Recapitalizations Involving Qualified Small Business Stock

Navigating through recapitalizations, reorganizations, stock splits, reverse stock splits, tax free exchanges, tax-free divisions, and stock distributions involving Section 1202 Qualified Small Business Stock (QSBS)

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

With the corporate federal income tax rate reduced from 35% to 21%, there is both a renewed interest in the C corporation as the entity of choice for closely-held businesses and a heightened awareness that business founders and inventors will be able to exclude millions of dollars of taxable gain if they can qualify for Section 1202's gain exclusion. The challenge is satisfying each of the issuing corporation and taxpayer level requirements before any Section 1202 gain exclusion can be claimed.

A key Section 1202 requirement is that the holder of QSBS must generally acquire the stock directly from the issuing corporation in exchange for money, property or services (i.e., QSBS generally can't be paid for with other stock). In order to qualify for the Section 1202 gain exclusion, the original purchaser of QSBS must generally hold the shares for at least five years and then sell the QSBS. During a holding period that extends for years, it isn't unusual for the issuing corporation to consider undertaking a recapitalization, a reorganization, a stock split or stock distribution. In some cases these transactions will involve only the issuing corporations and other instances the transaction will involve the stock of a second corporation. Fortunately, Section 1202's rules allow issuing corporations to undertake certain transactions without adversely affecting the QSBS status of its stockholders' shares. For obvious reasons, it is important to be able to distinguish between

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transactions that preserve QSBS status and those that will abruptly terminate QSBS status.

The discussion below assumes that an issuing corporation and stockholders have met all Section 1202 qualification requirements prior to undertaking any of the transactions discussed below.

Table of Contents:

Sections A – convertible QSBS

Sections B, C & D – recapitalizations ("E" reorganizations)

Sections E & F – tax-free reorganizations (Section 368)

Sections G & H – tax free exchanges (Section 351)

Section I – stock splits

Section J – reverse stock splits

Section K – spin-offs, split-offs or split-ups ("D" reorganizations)

Section L – taxable mergers and reorganizations

A. What happens to QSBS status if a stockholder exercises a conversion right and is issued a different class of stock of the corporation (e.g., convertible preferred stock converts into common stock)?

Section 1202(f) provides that if stock in a corporation is acquired solely through the conversion of QSBS, then the stock so acquired shall be treated as QSBS and the holding period for the original QSBS carries over to the holding period of the QSBS received in the conversion. So, if convertible preferred stock that is QSBS is converted into common stock, that common stock will also be QSBS and will step into the Section 1202 holding period for the original QSBS.

A stockholder's five-year holding period requirement must still be satisfied to claim the Section 1202 gain exclusion. The stock issued in the conversion must be sold by the stockholder to claim the Section 1202 gain exclusion.

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B. What happens to QSBS status if QSBS is exchanged in a tax-free recapitalization (an "E" reorganization) for other QSBS of the same corporation?

A transaction where stockholders exchange one class of stock for another class of stock is generally understood to be a recapitalization that qualifies for tax-free exchange treatment as an "E" reorganization under Section 368(a)(1)(E).[1] Section 1202(h)(4) provides that QSBS can be exchanged for other QSBS if the transaction qualifies as a reorganization under Section 368 (which includes an "E" reorganization). For that reason, when the holder ultimately sells the replacement QSBS, the holder will be able to claim the Section 1202 gain exclusion in spite of the fact that the stock being sold wasn't the original stock issued to the seller.

Section 1202(h)(4)(A) provides that stock received in an "E" reorganization will be "treated as qualified small business stock acquired on the date on which the exchanged stock was acquired," so the holding period of the original QSBS will tack onto the holding period for the QSBS received in the tax-free exchange. In an "E" reorganization, the holding period for the replacement non-QSBS will also be added to that of the original QSBS for purposes of achieving the five-year holding period requirement.

A stockholder's five-year holding period requirement must still be satisfied to claim the Section 1202 gain exclusion. The replacement stock must be sold by the stockholder in order to claim the Section 1202 gain exclusion.

Section 1202(h)(4)(C) provides rules for the situation where there are multiple recapitalizations or reorganizations over the life of a taxpayer's holding period for a corporation's stock. In general, if QSBS is exchanged for QSBS in one recapitalization or reorganization, it can then be exchanged for other QSBS in another recapitalization or reorganization, but the qualified small business tests would apply at the time of each recapitalization.

