Advanced Section 1045 Planning

Jan 17, 2020

Categories:

Qualified Small Business Stock (QSBS)
Section 1045 Rollover Planning
Tax Law Defined™ Blog

Authors:

Scott W. Dolson

This article is one of a series addressing planning issues relating to qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Internal Revenue Code.

With the corporate tax rate reduced from 35% to 21%, there is a heightened awareness that Section 1202 potentially allows business founders and investors to exclude millions of dollars of taxable gain when they sell QSBS if all of the taxpayer and issuing corporation level qualification requirements are met.

Section 1045 complements Section 1202, allowing taxpayers who haven't achieved a five-year holding period for their QSBS to roll otherwise taxable gain on the sale of their QSBS on a tax-deferred basis into replacement QSBS.

Section 1045 allows a taxpayer to defer gain on the sale of QSBS

Section 1045 permits a taxpayer to defer otherwise taxable gain on the sale of QSBS held for at least six months by rolling the sales proceeds over into replacement QSBS. If the taxpayer successfully rolls over the sales proceeds under Section 1045, gain on the sale of the original QSBS will be deferred until the replacement QSBS is sold. This result applies whether or not the taxpayer qualifies for Section 1202's gain exclusion on the sale of the replacement QSBS. The amount of gain deferred under Section 1045 will be reduced if less than 100% of the proceeds from the sale of the original QSBS are rolled over into replacement QSBS.

Section 1045 acts as a companion provision to Section 1202, allowing taxpayers who have rolled their sales proceeds over into replacement QSBS the opportunity to take advantage of Section 1202's gain exclusion if all of Section 1202's requirements are met when the replacement QSBS is sold.

Section 1045 also acts on a stand-alone basis to defer gain on the initial sale of the original QSBS. This gain deferral applies whether or not the ultimate sale of the replacement QSBS qualifies for the

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

FBT Gibbons

Section 1202 gain exclusion.

Satisfying the requirements to claim Section 1045's gain deferral on the sale of QSBS

In order to qualify for Section 1045's tax-deferred rollover of QSBS gain into replacement QSBS, the following requirements must be satisfied:

- With respect to the issuance of the original QSBS, both the taxpayer and the issuing corporation must meet all of Section 1202's requirements from the date of issuance of the original QSBS through the sale of the original QSBS.
- The original QSBS must be held by the taxpayer for more than six months when the initial sale occurs.
- The original QSBS must be sold (a liquidation of the issuing corporation or redemption, subject to applicable redemption rules, can be treated as a sale).
- If all of the proceeds from the sale of the original QSBS are rolled over into replacement QSBS, then all of the gain on the initial sale is deferred. If less than 100% of the sales proceeds are reinvested in replacement QSBS, then only a pro-rata portion of the gain will be deferred. If less than 100% of the proceeds will be rolled over into replacement QSBS, consider selling the original QSBS in separate blocks and rolling over 100% of the proceeds from a particular block of original QSBS into replacement QSBS.
- Replacement QSBS must be purchased during the 60-day period beginning on the date of the sale of the original QSBS. The proceeds from the sale of the original QSBS are not required to be traced to the purchase of the replacement QSBS. A taxpayer can purchase a pickup truck with proceeds from the original QSBS sale and use other funds to purchase replacement QSBS. A taxpayer with proceeds from the sale of the original QSBS can purchase replacement QSBS in one or more corporations issuing QSBS, including corporation(s) organized by the taxpayer.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

- The corporation issuing replacement QSBS must meet Section 1202(c)(2)'s active business requirements for a period of at least six months after issuing replacement QSBS. The significance of this requirement is that the taxpayer will be able to defer gain on the sale of the initial QSBS even if after six months the corporation issuing the replacement QSBS fails after six months one or more of Section 1202's requirements. But the replacement (former) QSBS will no longer be eligible for the Section 1202 gain exclusion when it is eventually sold if the corporation issuing the replacement QSBS fails the active business requirements.
- If the original QSBS is acquired, held and sold by a partnership, then either the partnership or the partner can elect under Section 1045 to roll the sales proceeds into replacement QSBS. Section 1045's regulations provide detailed rules for determining a taxpayer's proportionate share of QSBS sales proceeds and proceeds recognized by the flow-thru entity which would be eligible for reinvestment in replacement QSBS at the partnership or taxpayer levels.
- A taxpayer must make an election to roll over the proceeds under Section 1045 on a timely filed tax return for the year in which the original QSBS is sold.
- When Section 1045 applies, the taxpayer's holding period for the original QSBS is added to the holding period for the replacement QSBS.[1]
- A taxpayer making a Section 1045 election should maintain comprehensive documentation supporting the position that (a) the taxpayer and the corporation issuing the original QSBS met all of the Section 1202 requirements (other than the five-year holding period), (b) that the original QSBS was sold and the proceeds were reinvested during the 60-day window, and (c) that the replacement stock also met all of the Section 1202 requirements. If the replacement QSBS is ultimately sold and the Section 1202 gain exclusion claimed, the taxpayer will also need to document that all taxpayer level and issuing corporation level Section 1202 requirements were met during the entire holding period for the replacement QSBS.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

Section 1045 Planning Opportunities

As discussed above, Section 1045 functions both as a stand-alone gain deferral provision and also works in tandem with Section 1202 in situations where the taxpayer ultimately claims the Section 1202 gain exclusion with respect to the replacement QSBS.

