

these 50 shares, provided she holds them until February 1, 1995, and submits the certification with the tax return on which the capital gain is reported. Taxpayer Y's original 100 shares of JKL stock do not qualify for the small business stock capital gains exclusion.

### **B. On or after August 16, 1991**

Stock issued as a stock dividend on or after August 16, 1991, does not qualify for the small business stock capital gains exclusion since it is not purchased from the corporation at the time of incorporation. A stock dividend does not qualify for the capital gains exclusion even though attributable to stock that qualifies as small business stock.

**Example 1:** Prior to 1986, Taxpayer X acquired 200 shares of MNO Corporation stock that do not qualify as small business stock. MNO declared a stock dividend and, on October 1, 1991, issued one-half of a share of stock for each share owned by the shareholders. Therefore, Taxpayer X received an additional 100 shares. MNO met the small business stock requirements as of December 31, 1990.

The 100 shares of MNO stock issued to Taxpayer X on October 1, 1991, do not qualify for the small business stock capital gains exclusion since Taxpayer X did not purchase them from the corporation at the time of incorporation.

**Example 2:** On January 15, 1992, Taxpayer W acquired 500 shares of PQR Corporation stock that do not qualify as small business stock. PQR declared a stock dividend and, on March 15, 1994, issued one-half of a share of stock for each share owned by the shareholders. Therefore, Taxpayer W received an additional 250 shares. PQR met the small business stock requirements as of December 31, 1993, and so certified to each shareholder.

The 250 shares of PQR stock issued to Taxpayer W on March 15, 1994, do not qualify for the small business stock capital gains exclusion since Taxpayer W did

not purchase them from the corporation at the time of incorporation.

**Example 3:** Taxpayer V purchased 100 shares of STU Corporation stock on December 1, 1987, and received certification that the shares qualify as small business stock. STU declared a stock dividend and, on September 1, 1991, issued one-quarter of a share of stock for each share owned by the shareholders. Therefore, Taxpayer V received an additional 25 shares. STU met the small business stock requirements as of December 31, 1990.

The 25 shares of STU stock issued to Taxpayer V on September 1, 1991, do not qualify for the small business stock capital gains exclusion since Taxpayer V did not purchase them from the corporation at the time of incorporation. However, Taxpayer V may claim the capital gains exclusion for the 100 shares of STU stock issued on December 1, 1987, which qualify as small business stock, provided she holds them until December 1, 1992, and submits the certification with the tax return on which the capital gain is reported.

**Example 4:** Taxpayer U purchased 300 shares of VWX Corporation stock on September 15, 1993, and received certification that the shares qualify as small business stock. VWX declared a stock dividend and, on April 1, 1995, issued one-third of a share of stock for each share owned by the shareholders. Therefore, Taxpayer U received an additional 100 shares. VWX met the small business stock requirements as of December 31, 1994.

The 100 shares of VWX stock issued to Taxpayer U on April 1, 1995, do not qualify for the small business stock capital gains exclusion since Taxpayer U did not purchase them from the corporation at the time of incorporation. However, Taxpayer U may claim the capital gains exclusion for the 300 shares of VWX stock issued on September 15, 1993, which qualify as small business stock, provided she holds them until September 15, 1998, and submits the certification with the tax return on which the capital gain is reported.

**Question 9:** Does the capital gains exclusion for small business stock apply with respect to stock issued as a result of a stock split? (**Note:** A stock split is an increase in the number of shares which evidence ownership without a change in the amount of capital, surplus, or segregated earnings.)

**Answer 9:** The answer depends on whether or not the original shares qualify as small business stock under sec. 71.01(10), Wis. Stats., and, if they do not qualify, on when the new shares are issued, illustrated as follows:

### **A. Original Shares Qualify as Small Business Stock**

If the original shares of stock qualify as small business stock under sec. 71.01(10), Wis. Stats., new shares issued after January 1, 1986, as the result of a stock split will also qualify for the capital gains exclusion. In this situation, the issuance of new stock certificates to evidence the split up of the original shares of stock is not considered the issuance of new or additional stock. The new shares issued will qualify for the exclusion even though the corporation no longer meets the requirements under sec. 71.01(10), Wis. Stats., on the December 31 prior to the stock split (assuming the corporation was incorporated in a year prior to the issuance of the stock). In this situation, the holding period begins when the original shares were issued.