With respect to recapitalizations, Section 1202(h)(3) overlaps with Section 1202(h)(4), also permitting the preservation of QSBS status when QSBS is exchanged for other QSBS in a tax-free reorganization.

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As discussed in Section C below, if QSBS is exchanged for non-QSBS in a recapitalization, the built-in Section 1202 gain rule of Section 1202(h)(4)(B) applies as of the first recapitalization/reorganization when QSBS is exchanged for non-QSBS. An exception to this treatment is the situation where the recapitalization is merely the conversion of QSBS (e.g., convertible preferred stock is converted into common stock). In that instance, the conversion is treated as a tax-free "E" reorganization (recapitalization under Treasury Regulation Section 1.368-2(e)(4) but it is also expressly addressed in Section 1202(f), which provides that "if any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer— (1) the stock so acquired shall be treated as qualified small business stock in the hands of the taxpayer, and (2) the stock so acquired shall be treated as having been held during the period during which the converted stock was held." Section 1202(f) would appear to trump the general treatment of replacement stock received in a recapitalization discussed in section C below. An exception to the application of Section 1202(f) would be common stock received in the conversion of convertible preferred stock as payment for accrued and unpaid dividends. This additional common stock likely falls outside of the scope of Section 1202(f)'s favorable treatment and is generally immediately taxable at capital or ordinary income rates (see Treasury Regulation Sections 1.368-2(e)(5) and 1.305-7(c)(1)).

C. What happens if a corporation is no longer a qualified small business when its QSBS is exchanged in a tax-free recapitalization for other stock of the corporation?

As discussed in Section B above, Section 1202(h)(4) provides that if a transaction qualifies as a reorganization under Section 368, QSBS can be exchanged **for other QSBS** without adversely affecting QSBS status. A critical aspect of Section 1202(h)(4) is that replacement stock must qualify as QSBS when it is issued in connection with consummation of the tax-free reorganization.

QSBS can only be issued by a corporation with aggregate gross assets of less than $50 million at all times prior to issuance and

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immediately after issuance. This requirement appears to apply to stock issued in a tax-free recapitalization under Section 368(a)(1)(E). So, what happens if there is a recapitalization that qualifies as an "E" reorganization, but the corporation fails the $50 million aggregate gross assets test?

A tax-free recapitalization falls within the scope of both Section 1202(h)(4) and Section 1202(h)(3). What follows is a discussion of the consequences of undertaking a recapitalization at a time when the corporation fails the $50 million gross assets requirement.

Section 1202(h)(4) – recapitalizations qualifying as an "E" reorganization.

As discussed in Section B above, Section 1202(h)(4) addresses transactions that qualify as tax-free reorganizations under Section 368, including "recapitalizations" that qualify as "E" reorganizations.

Section 1202(h)(4) clearly distinguishes between tax-free reorganizations involving, on the one hand, an exchange of QSBS for other QSBS, and, on the other hand, a reorganization involving an exchange of QSBS for non-QSBS. If the replacement stock qualifies as QSBS at the time of the recapitalization, then the exchange will be seamless from a Section 1202 standpoint, with the holding period for the original QSBS added to the holding period for the replacement QSBS for purposes of determining whether the five year holding period requirement has been satisfied. But, if the replacement stock is not QSBS, including because the issuing corporation no longer satisfies the $50 million gross assets test, Section 1202(h)(4) provides that the amount of Section 1202 gain exclusion available when the replacement stock is eventually sold is limited by the amount of Section 1202 gain deferred under Section 368 in connection with the recapitalization exchange. For example, if QSBS with a $100 tax basis is exchanged in a recapitalization for replacement stock worth $1,000 that doesn't qualify as QSBS, and the replacement stock is later sold for $2,000, only $900 of the $1,900 gain will be eligible for the Section 1202 gain exclusion.

Section 1202(h)(3) – recapitalizations falling within the scope of Section 1244(d)(2).

