Private Equity and Venture Capital Fund Investment in Qualified Small Business Stock (QSBS) – A Guide to Obtaining the Benefits of Sections 1202 and 1045

Feb 17, 2020

Categories:

Advanced QSBS Planning
Qualified Small Business Stock (QSBS)
Tax Law Defined™ Blog

Authors:

Scott W. Dolson

This article is a guide for investors and fund sponsors who purchase, own and sell qualified small business stock (QSBS). The article focuses on investment in QSBS by private equity (PE) funds and venture capital (VC) funds (together, "Funds"), but would apply equally to other investors owning QSBS through LPs and LLCs.

The article also focuses on investments in QSBS through limited partnerships (LPs) and limited liability companies (LLCs) taxed as partnerships and the rules for claiming the Section 1202 gain exclusion through these pass-thru entities. This article also addresses the potential rollover of gain on the sale of QSBS under Section 1045 into replacement QSBS.

For those existing and potential Fund sponsors and investors who are new to Section 1202, this guide is intended to provide a high-level road map for structuring Fund investments in QSBS and documenting compliance with Section 1202's taxpayer level and issuing corporation level requirements. For those venture capital sponsors and investors who routinely invest in QSBS, this guide is a reminder that the satisfaction of each Section 1202 requirement must be adequately documented.

What is Qualified Small Business Stock (QSBS)? And what is the significance of Section 1202?

QSBS is the term used by Section 1202 for stock issued by a qualified small business that can potentially qualify for the Section 1202 gain exclusion. Section 1202 of the Internal Revenue Code provides for a potential exclusion from federal income tax (including alternative minimum tax and the 3.8% net investment income tax

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

and often state income taxes) of 100%[1] of gain from the sale of QSBS, if all of the requirements of Section 1202 are satisfied. Each taxpayer can potentially exclude at least $10 million of gain from each issuing corporation's QSBS.[2] Partnerships and S corporation pass through the excluded Section 1202 gain to owners on their Schedule K-1s. C corporations cannot claim the Section 1202 gain exclusion. QSBS can be any class or series of an issuing corporation's stock, including either or both preferred and common stock.

Businesses operating in partnerships (including LLCs) can be converted into C corporations and issue QSBS to the former Owners in connection with their conversion. But, if a VC or PE firm intends to operate a business through a pass-thru entity during the start-up period so that investors can take advantage of losses, the owners should be prepared to convert to a C corporation before Section 1202's $50 million fair market value threshold presents a problem.

No election or filing is required at the time of issuance for stock to qualify as QSBS. The Section 1202 gain exclusion must be claimed on the tax return for the year QSBS is sold. Unless QSBS is distributed by a Fund to its members or partners (Owners), the Fund that acquires original issue QSBS must sell the QSBS. There are a number of taxpayer and issuing corporation level requirements for stock to qualify as QSBS, including a five-year holding period requirement that applies both at the Fund level with respect to its holding of QSBS and at the Owner level with respect to the Fund's equity.

An important aspect of QSBS planning is the need to develop and maintain contemporaneous documentation confirming that each of the Section 1202 requirements have been satisfied. This effort should focus on determining what documentation can be gathered when QSBS is issued and during its holding period to establish to the IRS or Tax Court judge's satisfaction that each requirement has been satisfied. Several articles addressing Section 1202's qualification requirements in further detail are referenced at the end of this article.

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

Sections 1202 and 1045 background information

Most venture capitalists, PE groups (PEGs) and hedge fund sponsors are aware that the reduction in the corporate tax rate from 35% to 21% has increased interest in C corporations and that the C corporation's tax benefits can be dramatically enhanced if shareholders qualify for the Section 1202 gain exclusion. Today we are seeing both a steady stream of venture capitalists who are considering purchasing QSBS or are already holding and selling QSBS, and increased interest on the part of sponsors who are considering structuring funds focused on QSBS investments. We do not believe that the full potential of Section 1202 has been explored by PE sponsors (PEGs). Under the right circumstances, Section 1202 can deliver dramatic tax savings for a PEG's investors.

