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# Notice of Proposed Rulemaking and Notice of Public Hearing

## Qualified Small Business Stock

### IA-26-94

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed regulations relating to the 50-percent exclusion for gain from certain small business stock. The proposed regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) and provide guidance to the issuers and owners of the stock of certain small businesses. This document also provides a notice of public hearing on these proposed regulations.

**DATES:** Written comments and outlines of oral comments to be presented at the public hearing scheduled for October 3, 1996 must be received by September 4, 1996.

**ADDRESSES:** Send submissions to: CC:DOM:CORP:R (IA-26-94), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between

the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (IA-26-94), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Catherine A. Prohofskey at (202) 622-4930; concerning submissions and the public hearing, Christina Vasquez at (202) 622-7180; (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### *Background*

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) relating to section 1202 of the Internal Revenue Code. Section 1202 was added by section 13113 of OBRA '93. Section 1202 allows a taxpayer (other than a corporation) to exclude 50 percent of certain gain from the sale of qualified small business stock held for more than 5 years.

Section 1202(c)(1) provides that only stock acquired after August 10, 1993, at its original issuance in exchange for money, property other than stock, or as compensation for services to the corporation (other than as an underwriter) qualifies for the exclusion (the original issue requirement). Section 1202(c)(3) provides two rules to prevent evasion of the original issue requirement. Under the first rule, the exclusion does not apply to stock acquired by the taxpayer if, at any time during the 4-year period beginning 2 years before the issuance of such stock, the corporation purchased (directly or indirectly) any of its stock from the taxpayer or a related person. Section 1202(c)(3)(A). Under the second rule, the exclusion does not apply to stock issued by a corporation if, during the 2-year period beginning 1 year before the issuance of such stock, the corporation made one or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of the 2-year period. Section 1202(c)(3)(B).

The IRS and Treasury are concerned that, in many cases, redemptions that have neither the purpose nor the effect of evading the original issue require-

ment may result in disqualification under these rules. Section 1202(k) authorizes Treasury to prescribe such regulations as may be appropriate to carry out the purposes of section 1202.

##### *Explanation of provisions*

The proposed regulations permit a corporation to redeem de minimis amounts of stock without violating the anti-evasion rules. The proposed regulations also provide that certain redemptions that are incident to events affecting a shareholder and are unlikely to result in evasion of the original issue requirement are disregarded in determining whether redemptions exceed the de minimis amounts. In particular, redemptions upon termination of a shareholder's employment or the death, disability, or mental incompetency of a shareholder are disregarded. Finally, the regulations clarify that transfers of stock by a shareholder to an employee in connection with the performance of services are not treated as redemptions for purposes of the anti-evasion rules.

The regulations will apply to stock issued after the date they are published as final regulations. The regulations will also apply to stock issued on or before that date, but only with respect to the effect of redemptions occurring after that date.

##### *Special Analyses*

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these proposed regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

##### *Comments and Public Hearing*

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and 8 copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

The IRS and Treasury invite comments on matters addressed in the proposed regulations and suggestions for any additional exceptions and clarifications that may be appropriate in the context of the purpose of section 1202(c)(3) and the regulatory authority granted in section 1202(k). The IRS and Treasury specifically invite comments from the small business community.

The IRS and Treasury are particularly interested in comments regarding the scope of the exception for redemptions incident to termination of employment. The IRS and Treasury are committed to extending the exception to independent contractors, but seek comments regarding how to determine when a termination of the independent contractor's services has occurred.

A public hearing has been scheduled for October 3, 1996, at 10 a.m. in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and an outline of topics to be discussed and the time to be devoted to each topic (signed original and 8 copies) by September 4, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

##### *Drafting Information*

The principal author of these regulations is Catherine A. Prohofskey, Office of Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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##### *Proposed Amendments to the Regulations*

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*  
Section 1.1202-2 is also issued under 26 U.S.C. 1202(k).

\* \* \*

Par. 2. Sections 1.1202-0 and 1.1202-2 are added to read as follows:

§ 1.1202-0 *Table of contents.*

This section lists the major captions that appear in the regulations under § 1.1202-2.

§ 1.1202-2 *Qualified small business stock; effect of redemptions.*

(a) Redemptions from taxpayer or related person.

- (1) In general.
- (2) De minimis amount.
- (b) Significant redemptions.
  - (1) De minimis amount.
  - (2) Special rule.

(c) Transfers by shareholders in connection with the performance of services not treated as purchases.

(d) Exceptions for termination of services, death, or disability or mental incompetency.

- (1) Termination of services.
- (2) Death.
- (3) Disability or mental incompetency.
- (e) Effective date.

§ 1.1202-2 *Qualified small business stock; effect of redemptions.*

(a) *Redemptions from taxpayer or related person*—(1) *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.

(2) *De minimis amount.* For purposes of this paragraph (a), stock 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) 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.

(b) *Significant redemptions*—(1) *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.

(2) *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.

(c) *Transfers by shareholders in connection with the performance of services not treated as purchases.* 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).

(d) *Exceptions for termination of services, death, or disability or mental incompetency.* A stock purchase is disregarded for purposes of this section if—

(1) *Termination of services*—(i) *Employees and directors.* The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services;

(ii) *Independent contractors.* [Reserved];

(2) *Death.* The stock is purchased from the deceased shareholder's estate, beneficiary, heir, surviving joint tenant, or from a surviving spouse or a trust established by a decedent, the stock is purchased within 3 years and 9 months from the date of death, and the stock (or an option to acquire the stock) was acquired by the seller before or on account of the death of the decedent; or

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

(e) *Effective date.* This section applies to stock issued after the date these regulations are published as final regulations in the **Federal Register**. This section also applies to stock issued on or before the date these regulations are published as final regulations in the **Federal Register**, but only with respect to the effect of purchases by the issuing corporation that occur after that date.

Margaret Milner Richardson,  
*Commissioner of Internal Revenue.*

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