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Section 1202(h)(3) also applies to single-corporation recapitalizations ("E" reorganizations). Section 1202(h)(3) somewhat cryptically provides that "rules similar to the rules of section 1244(d)(2) shall apply for purposes of [Section 1202]," leaving it to the reader to work through exactly how this cross-reference functions in the Section 1202 context.[2]

Section 1244 allows a taxpayer to take an ordinary loss with respect to "small business stock" if a variety of requirements are satisfied and generally functions by a different set of rules and requirements than Section 1202, which causes the cross reference in some instances to be the equivalent of driving a square peg into a round hole. The functioning of Section 1244(d)(2) is addressed in Treasury Regulation Section 1.1244(d)-3, a regulation that addresses stock distributions and recapitalizations. Although the reference in Section 1202 to Section 1244(d)(2) doesn't elaborate as to how the cross-reference functions, it seems reasonable to conclude that only analogous aspects of Section 1244(d)(2) and Treasury Regulation Section 1.1244(d)-3 apply for Section 1202 purposes.

Section 1244(d)(2) provides that the requirement that Section 1244 stock be received for money or property (excluding stock) does not apply to certain transactions. Treasury Regulation Section 1.1244(d)-3(c) provides that if common stock of a corporation is exchanged by an individual or partnership in a recapitalization (i.e., an "E" reorganization) for other common stock of the same corporation, the benefits of Section 1244 remain available. Treasury Regulation Section 1.1244(d)-3 provides that the issuing corporation must meet the requirements of Section 1244 stock "determinable at the time of the exchange." The critical question is whether this language must be interpreted to require that, when applied in the context of Section 1202, the corporation must meet the $50 million gross assets requirement at the time of the recapitalization. Unfortunately, there is no IRS guidance or tax authority interpreting Section 1244(d)(2) and Treasury Regulation Section 1.1244(d)-3 in the context of Section 1202's issuing corporation requirements.

Obviously, the safest approach for dealing with QSBS in the context of recapitalizations would be to avoid undertaking one once the corporation fails the $50 million aggregate gross assets test.

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Management should approach recapitalizations involving preferred stock with caution for the reasons outlined above if the replacement stock doesn't clearly qualify as QSBS when the recapitalization occurs.

A stockholder's five-year holding period requirement must still be satisfied to claim the Section 1202 gain exclusion for the "built-in" gain existing on the date of the Section 368 reorganization. The replacement stock must be sold by the stockholder in order to claim the Section 1202 gain exclusion.

D. Can the problem of outstanding non-QSBS be cured through a recapitalization?

A problem that we encounter regularly is where a corporation has outstanding stock that isn't QSBS and the founders or other investors are looking for a way to "cure" that problem. This problem is frequently seen where a corporation starts life as an S corporation and none of the founder stock qualifies as QSBS. If that corporation is converted to a C corporation, newly-issued shares may qualify as QSBS if all of Section 1202's requirements are met, but the founder shares have already failed the requirement that they were issued by a C corporation. So, can this problem be cured through a recapitalization?

Any solution will require the corporation in question to be a C corporation, so if the corporation remains an S corporation, the S election must be terminated. Once the corporation is a C corporation, it is possible to issue QSBS. New investors can be issued QSBS. The existing stock presents a more difficult problem. There appears to be two possible solutions to fix this problem.

The first possible solution involves exchanging the founder stock (i.e., the non-QSBS stock) for newly-issued stock in a "E" reorganization under Section 368(a)(1)(E). Section 1202(c)(B) generally requires that QSBS be issued in exchange for money, property or as compensation for services, but there is an exception for stock issued in transactions falling within the scope of Section 1202(h). Section 1202(h)(3) provides that "rules similar to the rules of section 1244(d)(2) shall apply for purposes of this section."