Section 1045 allows sellers of QSBS who have not achieved the five-year holding period required by Section 1202 to roll their sales proceeds on a tax-deferred basis into replacement QSBS. A successful rollover of QSBS sales proceeds under Section 1045 defers gain until the replacement stock is sold. Assuming the replacement QSBS meets all of Section 1202's requirements, the taxpayer will be able to take advantage of the Section 1202 gain exclusion when the stock is eventually sold. The holding period for the original and replacement QSBS are combined for purposes of satisfying Section 1202's five year holding period requirement.[3]

A short history of Section 1202

Section 1202 originally become law in 1993. The legislative history states that Section 1202 was designed to provide "targeted relief for investors who risk their funds in new ventures [and] small businesses." The gain exclusion was intended to "encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing." In connection with increasing the gain exclusion to 100% in 2010, the legislative history noted that the "increased exclusion and the elimination of the minimum tax preference for small business stock will encourage and reward investment in qualified small business stock." Section 1202 has historically received strong support from the angel and VC communities.

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

Past legislative handouts circulated by the Angel Capital Association have supported passage of a 100% Section 1202 gain exclusion (this mission was accomplished in 2010), reducing the investment holding period from five to two years (not yet achieved), simplifying the determination of whether a business was a qualified small business (definitely not yet achieved) and allowing a taxpayer's holding period for his LLC interests to tack onto his QSBS holding period in connection with partnership incorporations (a great idea but not yet achieved).

The National Venture Capital Association (NVCA) has proposed that the size threshold for qualified small businesses be increased from $50 million (which was pegged in 1993) to $100 million, that the "substantially all" standard and the method of verifying Section 1202 qualification be reformed, and that the Section 1045 rollover period be expanded from 60 to 180 days.[4] The NVCA has asserted that a purpose of its lobbying efforts includes spurring the growth of larger venture capital funds financing the nation's startups.

Some academics have voiced skepticism about the economic justification for the QSBS gain exclusion. Professor Victor Fleisher has written of QSBS that "a better name would be the 'angel investor loophole'. Angel investors and venture capitalists, of course, argue that these are precisely the type of start-ups that tend to create new jobs, and thus they should be encouraged, not taxed. Perhaps the low tax rate encourages angels to put more money into start-ups instead of index funds. On the other hand, it is not clear that the tax break is necessary to encourage investment that would not otherwise take place . . . Tax is not a first-order consideration." [5]

Adam Looney of the Urban-Brookings Tax Policy Center argued in a blog focusing on wealthy taxpayer's use of C corporations that the QSBS gain exclusion "has little justification on economic grounds, accrues almost entirely to the highest-income taxpayers, and will prove costly with a 20 percent corporate rate; it should be repealed."[6]

U.S. Representative David Camp proposed an end to Section 1202 in 2014 draft tax reform legislation. Instead, Section 1202's 100% gain exclusion was retroactively extended in 2015 and made permanent.

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

Section 1202's gain exclusion was untouched in the extensive 2017 tax legislation.

During 2019, Representative Mark Pocan and Senator Elizabeth Warren introduced the "Stop Wall Street Looting Act." Section 710 of that draft legislation provided that Section 1202's gain exclusion would no longer apply to any gain allocated with respect to an "investment services partnership interest" (presumably a carried interest). As of February, 2020, this legislation hasn't advanced beyond its introduction, and it does not appear at this point that Section 1202 has surfaced in the tax reform discussions broached as part of the 2020 Presidential campaign.

If Section 1202's benefits are so great, why hasn't everyone been actively pursuing QSBS investments?

Section 1202 has been around since 1993 and has gone through several amendments over the years. With Section 1202's potential for an outsized gain exclusion, you might ask why the provision remains so obscure to so many investors and tax advisors. Put another way, why isn't everyone talking about Section 1202's benefits and why isn't everyone taking advantage of the gain exclusion?

From 1993 through 2017, there existed a combination of factors that made it unattractive for most founders and investors involved with main street businesses to consider Section 1202's benefits. Until 2011 or so, the Section 1202 percentage gain exclusion was less than 100% (at one point 50%, later 75%). Further, the gain exclusion was subject to alternative minimum tax and the portion not eligible for the Section 1202 gain exclusion was taxed at 28% (higher than the then-applicable capital gains rates).

