Maximizing Section 1202's Gain Exclusion

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Section 1202 permits a taxpayer to claim a gain exclusion in connection with the sale or exchange (including redemption) of qualified small business stock (**QSBS**) issued by a domestic (US) C corporation.[1] For QSBS issued prior to July 5, 2025, the per-taxpayer, per-issuing corporation (the "**QSBS Issuer**") amount of excluded gain is generally capped at $10 million, which translates into $2.38 million of tax savings at the federal level.[2] The **One Big Beautiful Bill Act (OBBBA)** increased the amount of excluded gain to $15 million for QSBS issued after July 4, 2025.[3] Sections 1202 and 1045 were enacted by Congress to encourage investment in C corporations and small businesses. But Congress placed limits on the amount of gain that can be excluded by a taxpayer with respect to a particular corporation's QSBS. Even with those limitations, Section 1202's gain exclusion is among the most attractive tax benefits found in the Internal Revenue Code.

This article first addresses how Section 1202's gain exclusion caps work, and then considers how taxpayers can potentially increase the amount of their excluded gain.

How Section 1202's gain exclusion caps work

Post OBBBA, taxpayers must be familiar with three separate gain exclusions caps:

The $10 million cap. For QSBS issued prior to July 5, 2025, there is a "standard" aggregate $10 million, per-taxpayer, per-QSBS Issuer gain exclusion cap. If a taxpayer is eligible to exclude only 50% or 75% of gain because the taxpayer's QSBS was issued prior to enactment of the 100% gain exclusion, then the caps would function to limit the aggregate gain amount that the applicable percentage would be applied against.[4]

The $15 million cap. OBBBA provides that for QSBS issued after July 4, 2025, the "standard" gain exclusion cap is increased to $15

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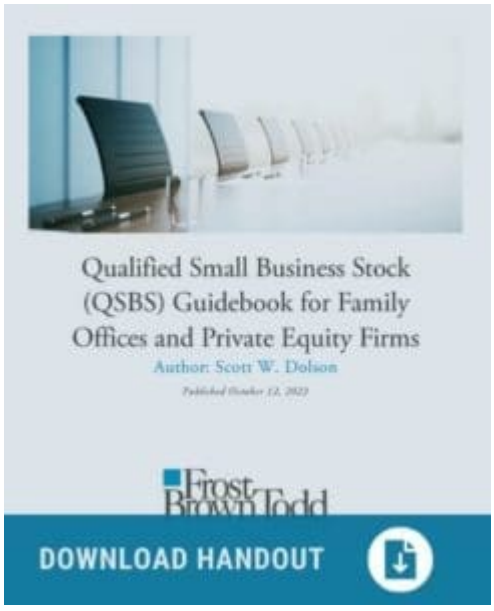
million. If a taxpayer is eligible to exclude only 50% or 75% of his gain because he sells QSBS when his holding period is less than five years, then the cap would be the applicable percentage of $15 million (i.e., $7.5 million or $11.25 million).

The 10X aggregate tax basis cap. In addition to the standard $10 or $15 million caps, taxpayers can take advantage of a separate gain exclusion cap equal to 10 times the taxpayer's adjusted tax basis in a corporation's QSBS sold during a particular tax year (the "**10X Cap**").[5] For example, if the taxpayer sells Corporation A's QSBS in year 2026 with an aggregate tax basis of $5 million, the potential gain exclusion applying the 10X Cap would be $50 million. For purposes of the 10X Cap, a taxpayer's original adjusted tax basis in a share of QSBS equals the money paid for the share and/or the fair market value of property exchanged for the share. If a share of QSBS is issued in exchange for services, the original adjusted tax basis would equal any consideration paid, plus the amount of any compensation income triggered by the issuance.[6] If an employee pays $100 in cash and has $2,000 of compensation income triggered by the issuance of an unrestricted share (or a restricted share coupled with a Section 83(b) election), the tax basis in the share would be $2,100. Capital contributions with respect to previously issued QSBS are ignored for purposes of calculating the 10X Cap.[7]



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Here are several key points to keep in mind:

- Each taxpayer has a separate per-QSBS Issuer standard cap and 10X Cap (but see the discussion below for the treatment of married couples). A taxpayer who holds shares in five QSBS Issuers has separate gain exclusion caps for each QSBS investment.
- If 10 taxpayers hold Corporation A's QSBS, each of the 10 taxpayers would be entitled to a separate Section 1202 gain exclusion and would be subject to a separate (per-taxpayer) gain exclusion cap. For example, if Corporation A issued QSBS founder stock to four taxpayers in year 2018, each of those four taxpayers would have a potential separate $10 million gain exclusion cap and separate 10X Cap.
- If a partnership or S corporation holds and sells Corporation A's QSBS, each owner holding an economic interest when the partnership or S corporation acquired Corporation A's QSBS would be entitled to a separate Section 1202's gain exclusion and would be subject to a separate gain exclusion cap.[8] For example, if Corporation A issued QSBS to Partnership B in year 2018, and at the time of issuance Partnership B had four owners holding economic interests, each of those four owners would have a potential separate $10 million gain exclusion cap and 10X Cap, whether Partnership B sells the QSBS or distributes the QSBS out to the equity owners and the QSBS is sold separately at the taxpayer level.
- For most taxpayers who do not have significant basis in their QSBS, the per-issuer gain exclusion will be limited to the standard $10 or $15 million gain exclusion (i.e., the taxpayers have no tax basis to support the separate 10X Cap).
- A taxpayer with an aggregate tax basis in Corporation A's QSBS greater than $1 million should be able to take advantage of the 10X Cap (the investor's gain exclusion cap exceeds $10 million, assuming Corporation's A's stock was issued prior to July 5, 2025) if all of the stock is sold in a single tax year. For example, if a taxpayer sells Corporation A QSBS with an aggregate $2 million tax basis during year 2025, the potential

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gain exclusion would be $20 million (10 x $2 million = $20 million).