The capital gains exclusion applies provided the taxpayer holds the stock for at least five years from the date of acquisition of the original shares and submits the certification with the tax return on which the capital gain is reported.

**Example 1:** Taxpayer T acquired 100 shares of YZA Corporation stock on November 1, 1988, and received certifi-

cation that the shares qualify as small business stock. YZA declared a two-for-one stock split and, on June 1, 1991, issued one share of stock for each share owned by the shareholders. Therefore, Taxpayer T retained her original stock certificate and received another stock certificate for the additional 100 shares. YZA no longer met the requirements under sec. 71.01(10), Wis. Stats., as of December 31, 1990.

Since Taxpayer T's original 100 shares of YZA stock qualify as small business stock, the additional 100 shares that she received in the stock split will also qualify as small business stock even though YZA no longer meets the small business stock requirements. To qualify for the capital gains exclusion, Taxpayer T must hold the 200 shares of YZA stock until November 1, 1993, and submit the certification with the tax return on which the capital gain is reported. In this situation, the holding period begins when the original shares were issued.

**Example 2:** Taxpayer S purchased 200 shares of BCD Corporation stock on June 1, 1992, and received certification that the shares qualify as small business stock. BCD declared a two-for-one stock split in which the shareholders surrendered their old shares of stock and received two new shares for each share surrendered. BCD issued the new shares on September 1, 1994. Taxpayer S has 400 shares of BCD stock after the stock split. BCD no longer met the requirements under sec. 71.01(10) as of December 31, 1993.

Since Taxpayer S's original 200 shares of BCD stock qualify as small business stock, her 400 replacement shares issued on September 1, 1994, will continue to qualify as small business stock even though the corporation no longer meets the small business stock requirements. To qualify for the capital gains exclusion, Taxpayer S must hold the 400 shares of BCD stock until June 1, 1997, and submit the certification with the tax return on which the capital gain is reported.

#### **B. Original Shares Do Not Qualify as Small Business Stock**

If the original shares of stock do not qualify as small business stock under

sec. 71.01(10), Wis. Stats., the treatment of shares issued as a stock split depends on when the new shares are issued:

##### **1. From January 1, 1986, to August 15, 1991**

Stock issued as a result of a stock split from January 1, 1986, to August 15, 1991, may qualify as small business stock, provided the corporation meets the requirements under sec. 71.01(10), Wis. Stats., as of the December 31 prior to issuance of the stock (assuming the corporation was incorporated in a year prior to the issuance of the stock).

Since the new shares are not acquired by gift, the small business stock capital gains exclusion applies, provided the taxpayer holds the stock for at least five years and submits the certification with the tax return on which the capital gain is reported.

**Example:** Prior to 1986, Taxpayer R acquired 100 shares of EFG Corporation stock that do not qualify as small business stock. EFG declared a three-for-one stock split and, on July 1, 1990, issued an additional two shares of stock for each share owned by the shareholders. Therefore, Taxpayer R retained his original stock certificate and received another stock certificate for the additional 200 shares. EFG met the small business stock requirements as of December 31, 1989, and so certified to the shareholders.

Since Taxpayer R did not acquire the 200 shares of EFG stock issued on July 1, 1990, by gift, he may claim the capital gains exclusion, provided he holds them until July 1, 1995, and submits the certification with the tax return on which the capital gain is reported. Taxpayer R's original 100 shares of EFG stock do not qualify for the small business stock capital gains exclusion.

##### **2. On or after August 16, 1991**

Stock issued as a result of a stock split on or after August 16, 1991, does not qualify for the small business stock capital gains exclusion even though the corporation meets the requirements under sec. 71.01(10), Wis. Stats., as of the December 31 prior to issuance of the stock (assuming the corporation was incorporated in a year prior to the issuance of the stock).

The capital gains exclusion does not apply since the new stock certificates evidence the split up of existing shares of stock that do not qualify as small business stock.

**Example 1:** Prior to 1986, Taxpayer Q acquired 900 shares of HIJ Corporation stock that do not qualify as small business stock. HIJ declared a four-for-one stock split and, on October 1, 1991, issued an additional three shares of stock for each share owned by the shareholders. Therefore, Taxpayer Q retained her original stock certificate and received another stock certificate for the additional 2,700 shares. HIJ met the small business stock requirements as of December 31, 1990.