A key requirement under Section 1202 is that the business be operated as a C corporation and that QSBS must be C corporation stock. Prior to 2018, few attorneys engaging in choice of entity planning for main street businesses would recommend operating through a C corporation rather than a pass-through entity (i.e., LLCs, limited partnerships or S corporations). There were a number

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

of significant reasons why a C corporation's tax features were unattractive for typical main-street businesses. All of those reasons related to the fact that over the lifecycle of a business, the after-tax money landing in the pocket of owners was often less if a closely-held business was operated through a C corporation rather than a pass-thru entity. Some examples of why this was the case include : (a) operating through a C corporation introduced the potential for double taxation (taxation at the corporation and shareholder levels); (b) shareholders could not use a C corporation's losses on their personal returns; (c) flushing money out of C corporations triggered taxation as compensation income or dividends; (d) dividends are not deductible; (e) money accumulated in C corporations is potentially subject to the personal holding company or accumulated earnings surtaxes, and (f) purchasers of C corporation stock do not benefit from a tax basis step-up allowing for future amortization of purchased goodwill for tax purposes.

The overwhelmingly negative view of C corporations held by many tax planners over the past several decades must be reconsidered today. One of the most significant changes introduced by tax legislation enacted during 2017 was the reduction of the corporate tax rate from 35% to 21%. This reduced tax rate delivers a windfall for businesses operating as C corporations, which has caused business owners and tax advisors to reconsider the C corporation. It seems that when Congress reduced the corporate rate to 21%, the potential additional benefits afforded by Section 1202 and 1045 were hiding in plain sight. Today, while operating a business in a C corporation may not be optimal for every situation, the potential use of the C corporation certainly merits serious reconsideration.

Another observation is that while main street businesses may have been firmly in the camp of pass-thru entities, Silicon Valley venture financed start-ups have historically been predominately organized as C corporations. For a number of reasons going back several decades, investors who support venture financed start-ups have elected to invest through in C corporation preferred stock. A positive consequence of Silicon Valley's loyalty to the C corporation is the fact that the preferred stock issued to VC angels and investors often satisfies Section 1202's requirements. As a result,

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

Section 1202 has successfully delivered a quiet windfall for VC investors.

Funds can hold QSBS and Fund Owners can take advantage of Section 1202's gain exclusion if the Fund sells QSBS.

Most taxpayers, including Funds, other pass-thru entities (e.g., S corporations), trusts and individuals can hold QSBS and qualify for the Section 1202 gain exclusion. If a Fund sells QSBS, its Owners (other than C corporation Owners) can potentially take advantage of the Section 1202 gain exclusion.

C corporations, including C corporation Fund investors, cannot take advantage of the Section 1202 gain exclusion. Tax-exempt investors in Funds aren't subject to tax on capital gains and won't benefit from the Section 1202 gain exclusion. Foreign investors are generally not subject to US taxation on capital gains, so they won't benefit from the Section 1202 gain exclusion. Fund promoters will need to take the identity of their investors into consideration when structuring investments in QSBS. Funds could focus on QSBS investments and focus on attracting investors who can fully utilize Section 1202's gain exclusion. Funds could also split out investors who can use the Section 1202 gain exclusion into their own blocker corporations, much as they do for investors who don't want Schedule K-1 pass-thru income.

A Fund can hold the QSBS of multiple issuing corporations. It isn't unusual for a Fund to invest in the QSBS of several corporations.

Sponsors can organize Funds focusing on QSBS investments. Sponsors could also concentrate on providing investors with a vehicle for rolling over Section 1202 gain into replacement QSBS.[7] Certainly, the former Fund objective is easier to accomplish than matching the needs of investors rolling over Section 1202 gain, as each investor will have a different holding period for his original QSBS along with varying investment objectives for the replacement QSBS.

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

Funds can distribute QSBS to eligible Owners who can then sell the QSBS and claim the Section 1202 gain exclusion at the Owner level.

Section 1202 permits Funds to distribute QSBS to Owners who can then take advantage of the Section 1202 gain exclusion, but each Owner is limited to the amount of gain exclusion that would have been allocated under Section 1202 if the Fund had sold the QSBS. For example, if QSBS is distributed to an Owner who wasn't an Owner at the time the QSBS was acquired by the Fund, that Owner generally won't be able to claim any Section 1202 gain exclusion when he sells the distributed QSBS.

Sales of Fund interests do not trigger the right to claim a Section 1202 gain exclusion.