- A taxpayer can have a different per-share tax basis in different blocks of QSBS. For example, a taxpayer might hold founder common stock with *de minimis* tax basis, preferred stock with $100 per share tax basis, and a second class of preferred stock with $200 per share tax basis. Another taxpayer might also hold blocks of QSBS issued before and after the enactment of OBBBA (i.e., stock issued on or prior to July 4, 2025, and stock issued after July 4, 2025). Holding several blocks of QSBS, each with a different per-share tax basis, might be relevant in connection with planning to maximize the amount of available gain exclusion for QSBS sold over multiple years (e.g., in multiple secondary sales).
- Section 1202(b)(3) provides that in the case of a separate return by a married individual, the applicable gain exclusion cap is 50% of the $10 million or $15 million gain exclusion cap. Section 1202 is silent regarding whether married individuals filing jointly are treated as a single taxpayer or separate taxpayers for purposes of the gain exclusion cap (see the discussion below).
- As noted above, capital contributions are ignored for purposes of determining tax basis for purposes of the 10X Cap, so material contributions should be paid in exchange for newly-issued QSBS.

Calculating the applicable gain exclusion cap[9]

Post OBBBA, taxpayers will need to identify blocks of QSBS acquired prior to July 5, 2025, QSBS acquired after July 4, 2025, and blocks of QSBS with tax basis for purposes of the 10X Cap.

With respect to capital gain generated from QSBS prior to July 5, 2025, every taxpayer has a potential standard aggregate gain exclusion cap of $10 million. Once a taxpayer has excluded an aggregate of $10 million of gain (or with respect to gain subject to the 50% or 75% percentage exclusions, the applicable percentage of $10 million), then the taxpayer has no more gain exclusion based on the "standard" $10 million cap. The standard $10 million cap can

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be applied against one or more tax years. If Taxpayer A's first sale of Corporation X QSBS is $5 million worth in year 2025, Taxpayer A can claim the gain exclusion on his 2025 return and has a balance of additional $5 million of potential gain exclusion for subsequent tax years based on the standard $10 million gain exclusion cap.

If Taxpayer A sells QSBS of Corporation X in year 2025, and the aggregate capital gain is $10 million, Taxpayer A would use the standard $10 million gain exclusion. If Taxpayer A sells additional QSBS of Corporation X in year 2032, that was acquired post-July 4, 2025, Taxpayer A would be entitled to an additional standard $5 million gain exclusion based on the OBBBA $15 million gain exclusion. But if the additional QSBS sold in year 2032 was acquired prior to the effective date of OBBBA, there would be no additional standard gain exclusion.

Assume that in year 2032, Taxpayer A holds a block of low basis pre-OBBBA QSBS worth $10 million and a block of low-basis post-OBBBA QSBS worth $5 million. If Taxpayer A's QSBS is sold during multiple years, the pre-OBBBA QSBS should be sold first. If the post-OBBBA QSBS is sold first (e.g., $10 million in capital gains in year 2032, including the post-OBBBA QSBS, and $5 million in capital gains in year 2033), the aggregate gain exclusion would be limited to $10 million. In contrast, if the pre-OBBBA QSBS is sold first and the post-QBBBA QSBS is sold in year 2033, the aggregate gain exclusion would be $15 million.

If Taxpayer A sells QSBS of Corporation X with an aggregate tax basis of $1 million in year 2025, and the aggregate capital gain is $10 million, Taxpayer A would exhaust the standard $10 million gain exclusion and would not receive any additional benefit from the 10X Cap. But, if Taxpayer A sold QSBS with an aggregate tax basis of $2 million in year 2025, and the aggregate capital gain is $20 million, then Taxpayer A would be able to take advantage of a $20 million gain exclusion applying the 10X Cap. But under these facts, the standard $10 million gain exclusion would also burn off in year 2025 – the standard gain exclusion cap applies to the first $10 million of gain excluded. In contrast, if Taxpayer A sold $10 million of QSBS in year 2025, and QSBS with an aggregate tax basis of $1 million in year 2026, then Taxpayer A would be able to use the standard $10 million

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gain exclusion cap to exclude capital gain in year 2025, and would be able to apply the 10X Cap against the $10 million in capital gain in year 2026.

Strategies for increasing the aggregate amount of gain exclusion

The following discussion identifies possible strategies that directly or indirectly result in an increase a taxpayer's Section 1202's gain exclusion.

Selling different blocks of QSBS over multiple years. Many sales of QSBS occur in connection with a sale process and taxpayers will be required to sell all of their QSBS during a single calendar year. But circumstances do arise where a taxpayer's sale of QSBS occurs over multiple years, including secondary sales and situations where taxpayers sell QSBS received as consideration in a sale transaction, which opens the door for some planning opportunities.

If a taxpayer holds low basis QSBS (e.g., founder common stock) and high basis QSBS (e.g., preferred stock), the taxpayer should consider whether selling the low basis stock first will increase the taxpayer's overall gain exclusion. For example, assume Taxpayer A holds founder common stock with a *de minimis* tax basis and preferred stock with a significant per-share tax basis. Taxpayer A sells $10 million of common stock in a secondary sale during year 2025 and claims a $10 million gain exclusion applying the standard $10 million cap. Taxpayer A would then be able to sell the preferred stock in year 2026 and claim a Section 1202 gain exclusion based on the 10X Cap. If the high basis stock is sold first, it will burn off both the standard $10 million cap and the 10X Cap, potentially reducing the taxpayer's overall gain exclusion.