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Section 1244(d)(2) directs the taxpayer to Treasury Regulation Section 1.1244(d)-3. Treasury Regulation Sections 1.1244(d)-3(c)(1) and (2) provide that if stock meets the requirements of Section 1244 stock "determinable at the time of the exchange", the stock received in the recapitalization will be Section 1244 stock. Treasury Regulation Section 1.1244(d)-3(c)(3) gives as an example of where the taxpayer fails the test, a recapitalization involving the exchange of preferred stock for common stock. Preferred stock can't qualify as Section 1244 stock. The example focuses on the fact that the stock was preferred stock at the time of the recapitalization, not whether the stock was preferred stock at the time of issuance. Applying these concepts to Section 1202's requirements, the question is whether the phrase "determinable at the time of the exchange [recapitalization]" means that the original stock being exchanged must only meet Section 1202's requirements when the recapitalization occurs, but also for purposes of meeting the requirement that a C corporation issues the stock, the requirement must have been met when the stock was originally issued (i.e., not determined de novo at the time of the recapitalization). There doesn't appear to be a clear answer to this question, which perhaps illustrates the drafting ambiguities that can arise when Congress takes a short cut by cross-referencing other Internal Revenue Code provisions rather than crafting a statute that can be interpreted and applied standing alone. The language of Section 1244 certainly opens the door for taking the position that the recapitalization cures the fact that the stock failed Section 1202's eligibility requirements when originally issued.

The holding period rules applicable to stock exchanged in a recapitalization generally would add the holding period of the original stock to the stock issued in the recapitalization. But if the position is taken that a recapitalization can effectively convert non-QSBS that originally failed the C corporation test into QSBS, it seems reasonable that the holding period of the shares issued in the recapitalization for Section 1202 purposes would commence when the recapitalization occurs rather than relating back to the issue date of the original non-QSBS stock. Again, a taxpayer taking the position that lead was turned into gold would be navigating uncharted territory in terms of available tax authorities (beyond the

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language of Section 1244) addressing these issues.

The second possible solution doesn't involve a recapitalization but instead would involve the issuance of additional stock by the C corporation to those stockholders holding non-QSBS. The initial non-QSBS could be left outstanding or possible redeemed more than two years after the issuance of the additional shares qualifying as QSBS.

E. What if QSBS is exchanged for a different corporation's QSBS in a Section 368 tax-free reorganization?

If a transaction qualifies as a tax-free reorganization under Section 368[3], and QSBS of the target corporation is exchanged for QSBS of the acquiring corporation, then the consequences outlined in Sections B and C above would apply. A Section 368 reorganization often involves an acquisitive transaction, where the assets or stock of the target corporation are exchange for stock of the acquiring corporation in an "A", "B" or "C" reorganization. If the acquiring corporation is a qualified small business, property or stock of the target corporation can be exchanged for stock of the acquiring corporation, with the target stockholders exchanging QSBS for QSBS.

A stockholder's five-year holding period requirement must be satisfied to claim the Section 1202 gain exclusion. The replacement stock must be sold by the stockholder in order to claim the Section 1202 gain exclusion.

F. What if QSBS is exchanged for a different corporation's non-QSBS in a Section 368 tax-free reorganization?

If a transaction qualifies as a tax-free reorganization under Section 368, but QSBS of the target corporation is exchanged for non-QSBS of the acquiring corporation, then the consequences outlined in Section C above would apply. Section 1202(h)(4) provides that the amount of Section 1202 gain exclusion available when the replacement stock is eventually sold is limited by the amount of Section 1202 gain deferred as a result of the Section 368 tax-free reorganization.

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A stockholder's five-year holding period requirement must still be satisfied to claim the Section 1202 gain exclusion for the "built-in" gain existing on the date of the Section 368 reorganization. The replacement stock must be sold by the stockholder in order to claim the Section 1202 gain exclusion.

G. What if QSBS is exchanged for different corporation's QSBS in a Section 351 tax-free exchange?

Under Section 1202(h)(4), QSBS can be exchanged for replacement QSBS in a transaction qualifying for Section 351 exchange treatment. Section 351 governs the tax-free exchange of assets (including corporate stock) by one or more persons in exchange of stock of a controlled corporation[4] after the exchange. A typical transaction qualifying for Section 351 is a holding company formation where stockholders exchange their QSBS in an operating corporation for stock in a holding company controlled by such stockholders after the exchange. Section 351 can also be used to structure an acquisition of a target corporation (i.e., an acquisitive Section 351 transaction).

The holding period for the stock received in the exchange generally commences when the original QSBS was issued and runs until the replacement QSBS is sold. The five-year holding period requirement must still be satisfied to claim the Section 1202 gain exclusion. The replacement stock must be sold by the stockholder in order to claim the Section 1202 gain exclusion.