A sale of an equity interest in a Fund is not treated as the sale of QSBS held by the Fund, and the sale doesn't trigger the right to claim a Section 1202 gain exclusion. The exception would be the situation where the Owner holds all of the equity of a disregarded LLC, since a wholly-owned disregarded LLC isn't a "pass-thru" entity for Section 1202 purposes but rather is treated as a "nothing" for tax purposes and the QSBS is treated as being owned directly by the Owner.

The assignee of a transferred Fund equity interest will generally not have the right to claim a Section 1202 gain exclusion when the Fund sells QSBS held at the time of the transfer.

As discussed in more detail below, the sharing of the right to claim the Section 1202 gain exclusion among Owners when a Fund sells QSBS is determined by reference to the "interest" held by each Owner in the Fund on the date QSBS was acquired. If an Owner transfers the equity interest in the Fund held on the date QSBS was acquired, the purchaser of the equity interest won't be able to claim the Section 1202 gain exclusion with respect to such Fund interest.

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

FBT Gibbons

Where an upper-tier Fund holds an equity interest in a lower-tier Fund, the purchaser of an equity interest in the upper-tier fund also won't be able to satisfy the requirement set out in the first sentence of this paragraph.[8]

One exception to the rule that transfers (e.g., sales) of a Fund's equity interest destroys Section 1202 gain exclusion eligibility with respect appears to be transfers of Fund interests by gift or upon death of the Owner.[9] Another exception is where the Fund distributes QSBS to an Owner and the Owner subsequently sells the QSBS. An Owner selling distributed QSBS will only be entitled to claim the Section 1202 gain exclusion with respect to those shares that represent the Owner's equity "interest" on the day the Fund originally acquired the distributed QSBS. For example, if the Owner had 100 Units in a Fund on the date QSBS was purchased and was distributed a disproportionate share of the Fund's QSBS in redemption of his 100 Units, the Owner would be limited to claiming the Section 1202 gain exclusion with respect to the share of QSBS associated with his original 100 Units.

Determining an Owner's "interest" in a Fund for purposes of claiming the Section 1202 gain exclusion

When a Fund holds and sells QSBS, Section 1202 governs the determination of the amount, if any, of Section 1202 gain exclusion that can be claimed by each Owner. An important concept for taxpayers to remember is that while the applicable partnership or operating agreement governs how Owners share taxable income and sales proceeds generated from the sale of QSBS, those agreements don't determine the amount of Section 1202 gain exclusion available to each Owner. In fact, the amount of Section 1202 gain exclusion available to be claimed by an Owner will often differ from the amount of gain on the sale of QSBS allocated to an Owner and the amount of sales proceeds distributed to an Owner.

Section 1202(g)(3) provides that the amount of Section 1202 gain exclusion available to an Owner when a Fund sells QSBS is limited to the amount available to the Owner by reference to the Owner's

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

"interest" in the Fund on the date the QSBS was acquired. Under the Section 1045 regulations, an "eligible partner" is defined as an Owner on the date the Fund acquires QSBS (or if the Owner is a partnership, then an Owner of the partnership in the tiered structure) or acquired the Fund interest by gift or upon death from an eligible partner.[10] These two descriptions of what constitutes an Owner who can claim a Section 1202 gain exclusion are consistent and the Section 1045 regulations actually expand the scope of Section 1202 to holders of Fund equity interests who obtained their interests by way of gift or upon the death of the original holder.

Section 1202(g)(2)(B) provides that an Owner's share of QSBS gain is eligible for the Section 1202 gain exclusion to the extent "such amount is includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-thru entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-thru entity." Section 1202(g)(3) further elaborates on the question of an Owner's interest by providing that the excludable gain is limited to the extent the gain exceeds the amount which would have been excluded if the Owner's interest in the Fund at the time of the sale exceeds the interest in the Fund at the time the QSBS was purchased.

The Section 1045 regulations provide some level of authority and at the least useful insight into what the IRS would likely argue constitutes an Owner's "interest" in the Fund for purposes of allocating gain exclusion. These regulations provide that an Owner's interest is "smallest percentage interest in partnership capital determined at the time of the acquisition of the QSB stock as adjusted prior to the time the QSB stock is sold to reflect any reduction in the capital of the eligible partner including a reduction as a result of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the eligible partner or the transfer of an interest by the eligible partner, but excluding income and loss allocations."[11] This definition of "interest" appears to place a limit on an Owner's share of Section 1202 gain equal to the Owner's relative capital interest on the date QSBS is purchased to the aggregate capital interests on that date.