The strategy described above involving the sale of QSBS over multiple years also works where the taxpayer holds a single class of QSBS if those shares have tax basis. The strategy would involve the taxpayer maxing out the standard gain exclusion cap ($10 or $15 million) and then selling additional shares in subsequent tax years. For example, if a taxpayer holds 200,000 shares of Corporation A's QSBS with a $1 per share tax basis, and sells 100,000 of those

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shares for $10.1 million in 2026, that sale would consume the entire $10 million standard gain exclusion cap. If the taxpayer then sells his remaining 100,000 shares in 2027, he can claim an additional $1 million gain exclusion based on the 10X Cap ($100,000 x 10 = $1 million).

The section above addresses the planning issues associated with holding pre-OBBBA and post-OBBBA blocks of stock. The ordering of the sale of those blocks could also affect a taxpayer's overall gain exclusion.

Increasing the potential gain exclusion amount by dividing initial QSBS ownership of QSBS among multiple taxpayers or transferring QSBS by gift to separate taxpayers. Section 1202's gain exclusion is a per-taxpayer gain exclusion. Since the Internal Revenue Code defines a "taxpayer" as "any person subject to any internal revenue tax," the door is wide open for strategies involving the dividing of QSBS among multiple taxpayers. This planning strategy is most effective if it is undertaken in harmony with the balance of a taxpayer's estate and wealth planning.

Taxpayers should consider dividing the initial ownership of QSBS among family members and associated family limited partnerships, LLCs and trusts.[10] Trusts and family entities also facilitate putting in place transfer restrictions and governance arrangements, along with facilitating wealth transfer planning, state income tax planning and asset protection planning. Beyond mere Section 1202 planning, dividing the ownership of assets that are expected to appreciate among family members and family entities can be a powerful strategy from both a estate and gift tax and federal income tax planning standpoint. The fact that Section 1202's gain exclusion is determined on a per-taxpayer basis turbocharges the potential benefits of this strategy. For example, if a taxpayer divides founder common stock among family members, trusts and family entities, gift and estate tax consequences will be minimized and the potential aggregate Section 1202 gain exclusion will be maximized. When the several family-related taxpayers sell the QSBS, each taxpayer will enjoy a separate standard gain exclusion cap.

In spite of the potential benefits of early-stage planning, many stockholders don't pursue planning until the QSBS has appreciated

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substantially in value. Gifting QSBS should still be considered even after the QSBS has appreciated substantially in value.

Under Section 1202, a transfer of QSBS that qualifies as a "gift" for federal income tax purposes is permissible as an exception to the general rule that the original holder must sell the QSBS in order to take advantage of the gain exclusion.[11] **The recipient of a gift of QSBS will step into the taxpayer's shoes with respect to the tax basis and holding period for QSBS, and has a separate gain exclusion cap**.[12] Theoretically, shares of QSBS could be gifted to an unlimited number of separate taxpayers, each of whom would have separate gain exclusion caps.

For example, if Taxpayer A is holding $20 million worth of Corporation A QSBS, she can gift $10 million worth of Corporation A QSBS to a sister who will have a separate $10 million gain exclusion cap when the sister sells the stock. The sister inherits Taxpayer A's per-share tax basis and holding period in the gifted QSBS. The gift and estate tax consequences of a gift transfer of QSBS among family members should be taken into consideration. Also, the parties should consider how the transfer functions within Taxpayer A's overall estate plan. Taxpayer A might also transfer QSBS as a gift to a non-grantor trust, which is treated as a separate taxpayer for federal income tax purposes. The transfer of QSBS by a taxpayer to a disregarded entity held by the taxpayer or to a grantor trust is not treated as a transfer for federal income tax purposes.

A taxpayer engaged in federal income tax planning should also consider federal and state wealth transfer planning and state income tax planning issues. Completed gifts of QSBS will be subject to the gift tax rules and gift tax return reporting requirements. Holders of QSBS can take advantage of annual gifting and the lifetime estate and gift tax exemption (i.e., $13.99 million per individual for year 2025, and under OBBBA, the cap is permanently increased to $15 million for year 2026, and thereafter indexed for inflation), or structure the terms of a trust so that it is a non-grantor trust for income tax purposes but not a completed gift for gift and estate tax purposes

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As noted above, QSBS should be gifted when the value is low, and hopefully well in advance of the sale of the QSBS.[13] If a taxpayer is gifting QSBS to an irrevocable trust, consideration should be given to reserving a special limited power to appoint the trust principal to beneficiaries other than the grantor. This transfer of assets to a trust would be structured as a gift of QSBS for Section 1202 purposes but would be treated as an incomplete gift for gift tax purposes. The taxpayer would not pay gift taxes or file a gift tax return, but here again, the assets of the trust would be included in the taxpayer's estate.[14]

One way to potentially further increase a family's aggregate gain exclusion applies when a taxpayer has blocks of low and high basis QSBS (e.g., founder common stock and preferred stock) and desires to gift stock to a nongrantor trust. For example, if the taxpayer holds a block of low/no basis Corporation A founder common stock issued during 2019 worth $200 million and preferred stock issued in 2024 with a $10 million tax basis, the taxpayer maximizes his family's overall gain exclusion by gifting $10 million of common stock to the nongrantor trust. Using that example, if both the taxpayer and trust sell their Corporation A stock, the taxpayer would claim a $100 million gain exclusion (10 x $10 million) and the trust a $10 million gain exclusion, for an aggregate $110 million gain exclusion. But if the taxpayer instead gifts $9 million worth of common stock and $1 million worth of preferred stock to the trust, the aggregate gain exclusion for the family would be reduced to $90 million at the taxpayer level (10 x $9 million) and $10 million at the trust level, for an aggregate $99 million gain exclusion. The numbers and stock holdings must be right to make this planning work, but the potential tax savings makes it worthwhile to run the numbers and if it works, plan the gifting accordingly.