H. What if QSBS is exchanged for a different corporation's non-QSBS in a Section 351 tax-free exchange?

Section 1202(h)(4) allowed the stockholder discussed in Section F above to preserve the potential for claiming the full Section 1202 gain exclusion because the replacement QSBS was issued in a tax-free exchange governed by Section 351. But as discussed in Section C above, a critical requirement under Section 1202(h)(4) is that the replacement stock qualifies as QSBS (i.e., stock issued by a qualified small business) at the time of the recapitalization.

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The analysis and conclusions with respect to Section 1202(h)(4) discussed in Section C above apply where QSBS is exchanged for a different corporation's non-QSBS in a Section 351 tax-free exchange. Section 1202(h)(4) provides that the amount of Section 1202 gain exclusion available when the replacement stock is eventually sold is limited by the amount of Section 1202 gain deferred as a result of the Section 351 tax-free exchange.

The holding period for the replacement non-QSBS received in the Section 351 exchange will be added to that of the original QSBS for purposes of achieving the five-year holding period requirement. A stockholder's five-year holding period requirement must still be satisfied to claim the Section 1202 gain exclusion for the "built-in" gain existing on the date of the Section 351 exchange. The replacement stock must be sold by the stockholder in order to claim the Section 1202 gain exclusion.

I. What if there is a "stock split" (e.g., where one share splits into 100 shares) involving QSBS?

In a stock split, one share of QSBS is split into multiple shares of the same corporation. A stock split can be accomplished by actually "splitting" a share of stock into multiple shares (e.g., one share of QSBS splits into 100 shares of the issuing corporation's stock) or by means of a stock distribution with respect to outstanding stock, (i.e., 99 shares of stock are distributed with respect to one outstanding share). An actual splitting of shares is accomplished through the filing of an amendment to a corporation's articles or certificate of incorporation, providing that each outstanding share of the corporation's stock is split into multiple shares.

A stock split falls within the scope of Section 1202(h)(4) because it qualifies under Section 368 as an "E" reorganization.[5] But as discussed in Section C above, if the issuing corporation fails the $50 million gross assets test at the time of the stock split, then only the amount of gain that would have been taxed if the stock split wasn't tax-free will be eligible for the Section 1202 gain exclusion when the stock is ultimately sold.

A stockholder's holding period for each share issued in the stock split will be deemed to have commenced when the stockholder's

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original QSBS was issued. A stockholder's five-year holding period requirement must still be satisfied to claim the Section 1202 gain exclusion. The QSBS must be sold by the stockholder in order to claim the Section 1202 gain exclusion.

Different rules apply if the stock split is accomplished through the making of a stock distribution. Section 1202(h)(3) provides that rules similar to those in Section 1244(d)(2) apply for purposes of defining the scope of QSBS transfers and issuances of stock with respect to QSBS that do not adversely affect QSBS status. Treasury Regulation Section 1.1244(d)-3(b) provides the following in respect to excluded stock distributions, "[i]f common stock is received by an individual or partnership in a nontaxable distribution under section 305(a) made solely with respect to stock owned by such individual or partnership which meets the requirements of section 1244 stock determinable at the time of the distribution, then the common stock so received will also be treated as meeting such requirements."

There are several key takeaways with respect to qualifying for the stock distribution exclusion under Section 1244 (and by Section 1202(h)(3)'s reference, for Section 1202 purposes). First, the stock distribution must be a nontaxable distribution under Section 305(a). Section 305(a) will apply to any transaction that is not (1) a distribution in lieu of money, (2) a disproportionate distribution, (3) a distribution of common and preferred stock to different stockholders, (4) a distribution on preferred stock other than an increase in the conversion ratio due to a stock split or stock distribution, and (5) a disproportionate distribution of preferred stock. Second, the issuing corporation must meet all of Section 1202's requirements for issuing QSBS at the time the stock distribution is made. This includes the requirement that the issuing corporation meet the less than $50 million aggregate asset value test at the time of the stock distribution. Additionally, Treasury Regulation Section 1.1244(d)-3(b)(2) further clarifies that if a stockholder owns both QSBS and non-QSBS from the same issuer, only the stock received with respect to the QSBS, assuming the issuer meets the QSBS requirements at the time of distribution, will be eligible to qualify for the Section 1202 gain exclusion.