Section 1045's gain exclusion operates independently to defer gain, whether or not the Section 1202 gain exclusion is ultimately available with respect to the replacement QSBS. In situations where a taxpayer sells the original QSBS prior to achieving the required five-year holding period, Section 1045 is available to defer gain if the taxpayer reinvests the sales proceeds into replacement QSBS. This deferral of gain on the initial sale of the original QSBS works whether or not the taxpayer ultimately claims the Section 1202 gain exclusion with respect to the replacement QSBS. In order to successfully roll over gain on the sale of the original QSBS, Section 1202(c)(2)'s active business requirements need only be met by the corporation issuing the replacement QSBS during the six-month period after the issuing the replacement QSBS. After six months, the corporation issuing the replacement QSBS could make an S election, begin engaging in business activities that don't qualify under Section 1202, or accumulate excessive cash, investment assets or non-operating real estate, in each case without affecting tax-deferred treatment of the reinvestment of gain from the sale of the original QSBS.

Dealing with the problem of finding replacement QSBS by forming a corporation to engage in start-up activities or acquire the assets or equity of an active business. Finding attractive investments in replacement QSBS won't be difficult for some venture capital investors. But for many taxpayers selling their original QSBS, finding a suitable place to invest sale proceeds within 60 days will be the most difficult part of Section 1045 planning. A possible solution would be to reinvest the sales proceeds in a newly-formed C corporation, organized by the taxpayer for the purpose of undertaking start-up and research and development activities intended to culminate in engaging in an active business under Section 1202(c)(2). As discussed below, another possible solution would involve reinvestment of the sales proceeds in a

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

newly-formed C corporation organized for the purpose of acquiring the assets or equity of an active business. As discussed below, the sales proceeds generated from the sale of the original QSBS sale can be, and often should be, divided into multiple newly-formed C corporations if these strategies are undertaken.

QSBS sales proceeds must generally be reinvested in a corporation engaged in an active business on the date replacement QSBS is issued. But there are a couple of potentially important exceptions to this general rule discussed below.

Forming a corporation (Newco) to issue replacement QSBS and engage in start-up or research and development activities. Section 1202(e)(2) permits a corporation issuing QSBS to engage in start-up activities and/or research and development intended to culminate in an active business. This language appears to give taxpayers quite a bit of latitude in fashioning a start-up business plan culminating in the undertaking of an active business. The period during which Newco engages in start-up activities and/or research and development activities are being undertaken should count towards the five-year holding period requirement for claiming the Section 1202 gain exclusion.

Taxpayers intending to engage in start-up activities through Newco should have a convincing business plan and budget supporting their position that Newco was an active business when it issued replacement QSBS. Taxpayers should not assume that they can meet the five-year holding period requirement by "parking" their original QSBS sales proceeds in the Newco while making feeble gestures towards engaging in start-up or research and development activities, followed by the liquidating of Newco when they have a five-year holding period for Newco's replacement stock (including the holding period for the original QSBS). Although there are no specific guidelines in Section 1202 regarding a taxpayer's intent, or the actual effort necessary for moving Newco from start-up activities into engaging in an active business, but it seems reasonable to assume that any naked attempt to take advantage of Section 1045 by merely parked funds would be unlikely to withstand a facts and circumstances analysis in connection with an IRS challenge. Taxpayers should develop a

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

compelling and convincing business plan and budget that demonstrates the need for 100% of the sales proceeds rolled over into Newco, assuming that Newco develops as hoped, including capital needs for funding start-up expenses, research and development (as applicable) and working capital, and, as applicable, acquiring assets or equity of other businesses necessary for Newco's active business endeavors. It is a reality, of course, that in many cases Newco's efforts will not succeed, and the founder will eventually shutter Newco, liquidate and distribute the remaining cash in Newco, if any, presenting an opportunity to claim the Section 1202 gain exclusion if all of the requirements are met. If Newco succeeds, then the goal would be to work towards a liquidity event where Newco's founder sells the replacement QSBS.