Taxpayers should also take into consideration how their state of residence treats various QSBS planning ideas for state income, gift and estate tax purposes. Not all states follow the federal income tax treatment of QSBS (e.g., California) or the federal gift and estate tax rules and exclusion limits. It may be possible to create non-grantor trusts in states such as Delaware, Ohio, Tennessee or Nevada, among several others, that provide state income tax benefits, in addition to providing asset protection planning and federal income

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tax planning benefits

Taxpayer A should not transfer QSBS to a family limited partnership or limited liability company in exchange for an economic interest. The transfer would generally be tax-free under Section 721 but would not be treated as a "gift" for federal income tax purposes and would destroy the QSBS status of the transferred stock. Presumably, Taxpayer A could gift QSBS to a family entity so long as Taxpayer A does not receive in exchange from the family entity any associated capital account credit or other economic rights.

Another way to potentially expand Section 1202's exclusion cap is to transfer QSBS at death to two or more beneficiaries, as transfers "at death" are permitted under Section 1202. Transfers "at death" should generally include both transfers from decedents to an estate or trust at death, and transfers by the estate to beneficiaries.

Increasing the potential gain exclusion amount through planning with non-grantor trusts. A taxpayer transfer QSBS to a non-grantor trust is generally treated as a "gift" for federal income tax purposes, which works under Section 1202. The trust would step into the transferor's holding period and tax basis for transferred QSBS.

Increasing the gain exclusion amount by gifting QSBS to a Delaware incomplete-gift non-grantor (DING) trusts or Nevada incomplete-gift non-grantor (NING) trusts, or acquiring QSBS from the issuing corporation through a DING or NING (or comparable trusts established in states such as Ohio and Tennessee who have adopted similar trust statutes that in some cases are intended to be more attractive than Delaware's trust statutes) has increased dramatically in popularity in recent years as more taxpayers have gravitated to operating their businesses through domestic (US) C corporation and pursued the benefits of QSBS ownership. The reason for the popularity of trust planning for QSBS stock is obvious. If Taxpayer A holds Corporation B's pre-OBBBA QSBS worth $200, and transfers $100 worth as a gift to non-grantor Trust D, each of Taxpayer A and Trust D will later be entitled to a separate $10 million gain exclusion. The same would be true if Taxpayer A waits until the QSBS was actually worth $20 million before transferring $10 million as a gift to

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Trust D, but under those circumstances, the gift and estate tax consequences would merit careful consideration.

The intent, purpose and terms of a trust agreement and the timing of gifts to trusts must be carefully considered. Founders and investors utilize DINGS and NINGS for a variety of mixed tax, business and personal reasons. Trusts can be a useful vehicle through which to engage in asset protection planning, shielding assets from beneficiaries or protecting assets from poor investment decisions through the use of professional asset management. Trusts are also a useful tool for advanced estate and gift tax and non-tax planning (for example, trust planning often centers around taking advantage of more favorable state laws for the administration of trusts). If a taxpayer creates multiple non-grantor trusts, each non-grantor trust should generally be treated as a separate taxpayer with its own separate gain exclusion caps. [15] Careful attention will need to be paid to establishing the bona-fide business (personal) non-tax reasons for establishing DINGS and NINGS, and consideration must be duly given to the potential impact of the IRS's ability to pursue trust consolidation under authority of Section 643(f).[16]

Strategies involving the 10X Cap – waiting for property to appreciate before contributing it to a corporation in exchange for QSBS (including incorporating a partnership). When property (other than money or stock) is contributed to a corporation in exchange for QSBS, Section 1202(i)(B) provides that the basis of the QSBS issued in exchange for the contributed property is no less than the fair market value of the property exchanged. This provision impacts the amount of Section 1202 gain exclusion in two important ways. First, since the tax basis for purposes of Section 1202 is equal to the fair market value of the property at the time of the contribution, any spread between the tax basis of the contributed property and its fair market value at the time of contribution would not qualify for Section 1202's gain exclusion. Second, an amount equal to the fair market value of the contributed property would be the applicable tax basis for purposes of determining the 10X Cap.

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For example, if Taxpayer A contributes property with a tax basis of zero and fair market value of $5 million in a Section 351 nonrecognition exchange to a C corporation in exchange for QSBS, and the QSBS is later sold for $65 million. Under those circumstances, the first $10 million of capital gains triggered by the sale does not qualify for Section 1202's gain exclusion, but the next $50 million would qualify applying the 10X Cap. The gain in excess of the 10X Cap would be subject to capital gains tax.