The 2,700 shares of HIJ stock issued to Taxpayer Q on October 1, 1991, do not qualify for the small business stock capital gains exclusion since Taxpayer Q's original 900 shares do not qualify as small business stock.

**Example 2:** On February 1, 1992, Taxpayer P acquired 600 shares of KLM Corporation stock that do not qualify as small business stock. KLM declared a two-for-one stock split and, on November 15, 1994, issued an additional share of stock for each share owned by the shareholders. Therefore, Taxpayer P retained her original stock certificate and received another stock certificate for the additional 600 shares. KLM

met the small business stock requirements as of December 31, 1993.

The 600 shares of KLM stock issued to Taxpayer P on November 15, 1994, do not qualify for the small business stock capital gains exclusion since Taxpayer P's original 600 shares do not qualify as small business stock.

**Question 10:** How does the capital gains exclusion for small business stock apply with respect to a corporate reorganization?

**Answer 10:** The answer depends on the type of reorganization, which stock shares are reissued, and when the stock is issued, illustrated as follows:

#### A. Consolidation

If two or more corporations consolidate forming a new corporation that issues all replacement shares, the treatment depends on when the replacement stock is issued:

##### 1. *From January 1, 1986, to August 15, 1991*

Replacement stock issued pursuant to a consolidation from January 1, 1986, to August 15, 1991, is considered small business stock if the new corporation meets the requirements under sec. 71.01(10), Wis. Stats., at the time it issues the replacement stock and so certifies to each shareholder.

Since the replacement stock is not acquired by gift, the capital gains exclusion applies, provided the taxpayer holds the replacement stock for at least five years and submits the certification with the tax return on which the capital gain is reported.

**Example:** NOP and QRS Corporations consolidated into new TUV Corporation on November 1, 1987.

On that date, TUV issued replacement shares to the shareholders of the NOP and QRS stock. TUV met the small business stock requirements as of November 1, 1987, and so certified to each shareholder.

Since the replacement stock was not acquired by gift, the capital gains exclusion applies to each taxpayer who holds the stock until November 1, 1992, and submits the certification with the tax return on which the capital gain is reported.

##### 2. *On or after August 16, 1991*

Replacement stock issued pursuant to a consolidation on or after August 16, 1991, does not qualify for the capital gains exclusion since the exclusion does not apply to stock acquired in a stock-for-stock exchange. The replacement shares do not qualify for the capital gains exclusion even if the original shares of stock in the consolidating corporations qualify as small business stock.

**Example:** WXY and ZAB Corporations consolidated into new CDE Corporation on December 1, 1991. On that date, CDE issued replacement shares to the shareholders of the WXY and ZAB stock. CDE met the small business stock requirements as of December 1, 1991.

Since the CDE replacement stock was issued in a stock-for-stock exchange, the capital gains exclusion does not apply to the shareholders who receive CDE stock in exchange for their previously owned WXY or ZAB stock. The capital gains exclusion would not apply even if the original shares of WXY and ZAB stock had qualified as small business stock.

**Note:** If, as part of the incorporation process, additional shares of stock are authorized and issued to new investors who purchase the shares from the

corporation at the time of incorporation and receive certification that the shares qualify as small business stock, these new investors may qualify for the capital gains exclusion. A new investor must hold the stock for at least five years and submit the certification with the tax return on which the capital gain is reported.

#### B. Merger — Replacement Shares Issued to All Shareholders

If two or more corporations merge into a surviving corporation that reissues all stock shares, the treatment depends on when the replacement stock is issued:

##### 1. *From January 1, 1986, to August 15, 1991*

Replacement stock issued pursuant to a merger to the shareholders of both the liquidating and the surviving corporations from January 1, 1986, to August 15, 1991, is considered small business stock if the surviving corporation meets the requirements under sec. 71.01(10), Wis. Stats., as of the December 31 before the stock is reissued (assuming the surviving corporation was originally incorporated in a year prior to reissuance of the stock) and the surviving corporation so certifies to each shareholder.

Since the replacement stock was not acquired by gift, the capital gains exclusion applies, provided the taxpayer holds the replacement stock for at least five years and submits the certification with the tax return on which the capital gain is reported.