Taxpayers who have sales proceeds from the sale of original QSBS that exceeds the amount reasonably needed by Newco should consider either coming up with a second or multiple start-up ventures (additional Newcos) in which to roll over sales proceeds, finding opportunities during the 60-day window for investing sales proceeds in third-party QSBS or keeping excess proceeds outside of Newco and forgoing the Section 1045 rollover with respect to the excess sales proceeds.

Under Section 1045, when a taxpayer uses the proceeds from the sale of the original QSBS to acquire replacement QSBS, the taxpayer's basis in the replacement QSBS is reduced by the amount of the gain deferral. So, when the replacement QSBS stock is sold, the deferred gain will either be permanently excluded from income as part of the Section 1202 gain exclusion or be taken into income as additional capital gain. A liquidation of the corporation (Newco) that issued replacement QSBS will be treated as a deemed sale of its assets for purposes of determining whether there is any corporate-level tax triggered by the liquidation. The liquidating corporation will have a tax basis in cash equal to the amount of the cash and may have net operating losses (NOLs) if the corporation never generated income. In many cases, there won't be any income at the corporation level triggered by the liquidation. If the owners qualify for the Section 1202 gain exclusion, there also won't be any taxable income at the shareholder level. For example, if a taxpayer defers taxable gain of $1 million under Section 1045, the

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

taxpayer will have zero basis in the replacement QSBS, and Newco will start with a $1 million basis in the cash subscription proceeds. If Newco operates for two years and spends $150,000 on deductible start-up activities, has no income during that period, and ultimately liquidates, Newco would usually have no gain at the corporate level in connection with the liquidation (unless it had developed valuable IP or holds other valuable assets other than cash) and the shareholders will either be entitled to exclude the $850,000 deemed sales proceeds for their replacement QSBS (triggered by the liquidation) or if they don't qualify for the Section 1202 gain exclusion, they would have $850,000 in capital gains.

Pursuing a strategy of using rolled over proceeds to acquire active businesses in taxpayer organized C corporations. Section 1202 appears to permit a strategy involving the use by a taxpayer of original QSBS sales proceeds to acquire the assets or equity of active businesses through one or more newly-formed Newcos. This conclusion is based on the fact that there is nothing in Section 1202 requiring Newco to start-up a business de novo. The only express guideline in Section 1202 is that Newco must own more than 50% of the combined voting power or value of any subsidiary's stock (applicable if Newco acquires the equity of active businesses). Section 1202(e)(5) indirectly confirms that Newco can operate its active businesses through subsidiaries. Although Section 1202 is silent regarding the treatment of joint ventures operated through partnerships and LLCs, there is no reason to conclude that Newco cannot be deemed to operate active businesses through joint ventures. Section 1202 requires that any cash, real estate holdings, investment assets and business activities of a subsidiary or joint venture be taken into account in determining whether Newco meets Section 1202's issuing corporation requirements.

The IRS might conceivably make a step-transaction or abuse argument if the taxpayer forms one or more Newcos to acquire the stock of active businesses, perhaps arguing that taxpayers, in the absence of Section 1045 planning, would purchase the equity of target corporation directly rather than through Newco. A significant counter to this position would be that holding companies are commonly formed by buyers as vehicles through which to purchase the equity or assets of target companies because there are

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

significant non-tax and tax (outside of Sections 1202 and 1045) reasons, including asset protection, for placing a "blocker" corporations between the buyer and the target business.

One potential further argument that the IRS would make relates to Congress' authorization for the IRS to promulgate Section 1202 anti-abuse rules that can include rules regarding "shell corporations."[2] Arguably, the reference in Section 1202(k) to "shell corporations" gives the IRS ammunition for arguing that reinvesting QSBS through a newly-formed corporation abuses Section 1202's purposes. As previously mentioned, there are good arguments why this isn't the case, including the fact that Section 1202 expressly contemplates parent-subsidiary arrangements[3] and doesn't suggest that a qualified small business must be one started de novo in order for the benefits of Section 1202 to be available to investors and founders holding QSBS. There appears to be little substantive difference between forming a new corporation to acquire assets of a qualified small business, something even the IRS should freely admit fits comfortably within the spirit and letter of Section 1202 and the further step of forming a new corporation to issue QSBS and acquire the equity or assets of a qualified small business. Another relevant point it that while Section 1202 was enacted in 1993, regulations addressing anti-abuse rules have never been promulgated by the IRS, which raises the question of whether Section 1202(k) has any import in the absence of those regulations.