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

The Section 1045 regulations go on to further reduce an Owner's share of Section 1202 gain in certain situations where the Owner's share of capital is reduced between the date of purchase and date of sale of QSBS. If these Section 1045 rules are applied to determine the sharing of the Section 1202 gain exclusion (i.e., where no Section 1045 rollover is involved), then the rules can be interpreted to limit or perhaps eliminate the ability of Owners holding profits interests (e.g., carried interests) on the date of QSBS purchase from entitlement to a Section 1202 gain exclusion. This result flows from the fact that the capital account and aggregate capital contributions of a profits interest holder is typically less than such Owner's share of profits and losses. For example, a carried interest issued on the day QSBS is purchased might have a zero capital account and capital contribution balance on that date, but might be entitled to a 20% interest in certain distributions. If the Section 1045 rules are literally applied to determine the sharing of the Section 1202 gain exclusion under these circumstances, the carried interest holder would not be entitled to any Section 1202 gain exclusion, in spite of the fact that when the QSBS is sold such Owner might be allocated substantial taxable income and distributed 20% of the net sales proceeds.

Some commentators argue that while the Section 1045 regulations may work for purposes of determining the right to roll over QSBS sales proceeds under Section 1045, those regulations don't work and shouldn't be applied, and might well be invalid, for purposes of determining the allocation of the Section 1202 gain exclusion in connection with a straight sale of QSBS under Section 1202, where no Section 1045 rollover of gain into replacement QSBS is involved. [12] Those same commentators might also argue that where an Owner's carried interest was issued and had the right to share in profits as of the date QSBS was purchased, the eventual profits allocated to the carried interest holder when the QSBS is eventually sold should determine the holder's "interest" in the Fund. While this result appears to be a logical and reasonable reading of Section 1202, taxpayers engaged in upfront compensation planning when structuring Funds with profits interests and capital interests should nevertheless consider the Section 1045 regulations as a tax authority (albeit not necessarily definitive authority) that would

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

support a restrictive reading of "interest" by the IRS.

If the potential application of the Section 1045 regulations is a significant issue for Fund promoters, they should consider whether Fund personnel can bypass the problem by investing directing in the issuing corporation's QSBS. Structuring an issuance of penny stock should be viable workaround solution to the carried interest problem, particularly where the issuing corporation is a start-up and a low value can be set on common stock subordinated to preferred equity issued to the Fund.

Regardless of how one comes out on the application of the Section 1045 regulations, it is clear that after QSBS is purchased by a Fund, an Owner's share of the Section 1202 gain exclusion can't ever proportionately increase and certainly can proportionately decrease. For example, if an Owner's interest in profits was 5% on the date QSBS was purchased, the Owner's share of the eventual Section 1202 gain exclusion can decrease after that date (for example, if the Owner transfers the Fund interest) but can never go above the 5% initial share of the Section 1202 gain exclusion. If an Owner's right to a share of Section 1202 gain exclusion is reduced or lost, that share is not reallocated to other Owners.

If additional Fund equity is issued after the Fund purchases QSBS and the new Fund equity shares in the allocation of profits, the 5% holder's share of the Fund's gain on the sale of QSBS will decrease and the new owners will not be entitled to share in the Section 1202 gain exclusion. An unanswered question is whether it would be possible to specially allocate profits from the sale of QSBS to only those Owners who held interests on the date QSBS was purchased. It does seem possible that classes of equity could be created for the purpose of specially allocating profits with respect to specific Fund holdings. But whether specially allocating Section 1202 gain would have substantial economic effect for Section 704(b) purposes is unclear based on current tax authorities.

Just as holders of convertible debt, options and warrants in an issuing corporation are not treated as holding QSBS for Section 1202 purposes, holders of convertible debt, options and warrants in a Fund purchasing QSBS will not be treated as Owners for purposes

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

of allocating the Section 1202 gain exclusion when the Fund sells the QSBS. Again, this would be the result even if the holders of convertible debt, options or warrants hold equity and are allocated taxable income when the QSBS is sold.