Section 1202(i)(B)'s tax basis for contributed property rule creates a planning opportunity. Business owners can operate their business as a limited partnership or LLC until the assets have attained sufficient value to make the 10X Cap work (i.e., in excess of $1 million), and then incorporate.[17] A partnership whose assets are worth $45 million can incorporate, creating the potential down the road for a $450 million (10 x $45 million = $450 million) gain exclusion. But take note that there are potential planning downsides associated with adopting this strategy. First, the spread between the tax basis and fair market value at the time of incorporation does not qualify for Section 1202's gain exclusion. If a partnership is incorporated when its assets are worth $2 million (with a zero basis) and the corporation's QSBS is ultimately sold for $10 million, waiting to incorporate will not have paid off since the gain exclusion will be $8 million rather than $10 million. Second, the holding period for the QSBS does not commence until the QSBS (corporate stock) is issued.[18] Finally, a corporation cannot issue QSBS if the aggregate value of the assets contributed upon incorporation exceeds $75 million (for QSBS issued after July 4, 2025).

See ***Converting Partnerships into C corporation Issuers of QSBS, Part 1*** and ***Converting Partnerships into C corporation issuers of QSBS, Part 2*** for more information about the tax and non-tax issues associated with moving from a pass-through entity to a domestic (US) C corporation.

Strategies involving the 10X Cap – "packing" a corporation with money, contributed property or services. Taking advantage of the 10X Cap can result in a stockholder's aggregate gain exclusion exceeding the standard $10 or $15 million caps.[19]

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As mentioned above, if a stockholder has an aggregate tax basis exceeding $1 million in Corporation A's QSBS, then the 10X Cap would potentially permit an aggregate gain exclusion exceeding $10 million. If it makes good business (and tax) sense to operate a business in the early start-up years as a partnership (i.e., limited partnership or multi-member limited liability company), and then later incorporate the business, it would be possible to take advantage of the provision in Section 1202 providing that appreciated property is contributed to the corporation at the property's fair market value for purposes of the Section 1202 tax basis. So, for example, if a business is incorporated when the tax basis of the partnership's assets is zero but worth $20 million, and the QSBS is later sold for $300 million, Section 1202 would function to require the first $20 million to be subject to capital gains tax, but the next $200 million would be eligible for gain exclusion applying the 10X Cap.

A potential planning opportunity arises because for purposes of the 10X Cap, you look at the aggregate tax basis for all QSBS sold by a taxpayer in a given taxable year, not merely the tax basis in QSBS that the holding period requirement for claiming the gain exclusion. Where a founder holds a block of low basis, high value founder common stock and a block of high basis preferred stock, if both blocks are QSBS and are sold in the same tax year, the tax basis of the QSBS sold is aggregated to determine the 10X Cap, even if the later purchased preferred QSBS has not met the required holding period for claiming the gain exclusion. Because of how the these rules function, a way to potentially increase a taxpayer's aggregate gain exclusion might be to "pack" the corporation with additional money or property in exchange for the issuance of additional high-basis QSBS.[20] "Packing" a corporation with money or property should be undertaken for non-tax bona-fide business reasons (i.e., does the corporation need the money, property or services?), and should be accompanied by contemporaneous evidence that fair values for any contributed property later used to support claiming the benefits of the 10X Cap.[21] Note that "packing" requires the issuance of additional QSBS – a capital contribution with respect to outstanding QSBS will not work.

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There are several planning issues that should be given careful consideration in connection with planning for the 10X Cap:

- Attention should be paid to avoid failing Section 1202's $75 million test (applicable to post-July 4, 2025, QSBS issuances). [22]
- The holding period doesn't commence until QSBS is issued and treated as being owned by the holder. Business owners should weigh the benefits of postponing incorporation to potentially take advantage of the 10X Cap against the benefit of commencing their QSBS holding period.
- Being able to substantiate the value of contributed property is critical as Section 1202 provides that the tax basis for Section 1202 is the value of the contributed property. The best evidence of value would be established through a contemporaneous appraisal.
- Intellectual property, including self-created intellection property can be contributed as property to a corporation in exchange for QSBS, but substantiation of value is critical.
- All of the rules of Section 351 apply with respect to contributed appreciated property. If the contributors of appreciated property do not have 80% control after the contribution, the contribution would be taxable to the contributors, which might be alright given the potential benefits of the 10X Cap.
- QSBS can be issued for services and the recipient of QSBS granted as compensation would have a tax basis in the QSBS for purposes of the 10X Cap equal to the amount of compensation income triggered by the issuance, plus any amount paid for the service-provider stock.

Potentially increasing the gain exclusion amount by splitting ownership of QSBS between spouses. Section 1202(b)(1) provides that if a **taxpayer** has eligible gain, that gain is subject to the gain exclusion caps discussed elsewhere in this article. Section 1202 speaks in terms of per-taxpayer gain exclusion. There is no question that spouses filing a joint return are each treated as separate "taxpayers" for various purposes the Internal Revenue

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Code.[23] But Section 1202 also includes language addressing that fact that if married individuals file separate returns the $10 million or $15 million general gain exclusion cap is split equally between spouses. So, the multi-million dollar tax savings question is whether under Section 1202, married individuals filing jointly can separately sell Corporation A QSBS and separately claim a gain exclusions subject to separate gain exclusion caps, or whether the married couple is limited to a single gain exclusion and cap?