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Section 1202 follows the general holding period rules of Section 1223, unless modified by Section 1202. Section 1202 and Section 1244(d)(2) provide no specific modifications for Section 305(a) stock distributions. Section 1223(4) provides that, "[i]n determining the period for which the taxpayer has held stock or rights to acquire stock received on a distribution, if the basis of such stock or rights is determined under Section 307, there shall (under regulations prescribed by the Secretary) be included the period for which he held the stock in the distributing corporation before the receipt of such stock or rights upon such distribution." Section 307 controls the allocation of basis for any tax-free stock distribution under Section 305(a). As forward stock splits afforded QSBS status will be controlled by Section 305(a) if accomplished through a stock distribution and the basis for Section 305(a) stock distribution is determined by Section 307, under Section 1223(4), the holding period for the stock issued through a forward stock split accomplished through a stock distribution will be the same as the stock held prior to the stock split.

A stockholder's five-year holding period requirement must still be satisfied to claim the Section 1202 gain exclusion. The QSBS must be sold by the stockholder in order to claim the Section 1202 gain exclusion.

J. What if there is a "reverse stock split" (e.g., where 10 shares are consolidated into one share) involving QSBS?

A reverse stock split is a transaction effected by an amendment to a corporation's articles or certificate of incorporation where multiple shares of outstanding stock are converted into one share (e.g., a reverse split where 30 shares are converted into one share). Typically, a corporation undertakes a reverse stock split when it is at risk for being delisted on an exchange because its per-share value is too low. If the transaction is a 1 for 30 reverse stock split, 30 shares valued at $1 each becomes one share valued at $30. Almost uniformly, public companies describing for their stockholders' benefit the federal income tax consequences of a reverse split expressly excludes from the discussion the effect of the reserve stock split on the corporation's outstanding QSBS. This void created by issuing corporations punting on the task of helping their

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stockholders navigate through the tax issues associated with holding QSBS involved in a reverse stock split has not been filled by tax authorities or any discussion in tax literature.

A reverse stock split does qualify as a tax-free "E" reorganization under Section 368(a)(1)(E), meaning that participating stockholders will not be taxed when their 30 shares are reduced to one share, assuming that they don't receive any cash for fractional shares or otherwise in the transaction. For purposes of Section 1202, a reverse stock split falls within the scope of Section 1202(h)(4) because it qualifies as an "E" reorganization.[6] But as discussed in Section H above, if the issuing corporation fails the $50 million gross assets test when a forward stock split occurs, then it appears that only the amount of gain that would have been taxed if the stock split wasn't tax-free will be eligible for the Section 1202 gain exclusion when the stock is ultimately sold.

The obvious question is whether the $50 million gross assets test requirement also apply at the time of a reverse stock split. The second sentence of Section 1202(h)(4)(B) refers to the issuance of stock in a recapitalization by a corporation that is a "qualified small business" (which definition includes satisfaction of the $50 million gross assets test). If this test isn't satisfied in connection with an "E" reorganization, there isn't a seamless exchange of QSBS for QSBS. If it is assumed that the shares resulting from a reverse stock split would be viewed as being issued for purposes of Section 1202(h)(4), then the requirement that the corporation be a "qualified small business" at the time of issuance would apply not only to forward but also to reverse stock splits. But unlike forward stock splits, where additional shares come into existence through the splitting of existing shares of a stock distribution, a reverse stock split merely involves the consolidation of multiple shares (all of which might be QSBS) into fewer shares. There doesn't appear to be a reason why Congress would want to impose the requirement that the corporation be a qualified small business at the time of the reverse stock split. But it remains an unanswered question how the IRS and courts would interpret and apply Section 1202's language in this situation.

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Another unknown is what the result would be if a taxpayer holds 10 shares, five of which are QSBS and five of which are not QSBS, and those 10 shares are reduced to one share in a reverse stock split. Perhaps a pro rata portion of the resulting share is QSBS? If a taxpayer holds 50 shares of QSBS and 50 shares that are not QSBS, and those 100 shares are reduced to 10 shares, are five shares then QSBS and five shares not QSBS?