**Example:** FGH and IJK Corporations, both incorporated in 1986, merged into IJK Corporation on

January 1, 1988. On that date, IJK issued replacement stock shares to all of the shareholders of the previous FGH and IJK stock. IJK met the small business stock requirements as of December 31, 1987, and so certified to each shareholder.

Since the IJK replacement stock was not acquired by gift, the capital gains exclusion applies to each taxpayer who holds the stock until January 1, 1993, and submits the certification with the tax return on which the capital gain is reported.

2. ***On or after August 16, 1991 — Shareholders of Liquidating Corporation***

Replacement stock issued pursuant to a merger to the shareholders of the liquidating corporation on or after August 16, 1991, do not qualify for the capital gains exclusion since the exclusion does not apply to stock acquired in a stock-for-stock exchange or to stock issued after the time of incorporation. The replacement shares do not qualify for the capital gains exclusion even if the original shares of stock in the liquidating corporation qualify as small business stock.

**Example:** LMN and OPQ Corporations, both incorporated in 1986, merged into OPQ Corporation on December 1, 1991. On that date, OPQ issued replacement stock shares to all of the shareholders of the previous LMN and OPQ stock. OPQ met the small business stock requirements as of December 31, 1990.

Since the OPQ replacement stock was not issued at the time of incorporation and it was issued in a stock-for-stock exchange, the capital gains exclusion does not apply to the shareholders who receive OPQ stock in exchange for their previously owned LMN stock. The capital gains exclusion would not apply even though the original shares of

LMN stock had qualified as small business stock.

3. ***On or after August 16, 1991 — Shareholders of Surviving Corporation***

Replacement stock issued pursuant to a merger to the shareholders of the surviving corporation on or after August 16, 1991, qualifies for the capital gains exclusion if their original shares of stock qualify as small business stock. In this situation, the holding period begins when the original shares were issued.

**Example:** RST and UVW Corporations merged into UVW Corporation on November 1, 1991. On that date, UVW issued replacement shares to all of the shareholders of the previous RST and UVW stock. Taxpayer O purchased stock from UVW on August 1, 1986, and received certification from UVW that the stock qualifies as small business stock. Taxpayer O sells the stock at a gain on September 1, 1992, and attaches the certification to her 1992 income tax return.

The capital gains exclusion applies since Taxpayer O held the stock for more than five years (August 1, 1986, to September 1, 1992). The merger has no effect on the holding period for UVW stock acquired prior to the merger.

C. ***Merger — Replacement Shares Issued Only to Shareholders of Liquidating Corporation***

If two or more corporations merge into a surviving corporation that reissues stock shares to replace those held by shareholders of the liquidating corporation but does not reissue stock to shareholders of the surviving corporation, the following treatment applies:

1. For shareholders of the liquidating corporation, the treatment

is the same as described in Answer 10, Part B.1. and 2., above.

2. For shareholders of the surviving corporation, the small business requirements and five-year holding period with respect to the shares that are not reissued go back to the original applicable date. The capital gains exclusion for those shares applies as if no merger had occurred.

D. ***"F" Reorganization***

If a parent corporation merges into its 100% owned subsidiary solely for the purpose of changing its state of incorporation and the transaction qualifies as an "F" reorganization under sec. 368(a)(1)(F) of the Internal Revenue Code, the treatment depends on when the replacement stock is issued:

1. ***From January 1, 1986, to August 15, 1991***

Replacement stock issued in an F reorganization from January 1, 1986, to August 15, 1991, may qualify as small business stock if the corporation meets the requirements under sec. 71.01(10), Wis. Stats., as of the December 31 prior to the issuance of the stock (assuming the corporation was incorporated in a year prior to the issuance of the stock).

**Example:** DEL Corporation, which was incorporated in Delaware prior to 1986, organized and owned 100% of the stock of WIS Corporation, a subsidiary corporation incorporated in Wisconsin. On January 1, 1989, DEL Corporation merged into WIS Corporation. The operations of DEL Corporation became those of WIS Corporation, and DEL Corporation ceased to exist as a corporation. WIS Corporation issued replacement shares to all of the shareholders of the previous DEL Corporation stock. WIS Corporation met the

small business stock requirements on January 1, 1989.

Since the WIS Corporation replacement stock was not acquired by gift, the capital gains exclusion applies to each taxpayer who holds the stock until January 1, 1994, and submits the certification with the tax return on which the capital gain is reported.