The Tax Court has held that "*it is a long recognized legal maxim that a husband and wife are separate and distinct taxpayers notwithstanding the fact that they have filed joint Federal income tax returns*."[24] Beyond that inescapable conclusion, there are tax authorities that can be cited as support for and against the argument that each spouse would be entitled to a separate gain exclusion cap. For example, the IRS has ruled, for purposes of the $5 million limitation of Section 453A, that the taxpayer and his spouse are not considered a single taxpayer. In coming to that conclusion, the IRS stated that:

In particular, if Congress had intended that married individuals be treated as one taxpayer for purposes of applying the $5,000,000 limitation set out in section 453A, it could have easily provided for this attribution in express terms rather than resort to a strained and unlikely interpretation of sections 52 and 1563. In fact, in numerous other Code provisions, Congress has specifically provided for the allocation of various limitations among married individuals. See, e.g., section 38(c)(3) (limitation on the general business credit); section 163(h) (limitations on amounts treated as acquisition or home equity indebtedness); section 179(b)(4) (limitation on election to expense certain depreciable business assets); section 1211(b) (limitation on capital losses). Where Congress is silent on this point, as in section 453A, we do not believe that an allocation between married individuals can be implied.[25]

The Tax Court's *Marvin I. Levy* decision could be cited by the IRS to support the imposition of a massive marriage penalty for spouses owning QSBS.[26] *Marvin I. Levy* involved a possible marriage

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penalty associated with the limit on claiming capital losses – two individuals each having a $2,000 cap on capital losses prior to marriage after marriage limited to a single $2,000 loss. In its decision, the Tax Court noted that the married couple was a "taxable unit" and that the joint return should be viewed as filed by a "single individual" and following that logic, the "*limitation of $2,000 above capital gains, upon capital losses, can be applied only once—to the aggregate net capital loss ascertained.*" The Tax Court went on to note that:

[t]he reason for filing a joint return is to amalgamate the items of income, losses, etc., of the two spouses, so that there may be offsets unavailable in the individual returns. Thus it appears that there are no longer two individuals, with their own rights to deductions, but an impersonalized return of items of income, losses, deductions, etc., which, though originating in the affairs of two people, are no longer so viewed, because all are merged and integrated into a whole. By exercising the option to obtain the benefit of such merger, the spouses are seen logically to lose their identity, and the right to claim individual deductions, which have become those of the integrated returner of income. It would be peculiar illogic to permit the 'joint' return to give the benefit of offset of gains and losses not available to the individual by merging all items, including capital gains and losses of the spouses, yet to say that in one very particular respect, the limitation on capital losses, there is no such merger, and that the identity of the taxpayer is preserved, so that each can individually take a deduction of $2,000 capital losses. More accurate consideration indicates that capital losses and gains, like all other items returned, are by virtue of such return no longer those of either party, but of one entity, the returner of income, that all items are, as indicated in the Janney case, added together, or put into hotchpotch, and that the aggregate result, and not the result in the case of each individual, is the subject of tax computation. It follows that if capital losses add up to more than capital gains plus $2,000, there can be, under section 117(d), no allowance above that limit. The limitation, like the offsetting of gains and losses, is

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not separate, but a part of the method of computation of the income under the integrated return. That there is such impersonality is well indicated by the fact that the resultant tax is less than that of both individuals considered separately-such result being the practical reason for filing a joint return.

But in a dissent from the Tax Court's majority opinion, Judge Kern noted that:

the majority opinion, reasoning from certain language used by the Supreme Court in the cases of Helvering v Janney, 311 U. S. 189, and Taft v. Helvering, 311 U. S. 195, has reached the conclusion that where husband and wife file a joint return a union results even more complete than the union created by the marriage ceremony in that 'there are no longer two individuals, with their own rights to deductions, but an impersonalized return of income, losses, deductions, etc., which, though originating in the affairs of two people, are no longer so viewed, because all are merged and integrated into a whole,' and that capital losses 'are by virtue of such return no longer those of either party, but of one entity, the returner of income' and thus are limited by section 117(d) to $2,000 plus capital gains. I can find no justification in the statute for this view and nothing in the Janney case or Taft case which compels this conclusion.

The tax authorities cited above scratch the surface of various tax authorities that could be cited when looking at this issue. The bottom line is that while there are tax authorities supporting a position that each spouse can separately tax advantage of the full gain exclusion caps, but there are no tax authorities expressly addressing the issue in the context of a claimed QSBS tax exclusion.

Increasing the gain exclusion amount by reinvesting QSBS sales proceeds in replacement QSBS under Section 1045. Section 1045 permits taxpayers to sell QSBS and reinvest tax-free some or all of their proceeds in one or more replacement QSBS investments. Usually, Section 1045 comes into play if the original QSBS

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investment is sold before attaining the necessary holding period to claim Section 1202's gain exclusion, but Section 1045's election can also be made by a taxpayer where the sale of the original QSBS has generated gain exceeding the applicable caps, and the taxpayer desires to reinvest the excess proceeds tax-free in replacement QSBS. Neither Sections 1202 or 1045, or other tax authorities addressing reinvestment in replacement QSBS appear to restrict the ability of taxpayers to spread their reinvested proceeds among multiple issuers of replacement QSBS, thereby potentially multiplying the gain exclusion to include the standard gain exclusion for each investment in replacement QSBS. For example, if Taxpayer A sells an original investment in pre-OBBBA founder QSBS of Corporation A acquired in year 2019 for $18 million, Taxpayer A can claim a $10 million gain exclusion and elect to reinvest $8 million under Section 1045 in one or 10 investments in replacement QSBS. Taxpayer A has a potential $10 million gain exclusion for each separate investment in replacement QSBS. If the original QSBS was acquired prior to July 5, 2025, the replacement QSBS acquired pursuant to a Section 1045 election would not be eligible for the increased gain exclusion under OBBBA.

