) whether the consideration furnished by the employee or independent contractor in exchange for the transferred property is services; and (4) the employer's intent in transferring the property. There are a number of cases that confirm that property can be considered transferred in connection with the performance of services even if the service provider pays full value at the time of issuance.

[9] Victor Fleischer in his article "*Taxing Founders' Stock*" noted, "*founders of a start-up usually take common stock as a large portion of their compensation for current and future labor efforts*." Victor Fleischer, *Taxing Founders' Stock*, 59 UCLA L. Rev. 60 (2011).

[10] Revenue Ruling 2007-49, 2007-2 C.B. 237 (7/6/2007).

[11] In particular, in cases where the interpretation and meaning of a specific, albeit undefined, term found in the Internal Revenue Code is being scrutinized, the United States Supreme Court has looked to leading authorities such as Black's Law Dictionary and Webster's Dictionary for support. The IRS noted in Private Letter Ruling 202114002 (4/89/2021) that "*words in a statute generally are presumed to bear their ordinary, contemporary, common meaning. Walters v. Metro. Educ. Enters., Inc., 519 U.S. 202, 207 (1997). To ascertain the plain meaning of terms, courts have consulted the definitions of those terms in popular dictionaries. Metro One Telecommunications, Inc. v. Commissioner, 704 F.3d 1057, 1061 [110*

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AFTR 2d 2012-7087] (9th Cir. 2012)."

[12] Definition of "Incident," Merriam-Webster.com.

[13] *See Montelepre*; *Bagley v. Commissioner*, 85 T.C. 663 (1985), *aff'd* 806 F.2d 169 (8th Cir. 1986); *Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984).

[14] *Montelepre* at 91-171.

[15] A court might conclude that the reference to the one-year period after divorce to define the scope of "incident to" in Section 1041(c) also provides a useful safe harbor for purposes of Section 1202.

[16] Treasury Regulation Section 1.709-2(a) defines the phrase "*are incident to the creation of a partnership" to mean the incurring of an expense "during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (determined without regard to any extensions of time) for the taxable year the partnership begins business. In addition, the expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business." With respect to the use of the term "incident to" in Section 248, Treasury Regulation Section 1.248-1(b) refers to organizational expenditures that are "directly incident to the creation of the corporation*." In Section 304, the phrase "incident to" appears to refer to a relationship or connection of undefined scope between two things/events.

[17] Treasury Regulation Section 1.1202-2(d) excludes stock redeemed from consideration in connection with the anti-churning rules under the following circumstances:

"*(2) Death. Prior to a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and—*

(i) The stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift),

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heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and

(ii) The stock is purchased within 3 years and 9 months from the date of the decedent's death;

(3) Disability or mental incompetency. The stock is purchased incident to the disability or mental incompetency of the selling shareholder; or

(4) Divorce. The stock is purchased incident to the divorce (within the meaning of section 1041(c)) of the selling shareholder."

[18] *See* the section "*Is there a required holding period for Replacement QSBS before Section 1202's gain exclusion can be claimed?* in the Scott Dolson article *"Part 2 – Reinvesting QSBS sales proceeds on a pre-tax basis under Section 1045."*

[19] Treasury Regulation Section 1.83-6(d)(1) provides that: "*If a shareholder of a corporation transfers property to an employee of such corporation or to an independent contractor (or to a beneficiary thereof), in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee or independent contractor under paragraphs (a) and (b) of this section. For purposes of this (1), such a transfer will be considered to be in consideration for services performed for the corporation if either the property transferred is substantially nonvested at the time of transfer or an amount is includible in the gross income of the employee or independent contractor at the time of transfer under §1.83-1(a)(1) or § 1.83-2(a). In the case of such a transfer, any money or other property paid to the shareholder for such stock shall be considered to be paid to the corporation and transferred immediately thereafter by the corporation to the shareholder as a distribution to which section 302 applies.*"

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