Determining the amount of Section 1202 gain exclusion when QSBS is held by a Fund

If a Fund holds and sells QSBS, each qualifying Owner of the Fund will have a separate per-issuing corporation gain exclusion of at least $10 million. In other words, if a Fund invests in five corporations, each Owner can potentially exclude at least $10 million of gain arising out of the sale of each corporation's QSBS (i.e., for a potential aggregate per-Owner gain exclusion of $50 million). [13]

Issuing QSBS in connection with venture financed start-ups

Many venture financed businesses can be structured to issue QSBS. Any class or series of C corporation stock can be QSBS, including preferred stock and convertible preferred stock. Investors and venture fund promoters focused on structuring their venture financing to obtain the benefits of QSBS should make sure that all taxpayer and issuing corporation level requirements are met and adequately documented. Investors should negotiate for appropriate representations and covenants in their stock purchase agreements addressing Section 1202 issues.

Founders can acquire QSBS from start-ups for nominal cash consideration or services. QSBS that is subject to vesting will not be treated as being owned for purposes of starting the clock ticking on the five-year holding period requirement until either a Section 83(b) election is made or the stock vests for Section 83 purposes. Stock issued upon the exercise of options and warrants or convertible debt can be QSBS, but for purposes of the five-year holding period requirements, the clock won't begin to run until the QSBS is issued.

Is Section 1202 relevant to private equity?

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

The PEG business model of buying and selling businesses makes PEG investments natural candidates for including the issuance of QSBS in the transaction structure. The difficult task is molding a traditional leveraged buy-out (LBO) transaction into a structure that permits both an investment by the PEG fund in QSBS and a tax-free rollover of target company equity by the management team. The holding period requirement may exclude some PEG investments from Section 1202 planning, but the holding period for at least some PEG and family office investments exceeds five years.

A critical point from a planning standpoint is that Section 1202 doesn't limit its scope to investment in corporations engaged in de novo start-up activities. There is nothing in the language of Section 1202 that restricts an issuer of QSBS from acquiring equity or assets of a qualified small business. This interpretation of Section 1202 opens the door to investment in QSBS by PEGs in connection with their M&A investment activities.

An issuer of QSBS to a PEG could be a corporation organized to roll up assets or equity of a target company or it could be the equivalent of a "blocker corporation" organized to hold an equity interest in a target company. The target company itself might be a pass-thru entity such as an LLC (taxed as a partnership) or a greater than 50% owned corporate subsidiary. With careful attention to Section 1202's workings, it should be possible in most cases to structure an acquisition that accomplishes both the issuance of QSBS (i.e., including avoiding the redemption issue) to the PEG and the tax-free rollover of target company equity or assets by target management.

Where a target company would cause the corporation issuing QSBS to fail the $50 million size test, possible solutions might include first forming a C corporation to issue QSBS to the PEG, followed later by the corporation's acquisition of target company assets or equity, or the formation of two or more corporations issuing QSBS and acquiring assets or equity of the target company.

Navigating through Section 1202's qualification requirements in connection with structuring a

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

FBT Gibbons

typical private equity leveraged buy-out (LBO) transaction

Given the typical LBO transaction structure, it is feasible to issue QSBS? In the typical PEG structured LBO transaction, an acquisition entity (Newco) will be formed (often an LLC taxed as a partnership), the PEG's fund will make a capital investment in Newco, the target company's owners will roll over a portion of their equity into Newco, and the target company or Newco will be the borrower of the acquisition debt. A key point to remember is that only C corporations can issue QSBS.

There are several Section 1202 requirements that would need to be carefully considered by a PEG structuring an LBO involving Newco's issuance of QSBS. The PEG would need to reach the reasonable conclusion that that future buyers would be willing to purchase the Newco's QSBS rather than target company assets, as the full benefits of Section 1202 are obtained only through the sale of Newco's QSBS. The five-year holding period requirement under Section 1202 would need to be factored into the equation, as it is unlikely that the PEG's Fund investors would want to roll over their QSBS sales proceeds into replacement QSBS under Section 1045.