Increasing the gain exclusion amount using Roth IRAs. Stock purchased through a Roth IRA can appreciate without triggered taxable income, can be sold by the Roth IRA without triggering taxable income, and subject to the rules regarding distributions, sales proceeds can be distributed to the beneficiary free from federal income taxes. The Roth IRA is effectively an alternative strategy for avoiding federal income tax on capital gain triggered by a stock sale, regardless of whether that stock is QSBS. Roth IRAs may be particularly helpful where the aggregate gain exceeds a taxpayer's gain exclusion caps. See ***Structuring the Ownership of Qualified Small Business Stock (QSBS) – Is There a Role for Roth IRAs?***

Increasing the gain exclusion amount through the original issuance of QSBS to nonresidents who are not citizens of the United States. This strategy is similar to spreading QSBS at an early stage among multiple US citizens, with the only difference being that there is no cap on the exclusion from capital gains for nonresident, non-US citizens. Nonresidents who are not citizens of

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the United States are generally not subject to US taxation on capital gains, although these seller may be subject to taxes triggered by the stock sale in non-US taxing jurisdictions. The beneficial treatment of capital gains for nonresidents who are not citizens of the United States applies to the stock of any domestic corporation, including QSBS Issuers.

Increasing the gain exclusion amount by making gifts of QSBS to nonresidents who are not US citizens. This strategy is similar to transferring QSBS by gift at among multiple US citizens, with the only difference being that there is no cap on the exclusion from capital gains for nonresident, non-US citizens. The transfer of stock, including QSBS, as a gift (for federal income tax purposes) by a US resident to either a US resident or nonresident does not trigger federal income taxation. Under Section 2501(a), the transfer of stock by a US resident to a resident or nonresident may be subject to gift tax. If the nonresident, non-US citizen later sells the stock, the seller would generally not be subject to US taxation on the capital gains regardless of the amount of gain, although the seller may be subject to taxation in non-US taxing jurisdictions. An obvious strategy would be to either transfer QSBS to a nonresident, non-US citizen while the value is low, thereby avoiding any transfer tax issue.

Closing remarks

Engaging in one or more of the planning strategies outlined will often have tax, business and often personal consequences for the parties involved beyond QSBS planning. All of these factors and consequences should be taken into account as part of the planning process. Taxpayers engaged in advanced QSBS tax planning should consider seeking the advice of tax professionals who regularly work with QSBS.

Please 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 for more QSBS-related analysis curated by topic, from the choice of entity decision and Section 1202's gain exclusion to Section 1045 rollover

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transactions.

More QSBS Resources

- Substantiating the Right to Claim QSBS Tax Benefits | Part 1
- Substantiating the Right to Claim QSBS Tax Benefits | Part 2
- One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors
- To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)
- Advanced Section 1202 (QSBS) Planning for S Corporations
- Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 2
- Structuring the Ownership of Qualified Small Business Stock (QSBS) – Is There a Role for Roth IRAs?
- Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide
- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations
- Can Stockholders of Employee Leasing or Staffing Companies Claim Section 1202's Gain Exclusion?
- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving QSBS
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion
- A SPAC Merger Primer for Holders of Qualified Small Business Stock

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- 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

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[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. Many but not all states follow the federal income tax treatment of QSBS. For QSBS issued prior to July 5, 2025, the required holding period is greater than five years. For QSBS issued after July 4, 2025, the required holding period starts at three years for a 50% gain exclusion and increases to five years for a 100% gain exclusion.

[2] This example assumes a 20% capital gains rate, plus a 3.8% net investment income tax. Additional tax saving may be available at the state level. In addition to the $10 million or $15 million per-taxpayer, per-corporation gain exclusion cap, there is a separate cap equal to 10 times the aggregate tax basis of QSBS sold in a tax year, which can result in more than a aggregate $10 million or 15 million gain exclusion depending on a taxpayer's aggregate tax basis on whether the QSBS is sold over more than one year.

[3] A discussion of the OBBBA can be found in *One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors*. The amendments to Section 1202 include a reference to Section 1223 which has the effect of blocking the conversion of pre-OBBBA QSBS

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into post-July 4, 2025, QSBS through stock-for-stock exchanges or in connection with the reinvestment of pre-OBBBA sale proceeds into replacement QSBS under Section 1045.

[4] For example, the standard gain exclusion cap for QSBS issued in 2008 would be $10 million, and the applicable percentage exclusion would be 50%, with the other 50% taxed at 28%, plus the 3.8% investment income tax), plus treatment of the excluded percentage as a preference item for purposes of the alternative minimum tax.

[5] Language of Section 1202(b) prior to amendment by OBBBA:

Per-issuer limitation on taxpayer's eligible gain.

(1) In general. If the taxpayer has eligible gain for the taxable year from 1 or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation which may be taken into account under subsection (a) for the taxable year shall not exceed the greater of—

(A) $10,000,000 reduced by the aggregate amount of eligible gain taken into account by the taxpayer under subsection (a) for prior taxable years and attributable to dispositions of stock issued by such corporation, or

(B) 10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year. For purposes of subparagraph (B), the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued.

(2) Eligible gain. For purposes of this subsection, the term "eligible gain" means any gain from the sale or exchange of qualified small business stock held for more than 5 years.

(3) Treatment of married individuals.

(A) Separate returns. In the case of a separate return by a married individual, paragraph (1)(A) shall be applied by substituting "$5,000,000" for "$10,000,000."

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(B) Allocation of exclusion. In the case of any joint return, the amount of gain taken into account under subsection (a) shall be allocated equally between the spouses for purposes of applying this subsection to subsequent taxable years.

(C) Marital status. For purposes of this subsection, marital status shall be determined under section 7703.

[6] An employee's tax basis in a share of QSBS would be the value of QSBS when it vests for purposes of Section 83, or at the time of issuance if a Section 83(b) election is made (the value should equal the aggregate of the per share amount paid and compensation). Unvested shares (shares subject to substantial risk of forfeiture under Section 83) are not eligible for Section 1202's gain exclusion when sold.