Taking advantage of the "substantially all" reference in Section 1202 in connection with satisfying the active business requirement. Section 1045 literally requires that QSBS sales proceeds be reinvested in the QSBS of a corporation engaged in an "active business." But as discussed above, a taxpayer should be able to satisfy this requirement if the sales proceeds are ultimately expended to either create or acquire an active business. If sales proceeds rolled over under Section 1045 sit idle in Newco for the purpose of being used to purchase the assets of an active business, a taxpayer should be able to rely on the "substantially all" requirement of Section 1202(c)(2) in connection with satisfying the active business requirement, which is generally thought to translate into a requirement that the active business requirement must be met for approximately 80% of a taxpayer's QSBS holding period.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

For example, if a taxpayer holds original QSBS for one year, then sells the original QSBS and purchases replacement QSBS from Newco, which in turn uses the funds six months later to acquire an active business, the taxpayer should satisfy the active business requirement at the point the taxpayer has held the replacement QSBS for at least 80% of the taxpayer's replacement QSBS holding period. For example, at the point the taxpayer has held replacement QSBS for three years, the reinvested sales proceeds would have been invested in an active business for 2½ years out of the taxpayer's 3 year holding period for the replacement QSBS, or 80% of the taxpayer's holding period for the replacement QSBS.

Multiplying the Section 1202 gain exclusion using Section 1045. Section 1202(b) places limits on the amount of gain that can be excluded by a taxpayer under Section 1202 with respect to an issuing corporation's QSBS. In general, where a taxpayer has minimal tax basis in QSBS, the limit is $10 million per issuing corporation. This raises the question of whether the $10 million limit can be expanded by reinvesting QSBS sales proceeds under Section 1045 into multiple corporations. Neither Section 1045 nor Section 1202 explicitly addresses this issue, but the literal wording of Section 1202(c)(2) supports the position that if a taxpayer's original QSBS sales proceeds are reinvested under Section 1045 in QSBS of multiple issuing corporations, the taxpayer should have a separate $10 million gain exclusion available for each issuing corporation. This conclusion opens the door for the strategy of reinvesting sales proceeds into multiple Newcos, each of which engages in start-up activities or acquires the assets or equity of an active business.

Section 1045 planning for partnerships. Partnerships (including venture capital and private equity funds) can invest in QSBS. If the partnership sells QSBS that it has held for six months, Section 1045 and applicable Treasury Regulations[4] allow for Section 1045 rollover of QSBS gain by either the partnership or eligible partners. A companion article addressing investment in QSBS through Funds (limited partnerships and LLCs taxed as partnerships) will be forthcoming.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

How to handle the Section 1045 election when the original QSBS is sold in a Section 453 installment sale. QSBS can be sold in an installment sale transaction under Section 453[5], and the instructions to Schedule D provide clear guidance regarding how to report and take the Section 1202 gain exclusion. But what happens if there is an installment sale of QSBS where the taxpayer desires to roll over the sales proceeds under Section 1045 because he doesn't have the five-year holding period necessary to qualify for the Section 1202 gain exclusion? Both the language of Section 1045 and the instructions to Schedule D strongly suggest that a taxpayer must buy replacement QSBS during the 60-day period beginning on the date of the sale of the original QSBS and that the Section 1045 election must be made no later than the due date (including extensions) for filing his tax return for the tax year in which the original QSBS is sold. Given this framework, the safe advice appears to be to elect out of installment sale treatment and rollover sales proceeds into replacement QSBS during the 60-day period after the sale of the original QSBS. This plan should be implemented even though some of the actual payment installments are in subsequent years. The fact that a taxpayer may not have the funds available to roll over into replacement QSBS until later installment payments are received is a problem without a clear solution.

Closing remarks

The details of advanced Sections 1202 and Section 1045 planning are not commonly understood. Founders, investors, advisors, and return preparers engaging in advanced planning should consider seeking the advice of tax professionals who regularly handle QSBS issues. In particular, taxpayers and other participants in the planning process should want to know whether there is substantial authority for tax return positions. Finally, taxpayers and other participants in the planning process should also seek advice regarding potential penalties and the IRS's disclosure rules.

Business owners and professionals who want to learn more about IRC §§ 1202 and 1045 planning opportunities are directed to several articles on the Frost Brown Todd website:

- Section 1202 Qualification Checklist and Planning Pointers

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- The 21% Corporate Rate Breathes New Life into IRC § 1202
- 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

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

---

[1]Section 1223(13).

[2]Section 1202(k) provides that "the Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including regulations to prevent the avoidance of the purposes of this section through split-ups, shell corporations, partnerships, or otherwise."

[3] Section 1202(e)(5) contemplates that you "look-thru" to more than 50% owned subsidiaries and take account of their attributes relevant to the determination of whether the issuing corporation qualifies as an active business for Section 1202 purposes.

[4] Treasury Regulation § 1.1045-1.

[5]Installment sale treatment under Section 453 generally applies if there is a sale in one tax year and one or more payments are made in taxable years after the year of sale.

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

FBT Gibbons