There are two gross asset tests that would need to be met by Newco: (1) the aggregate gross assets of Newco at all times on or after 1993 and before the issuance of the QSBS being tested must not exceed $50 million and (2) the aggregate gross assets of Newco immediately after the issuance of the stock being tested (determined by taking into account amounts received in the issuance) must not exceed $50 million. Where the enterprise value of the target company falls comfortably below the $50 million threshold, these gross assets tests should not present a challenge.

But what about a situation where Newco's equity investment in the LBO falls below $50 million but the enterprise value (acquired in part through the debt piece in the transaction) of the target entity exceeds $50 million? Based on the language of Section 1202, it might be possible to first infuse capital into Newco in exchange for the issuance of QSBS. The $50 million gross assets test would be satisfied so long as the equity falls below $50 million. If the numbers

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

work to keep the fair market value under $50 million, Newco's initial capital infusion could include not only the Fund's equity but also the target owner's rollover assets or equity. As a second step, the target business' assets or equity would be acquired by Newco, with debt placed at either the target entity level or possibly at the Newco level. There is a risk that the IRS will attempt to invoke an anti-abuse principle to attack the claiming of Section 1202 gain exclusions by Newco's shareholders, but there is little language in Section 1202 supporting that argument beyond Section 1202(k)'s obscure reference to "shell corporations."[14]

Once the two gross asset tests mentioned above are satisfied with respect to the issuance of certain QSBS, the $50 million test has no further applicability with respect to that QSBS. In other words, the issuing corporation can then grow into a billion dollar company without affecting eligibility of the previously-issued QSBS for the Section 1202 gain exclusion.

Potential problems associated with Owners with carried interests (profits interests) in Funds holding QSBS are addressed in the section above titled "Determining an Owner's 'interest' in a Fund for purposes of claiming the Section 1202 gain exclusion."

What if the target company is a C corporation? Can the target corporation simply issue QSBS to the PEG's fund and redeem out some or all of the target company owner's stock? Unfortunately, any material redemptions of stock in proximity to a stock issuance can disqualify that stock issuances for Section 1202 purposes, so a simple acquisition of equity from the target corporation won't work. A potentially better result is obtained if the PEG forms a blocker corporation that acquires a majority of the target corporation's stock. There doesn't appear to be any reason why a newly formed blocker corporation cannot issue QSBS. Section 1202 expressly contemplates that a corporation issuing QSBS might hold a majority of the stock of another C corporation. The newly-formed blocker corporation might acquire 100% of the target company's equity or if there is an agreement that equity will be rolled over in the transaction, then less than 100% but more than 50% of the equity of the target corporation.

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

What if the target company is an S corporation? The PEG can organize one or more blocker corporations that in turn acquire membership interests in a Newco Delaware LLC that holds either the assets of the target company or a 100% membership interest in the target company.[15] The PEG's fund investors would contribute cash to the blocker corporation, which in turn would contribute that cash to Newco in exchange for a Newco membership interest. The target company assets or membership interest would be contributed to Newco by the target company's owners in exchange for both a Newco membership interest and the cash generated from blocker corporation contributions and acquisition debt.

What if the target company is an LLC or LP taxed as a partnership? In most instances, a similar structure to the one employed where the target company is an S corporation could be used to facilitate the transaction.

The potential application of the $50 million gross assets rule discussed above must be taken into consideration. If the $50 million gross assets test is a problem given the size of the target company, a possible solution would be the use of multiple blocker corporations if the target company is an S corporation or LLC. Each blocker corporation would hold a membership interest in Newco that would keep the value of the blocker corporation's assets at the time of the LBO under $50 million.

Rolling over gain under Section 1045 when a Fund sells QSBS

Section 1045 allows taxpayers to roll over gain on the sale of QSBS where the taxpayer has less than a five-year holding period into replacement QSBS. Where the QSBS is held by a Fund, an election to rollover gain can be made at either the Owner or Fund level.[16]

The Section 1045 regulations have detailed rules governing the sharing of gain for purposes of Sections 1045 and 1202 when a Fund sells QSBS. As discussed above, when Owners at the time QSBS is purchased include holders of profits interests, the application of the Section 1045 regulations will generally reduce or eliminate the ability of those Owners to roll over gain under Section 1045 in

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

connection with the Fund's sale of QSBS.