[7] If utilizing the 10X Cap is a key objective, additional QSBS should be purchased from the issuer rather than making capital contributions.

[8] There are somewhat complicated rules regarding the sharing of Section 1202's gain exclusion among partners when the partnership sells QSBS.

[9] This example and others throughout this article assume for purposes of illustration that all of Section 1202's eligibility and holding period requirements are satisfied when the applicable QSBS was sold.

[10] If the trust is a grantor trust, the "taxpayer" is the grantor and is treated as the owner of the QSBS for Section 1202 purposes. If the trust is a non-grantor trust, the "taxpayer" is the trust, and the trust is treated as the owner of the QSBS for Section 1202 purposes.

[11] The transfer of QSBS must qualify as a "gift" for federal income tax purposes. A transfer of QSBS for value will terminate the treatment of stock as QSBS. A transfer of QSBS by an employer or another stockholder on behalf of the corporation to another stockholder generally won't qualify as a "gift." A transfer undertaken in connection with a business transfer also won't generally qualify as a "gift." Tax authorities note that what constitutes a gift for federal income tax purposes may not qualify as a gift for federal gift and

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estate tax purposes, and vice versa. A transfer of QSBS into a non-grantor trust is generally treated as a gift for federal income tax purposes. A transfer or sale of QSBS to a grantor trust is generally ignored for federal income tax purposes. A transfer by Taxpayer A into a family limited partnership or limited liability company in exchange for an interest is generally not a gift for federal income tax purposes (e.g., the transferor receives a capital interest, capital account credit or other economic rights in the exchange).

[12] This result assumes that the gift is made before there is a binding contract to sell the QSBS, thereby avoiding an assignment of income argument.

[13] QSBS should be gifted before there is a binding contract to sell the QSBS to avoid an "assignment of income" argument by the IRS.

[14] This incomplete gift, non-grantor trust is referred to generally as an ING (a DING in Delaware and NING in Nevada).

[15] Referred to by some as "stacking" (multiplying) trusts for Federal income tax planning purposes. There are no tax authorities addressing the use of non-grantor trusts in connection with Section 1202 tax planning, but see Treasury Regulation Section 1.199A-6(d)(3)(vii) which provides that that a trust formed with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A will not be respected as a separate trust for purposes of determining the threshold amount for purposes of Section 199A and Treasury Regulation Section 1.643(f)-1 which provides that "two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of this rule, spouses will be treated as one person."

[16] Section 643(f) provides that "*2 or more trusts shall be treated as 1 trust if — such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and a principal purpose of such trusts is the*

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avoidance of the tax Imposed by this chapter."

[17] The pre-incorporation business could also be operated as a sole proprietorship.

[18] For QSBS issued prior to July 5, 2025, the QSBS must have been held for more than five years when sold in order to qualify for claiming Section 1202's gain exclusion.

[19] A taxpayer could have tax basis for Section 1202 by contributing cash or property to the issuing corporation in exchange for QSBS.

[20] See Paul S. Lee, L. Joseph Comeau, Julie Miraglia Kwon and Syida C. Long, Tax Notes Federal, *Qualified Small Business Stock: Quest for Quantum Exclusions*, Special Report, and Daniel Mayo, Withum, Smith+Brown, *Stacking and Packing — Strategies to Maximize the Section 1202 Exclusion*.

[21] For example, if there are contemporaneous Section 409A valuations or other valuations of the corporation, those should be taken into account in determining the amount and economic features of the newly-issued QSBS. Section 1202(k) provides that the IRS may issue regulations to prevent "the avoidance of the purposes of [Section 1202] through split-ups, shell corporations, partnerships, or otherwise." To date, the IRS hasn't addressed Section 1202 income tax avoidance schemes through regulations, but the potential focus on "shell corporations" is there.

[22] When appreciated property is contributed into an issuer of QSBS on a tax-free basis under Section 351 nonrecognition exchange, including upon incorporation of a partnership, the tax basis of the property for purposes of Section 1202, including the 10X Cap, is the fair market value of the property rather than its historic tax basis. Deferring the date that a partnership is incorporated could backfire if the greater than five year holding period requirement becomes an issue down the road.

[23] A husband and wife filing a joint return are persons who are jointly and severally subject to a tax, and therefore, each is a taxpayer within the meaning of the Internal Revenue Code. Section 7701(a)(14) defines a taxpayer to be "any person subject to any

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internal revenue tax" and that under Section 6013(d)(3), each spouse has joint and several liability for the tax shown on a joint return.

[24] *Nell v. Commissioner*, T.C. Memo 1982-228 (citing *Dolan v. Commissioner*, 44 T.C. 420, 428 (1965)). In *Dolan*, the Tax Court stated that

> *[t]he case law also supports treating as separate 'taxpayers' a husband and wife who have filed a joint return. In what appears to be the only case in which the single entity theory was expressly ruled upon, the court held that husband and wife who filed a joint return were separate taxpayers, so that an assessment entered pursuant to a notice of deficiency sent to the husband was ineffective as to the wife. United States v. Hammerstein, 20 F. Supp. 744 (S.D.N.Y. 1937).*" The Tax Court in *Kroh v. Commissioner*, 98 T.C. 383, states that "*section 6013(d)(3) and section 1.6013-4(b), Income Tax Regs., provide very strong support for the proposition that a husband and wife remain separate taxpayers even though they file a joint return.*

[25] TAM 9853002 (1/04/1999).

[26] 46 BTA 1145 (1942).

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