## 2. *On or after August 16, 1991*

Replacement stock issued in an F reorganization on or after August 16, 1991, does not qualify for the capital gains exclusion since the exclusion does not apply to stock acquired in a stock-for-stock exchange. The replacement shares do not qualify for the capital gains exclusion even if the original shares of stock in the merged corporation qualify as small business stock.

**Example:** WIS corporation, which was incorporated in Wisconsin in 1987, organized and owned 100% of the stock of NEV Corporation, a subsidiary corporation incorporated in Nevada. On April 1, 1992, WIS Corporation merged into NEV Corporation. The operations of WIS Corporation became those of NEV Corporation, and WIS Corporation ceased to exist as a corporation. NEV Corporation issued replacement shares to all shareholders of the previous WIS Corporation stock. NEV Corporation met the small business stock requirements on April 1, 1992.

Since the NEV Corporation replacement stock was issued in a stock-for-stock exchange, the capital gains exclusion does not apply to the shareholders who receive NEV Corporation stock in exchange for their previously owned WIS Corporation stock. The capital gains exclusion would not apply even though the original shares of WIS Corporation stock had qualified as small business stock.

**Question 11:** Does the capital gains exclusion for small business stock apply with respect to stock issued in a recapitalization?

**Answer 11:** The answer depends on when the new shares are issued, illustrated as follows:

### A. *From January 1, 1986, to August 15, 1991*

The new shares issued in a recapitalization from January 1, 1986, to August 15, 1991, may qualify as small business stock, provided the corporation meets the requirements under sec. 71.01(10), Wis. Stats., as of the December 31 prior to issuance of the stock (assuming the corporation was incorporated in a year prior to the issuance of the stock).

Since the new shares are not acquired by gift, the small business stock capital gains exclusion applies, provided the taxpayer holds the stock for at least five years and submits the certification with the tax return on which the capital gain is reported.

**Example:** Taxpayer N acquired 100 shares of XYZ Corporation common stock prior to 1986 that do not qualify as small business stock. On April 1, 1990, as part of a recapitalization, Taxpayer N surrendered the 100 shares of common stock and in exchange received 100 shares of XYZ preferred stock. XYZ met the requirements under sec. 71.01(10), Wis. Stats., as of December 31, 1989, and so certified to the shareholders.

Since Taxpayer N did not acquire the 100 shares of XYZ preferred stock issued on April 1, 1990, by gift, he may claim the capital gains exclusion, provided he holds them until April 1, 1995, and submits the certification with the tax return on which the capital gain is reported.

### B. *On or After August 16, 1991*

The new shares issued in a recapitalization on or after August 16,

1991, do not qualify for the small business stock capital gains exclusion. The new shares issued do not qualify for the capital gains exclusion even if the original shares qualify as small business stock under sec. 71.01(10), Wis. Stats., or the corporation meets the requirements under sec. 71.01(10), Wis. Stats., as of the December 31 prior to the issuance of the stock (assuming the corporation was incorporated in a year prior to the issuance of the stock).

The capital gains exclusion does not apply since the new shares are not the original shares that were authorized and issued by the corporation at the time of incorporation.

**Example 1:** Taxpayer M acquired 500 shares of ABC Corporation common stock on March 1, 1989, and received certification that the shares qualify as small business stock. On October 1, 1991, as part of a recapitalization, Taxpayer M surrendered the 500 shares of common stock and in exchange received 500 shares of ABC preferred stock. ABC met the requirements under sec. 71.01(10), Wis. Stats., as of December 31, 1990.

The 500 shares of ABC preferred stock issued to Taxpayer M on October 1, 1991, do not qualify for the small business stock capital gains exclusion since they are not the original shares authorized and issued by the corporation at the time of incorporation.

**Example 2:** Taxpayer L acquired 300 shares of DEF Corporation common stock prior to 1986 that do not qualify as small business stock. On August 1, 1993, as part of a recapitalization, Taxpayer L surrendered the 300 shares of DEF common stock and in exchange received 300 shares of DEF preferred stock. DEF met the requirements under sec. 71.01(10), Wis. Stats., as of December 31, 1992.

The 300 shares of DEF preferred stock issued to Taxpayer L on August 1, 1993, do not qualify for the small business stock capital gains exclusion since they are not the original shares authorized and