Closing remarks

The details of Sections 1202 and 1045 are not commonly understood. In spite of the potential for extraordinary tax savings, many otherwise experienced tax advisors are unfamiliar with the innerworkings of Section 1202. Given the challenges associated with structuring investments in QSBS and documenting Section 1202 eligibility, we recommend that venture capitalists and PEGs identify tax advisors who have extensive experience working with Sections 1202 and 1045.

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*
- *A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock*
- *Maximizing the Section 1202 Gain Exclusion Amount*
- *The 21% Corporate Rate Breathes New Life into IRC § 1202*

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] For QSBS acquired after September 27, 2010. QSBS acquired between August 11, 1993 and February 17, 2009 will receive a 50% gain exclusion. QSBS acquired between February 18, 2009 and September 27, 2010 will received a 75% gain exclusion.

[2] If a husband and wife both own QSBS in a particular issuer and file separately or jointly, their aggregate gain exclusion may be limited to $10 million.

[3]See Section 1223(13).

[4] July 17, 2017, letter from the National Venture Capital Association to Orrin Hatch, Chairman of the Senate Finance Committee.

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

[5] Victor Fleischer, The New York Times DealBook, "Tax Extenders that Slip Under the Radar" (January 15, 2013).

[6] Adam Looney, The Brookings Institution, Up-Front Blog, "The next tax shelter for wealthy Americans: C-corporations" (November 30, 2017). The blog was focusing on tax law changes proposed as part of the 2017 federal tax legislation.

[7] Taking advantage of the ability to rollover Section 1202 gain under Section 1045 in situations where the holder doesn't have a five-year holding period for the QSBS.

[8] Treasury Regulation § 1.1045-1(g)(iii) provides that where there are tiered Funds, you look through the lower-tier Fund and apply the eligible partner rules as though the Owners of the upper-tier Fund held direct interests in the lower-tier Fund.

[9] Treasury Regulation § 1.1045-1(g)(3)(ii) provides that for purposes of determining who is an eligible partner for Section 1045 purposes, a taxpayer who acquires from an Owner (other than a C corporation) by gift or at death an interest in a Fund that holds QSBS is treated as having held the acquired interest in the Fund during the period the Owner hold the Fund interest.

[10] Treasury Regulation § 1.1045-1(g)(3).

[11] Treasury Regulation § 1.1045-1(d)(2).

[12] Ginsburg, Levin, and Rocap, Mergers, Acquisitions, and Buyouts at ¶215.2 (November, 2019 Edition).

[13] If a husband and wife both own QSBS in a particular issuer and file separately or jointly, their aggregate gain exclusion may be limited to $10 million.

[14] Arguably, the reference in Section 1202(k) to "shell corporations" would give the IRS ammunition for arguing that reinvesting QSBS through a newly-formed corporation abuses Section 1202's purposes. Obviously, there are good arguments why this isn't the case, including the fact that Section 1202 expressly contemplates parent-subsidiary arrangements 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

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

founders holding its stock. There is little substantive difference between forming a new corporation to acquire assets of a qualified small business, something which seems to be comfortably within the spirit and letter of Section 1202 and forming a new corporation to acquire the stock 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.

[15] If the target company is an S corporation, a likely pre-acquisition step would involve the target company undergoing an "F" reorganization, resulting in a new S corporation holding company being owned by the target shareholders and the target company converting into a disregarded entity. The disregarded entity's membership interest is often contributed to the Newco Delaware LLC in exchange for interests in the Newco LLC and cash, allowing for a tax-free rollover of the non-cash part of the consideration under Section 721, so long as the S corporation doesn't distribute out the LLC membership interest. There is no express authority in Section 1202 or other tax authorities interpreting Section 1202 addressing the issue of whether a C corporation can meet Section 1202's requirements through the holding of a joint venture or membership interest rather than directly through ownership of assets or through a "subsidiary" as defined in Section 1202. A factor that strongly supports the conclusion that you look through on a pro rata basis to the activities of joint ventures for purposes of meeting Section 1202's requirements, is the accepted fact that for business and tax purposes, many corporations engage in their business activities through one or more joint ventures and those corporations are considered to be actively engaged in the joint venture's trade or business for federal income tax purposes.

[16] See Revenue Procedure 98-48 and Treasury Regulation §§ 1.1045-1(b) and (c).

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

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