The five-year holding period requirement must still be satisfied for any Section 1202 gain exclusion to be claimed, even in situations where the replacement stock isn't QSBS. For purposes of satisfying the five-year holding period requirement, the clock begins ticking when the original QSBS is issued and ends when the "replacement" QSBS is sold. If QSBS with different holding periods are combined in a reverse stock split, the holding period for the resulting shares would be the average of the holding periods for those shares combined in the reverse stock split.

K. What happens if a corporation that has issued QSBS undergoes a tax-free division (e.g., spin-off split-off or split-up) governed by Section 355?

In most cases, holders of QSBS and management of the issuing corporation won't need to consider the impact of tax-free divisions on outstanding QSBS, because under Section 355, the issuing corporation must have at least a five-year operating history before it can undertake a spin-off, split-off or split-up (i.e., a tax-free division) under Section 355. Holders of QSBS should generally be more focused on selling their QSBS after five years than participating in a tax-free division. And aside from the tax issues associated with outstanding QSBS, tax-free divisions are uncommon transactions. But there could be tax or business reasons driving a division, even in a situation where some of the outstanding stock is QSBS. For example, a qualified small business (C corporation) might operate two or more incompatible and distinct business divisions, each operating with a different degree of success, a different timeline and path to exit for owners, different audiences of potential buyers, lenders or investors or a variety of other factors pointing towards a better result if the businesses operated in two separate C corporations.

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Companies with issued and outstanding QSBS considering a division (spin-off, split-off or split-up) will want that transaction to be tax-free under Section 355 and will want any outstanding QSBS to remain QSBS. If a C corporation is operating two business divisions inside the C corporation or in single member LLCs, then the tax-free division would normally be effected through the contribution by the qualified small business of one division's assets to a newly-formed corporate subsidiary and the distribution of that subsidiary to the qualified small business' stockholders. Assuming all of the requirements are met, that transaction would be tax-free under Section 355 and qualify as a "D" reorganization under Section 368(a)(1)(D).

Where a QSBS is operating with one business held in the corporation and the second business held in a subsidiary, the mere distribution of the subsidiary to the holders of QSBS in a transaction qualifying as a tax-free division under Section 355 may not allow QSBS to retain its status on a going forward basis. Section 1202 allows for exchanges and distributions that fall within the tax-free reorganization provisions under Section 368 or a tax-free exchange under Section 351, but it doesn't provide for continued QSBS treatment for shares distributed or exchanged in a transaction that falls solely within Section 355. A possible remedy for this would be to drop the stock of the subsidiary into a newly-formed subsidiary of the qualified small business and distribute the stock of that new holding company to stockholders of the qualified small business in a transaction then qualifying as a tax-free D reorganization (which brings allows for the stock issued or exchanged to qualify for QSBS status under Section 1202). There isn't any published tax authority addressing this issue or planning workaround.

As discussed in Section C above, a transaction qualifies as a tax-free reorganization under Section 368 (here a "D" reorganization under Section 368(a)(1)(D)) will fall within the scope of Section 1202(h)(4), and the QSBS distributed or exchanged will generally be QSBS in the hands of the stockholders of the qualified small business. But as discussed in Section C above, if the issuing corporation fails the $50 million gross assets test at the time of the division, then only the amount of gain that would have been taxed if the stock split wasn't tax-free will be eligible for the Section 1202

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gain exclusion when the stock is ultimately sold. The five-year holding period requirement must still be satisfied for any Section 1202 gain exclusion to be claimed, even in situations where the replacement stock isn't QSBS.

If the reason behind the division is the desire to sell one division and retain the other division in the most tax-efficient way, which often is holding each division in a separate C corporation whose stock is QSBS than holding the stock of one qualifies small business with two divisions (which could lead to a buyer naturally wanting to purchase the assets of the division it wants to own rather than purchasing the stock of the qualifies small business), then the potential limitations imposed by Section 355(e) must be considered.

Under Section 355(e), if a division occurs (e.g., the assets of one division are dropped into new subsidiary and that subsidiary's stock is distributed), and more than 50% of the stock of either the hold qualified small business or the new corporation is sold (including through stock issuances, including Series A financing or conversion of convertible notes) during the two year period after the spin-off, there is a presumption that the distribution of stock should be treated as a taxable distribution by the distributing corporation. Section 355(e) requires a sale pursuant to a "plan" and the presumption that there was a plan if the sale takes place during the two years after the spin-off can be rebutted. If Section 355(e) applies, there is a corporate level tax but not a stockholder level tax. If there is an acquisition after a distribution, the distribution and acquisition can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the 2-year period ending on the date of the distribution.

L. What happens if QSBS is treated as being sold in a taxable merger, reorganization or other capital transaction?

Taxable transactions involving the sale of QSBS prior to satisfying the five year holding period requirement that involve the exchange of QSBS for another corporation's QSBS may fall within the scope of Section 1045, a provision permitting the rollover of gain from QSBS

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to another QSBS if all of the statute's requirements are satisfied. The workings of Section 1045 were explored this recent article.

Closing Remarks

A significant part of our work involves providing advice and delivering tax opinions with respect to the Section 1202 requirements discussed above. We also focus on assisting clients with their efforts to identify and pull together documentation that will serve as evidence for their position that each of Section 1202's taxpayer level and issuing corporation level requirements have been satisfied.

In spite of the potential for extraordinary tax savings, many otherwise experienced tax advisors are not familiar with Sections 1202 and 1045 planning. Venture capitalists, founders and investors who want to learn more about Section 1202 and Section 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
- Private Equity and Venture Capital Fund Investment in Qualified Small Business Stock (QSBS) – A Guide to Obtaining the Benefits of Sections 1202 and 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.

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[1] Neither the Code nor the regulations define what qualifies as a recapitalization. The Supreme Court and the Second Circuit has defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation." *Helvering v. Southwest Consol. Corporation*, 315 US 194 (1942). The Third Circuit has determined that the term recapitalization signifies: … an arrangement whereby the stock and bonds of the corporation are

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readjusted as to amount, income, or priority, or . . . an agreement of all shareholders and creditors to change and increase or decrease the capitalization or debts of the corporation, or . . . both of the above. *United Gas Improvement Co. v. Commissioner*, 142 F.2d 216 (3rd Cir. 1944).

[2] Section 1244(d)(2) provides the following: "**Recapitalizations, changes in name, etc.**To the extent provided in regulations prescribed by the Secretary, stock in a corporation, the basis of which (in the hands of a taxpayer) is determined in whole or in part by reference to the basis in his hands of stock in such corporation which meets the requirements of subsection (c)(1) (other than subparagraph (C) thereof), or which is received in a reorganization described in section 368(a)(1)(F) in exchange for stock which meets such requirements, shall be treated as meeting such requirements. For purposes of paragraphs (1)(C) and (3)(A) of subsection (c), a successor corporation in a reorganization described in section 368(a)(1)(F) shall be treated as the same corporation as its predecessor."

[3] Reorganizations under Section 368 include the following:

- "A" Reorganization: Tax-free mergers and consolidations under Section 368(a)(1)(A) with one corporation surviving.
- "B" Reorganization: Stock for stock transfers under Section 368(a)(1)(B) involving target stockholders trading all target company stock for a portion of the stock of the acquiring parent corporation.
- "C" Reorganization: Stock for asset acquisitions under Section 368(a)(1)(C) involving the exchange of acquiror stock for all the assets of the target and a distribution of the acquiror stock to target stockholders in connection with the target's liquidation.
- "D" Reorganization: Forward triangular mergers under Section 368(a)(1)(D) where a corporation is acquired by the subsidiary of a parent company in a stock for stock.
- "E" Reorganization: A recapitalization under Section 368(a)(1)(E).

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- "F" Reoganization: A mere change in identity, form or place under Section 368(a)(1)(F).
- "G" Reorganization: A reorganization in the event of a bankruptcy or insolvency proceeding under Section 368(a)(1)(G).

  Reverse triangular mergers under Section 368(a)(2)(E), where the target corporation merges into subsidiary of the acquiring corporation, with the target corporation surviving.

[4] Section 368(c) defines a controlled corporation for purposes of Section 351 as being where the contributing stockholders own stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

[5] The forward stock split is also treated as a Section 305 transaction, thereby bringing it within the scope of Section 1202(h)(3).

[6] The forward stock split is also treated as a Section 305 transaction, thereby bringing it within the scope of Section 1202(h)(3).

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