Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?

Apr 19, 2022

Categories:

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

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A stockholder must hold qualified small business stock (QSBS) for more than five years in order to claim Section 1202's generous gain exclusion.[i]

This is one in a series of articles and blogs addressing planning issues relating to QSBS and the workings of Sections 1202 and 1045. During the past several years, there has been an increase in the use of C corporations as the start-up entity of choice. Much of this interest can be attributed to the reduction in the federal corporate income rate from 35% to 21%, but savvy founders and investors have also focused on qualifying for Section 1202's generous gain exclusion. Legislation proposed during 2021 sought to curb Section 1202's benefits, but that legislation, along with the balance of President Biden's Build Back Better legislation, has stalled in Congress, perhaps permanently. More background information regarding qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Internal Revenue Code is available on our website.

Here are some steps to consider if it appears that you may be selling your QSBS before satisfying the five-year holding period requirement:

1. Postpone your sale of QSBS

Consider working with the buyer (or your company's management) to postpone the closing of your stock sale (which might include a stock redemption) until you have satisfied Section 1202's five-year holding period requirement. Depending on how long your sale must be postponed, possible planning suggestions include signing a sale agreement with a deferred (later) closing date, signing a sale agreement coupled with an agreement to have the buyer operate the business under a management arrangement until you have

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satisfied the five-year holding period requirement, or causing the company to enter into a joint venture arrangement with the buyer, again postponing the buyer's purchase of the company's QSBS until you have satisfied the five-year holding period requirement. Structuring the transaction as an installment sale with deferred payments won't work because even if payments are delayed until after the five-year mark, the sale date will be when the transaction closes, not when the deferred purchase consideration is paid.

2. Exchange your QSBS for buyer stock (either QSBS or non-QSBS)

Section 1202 allows stockholders to exchange their QSBS for other stock (either QSBS or non-QSBS) in a Section 351 nonrecognition exchange or a Section 368 tax-free reorganization.[ii] Many buyers require sellers to roll over a portion of their equity into buyer equity. Holding QSBS with less than a five-year holding period provides an additional incentive for target stockholders to negotiate an exchange of target company stock for buyer stock. In an exchange governed by Sections 351 or 368, the holding period for the original QSBS is tacked onto the holding period for the replacement stock, positioning the stockholder for claiming Section 1202's gain exclusion when the combined holding period exceeds five years. If the buyer's stock is non-QSBS, then Section 1202's gain exclusion will apply only to the extent of the gain deferred at the time of the exchange, and any additional appreciation will be subject to long-term capital gains treatment. If the buyer's stock is QSBS, then the stockholder will be able to claim Section 1202's gain exclusion for the entire amount of the gain, subject to Section 1202's gain exclusion cap. Unfortunately, if QSBS is exchanged for LLC or LP (partnership) equity in a Section 721 nonrecognition exchange, neither the buyer nor the target stockholders will be able to claim Section 1202's gain exclusion with respect to the QSBS given up in the exchange.

3. Reinvest QSBS sales proceeds into replacement QSBS under Section 1045

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Under Section 1045, proceeds from the sale of a stockholder's original QSBS investment can be reinvested on a tax-deferred basis into replacement QSBS, if the rollover occurs during the 60-day period beginning on the date of the sale of the original QSBS. The corporation issuing the replacement QSBS can be an unaffiliated or affiliated (even newly-organized and wholly-owned) corporation.

Replacement QSBS must "stock" for federal income tax purposes, which excludes convertible notes and makes purchasing a SAFE instrument a risky proposition, as there is no guarantee that the IRS will agree that a particular issuer's SAFE instrument is equity for federal income tax purposes. The holding period for the original QSBS is tacked onto the holding period for the replacement QSBS, and after the combined holding period exceeds five years, the stockholder can sell the replacement QSBS and claim Section 1202's gain exclusion. An important aspect of a successful Section 1045 transaction is that the corporation issuing the replacement QSBS must satisfy Section 1202(c)(2)'s active business requirements for at least six months after issuing the replacement QSBS.

It is important for the stockholder to confirm, if possible, by obtaining representations and covenants from the corporation issuing the replacement QSBS, that all issuing corporation level eligibility requirements are satisfied as of the date of issuance of the replacement QSBS, and management agrees to use its best efforts to maintain Section 1202 eligibility and cooperate in efforts to document Section 1202 eligibility.

Although the language of Section 1045 isn't 100% clear, it does appear possible for stockholders to pool the proceeds from the sale of their original QSBS in an LLC/LP for the purpose of purchasing replacement QSBS. But note that it won't satisfy Section 1045's 60-day reinvestment requirement to merely deposit funds into the LLC/LP. The LLC/LP must purchase the replacement QSBS within the stockholder's 60-day period and the stockholder's share of the LLC's/LP's investment must equal or exceeds the reinvested funds.

For an in-depth discussion of Section 1045 tax planning, see the articles: Reinvesting QSBS sales proceeds on a pre-tax basis under Section 1045, Part 1 and Part 2.

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4. Acquire replacement QSBS of a corporation incorporated for the purpose of undertaking the creation (start-up) of an active business

We frequently work with stockholders who sell their original QSBS before satisfying Section 1202's five-year holding period requirement. Some of these stockholders reinvest their QSBS proceeds into minority investments in replacement QSBS. But for many stockholders, the idea of sourcing substantial minority investments during a short 60-day window isn't attractive. In some cases, the stockholder elects to fund an existing controlled active qualified business. More frequently, the stockholder funds a new C corporation (Newco) with original QSBS sales proceeds. Newco can be organized (i) to engage in the de novo creation of a business or (ii) to seek and (hopefully) acquire the assets or equity of an existing active qualified business. Section 1202(e)(2)(A) provides that assets are considered to be used in the active conduct of a qualified trade or business if a corporation is engaged in start-up activities of the nature described in Section 195(c)(1)(A). Section 195(c)(1)(A), which separately governs the deductibility of certain start-up expenditures, includes within its scope engaging in typical activities of a business start-up and references the creation and acquisition-related activities. Section 1202(e)(2) confirms that it isn't necessary for a corporation to have any gross income to be considered to be engaging in qualifying start-up activities.

From the standpoint of meeting the eligibility requirements of Sections 1045 and 1202, the most critical planning issue is how to best position a stockholder to prove that the requirements of Section 1202's 80% Test (i.e., that at least 80% (by value) of the corporation's assets must be used in the active conduct of one or more qualified businesses) and Active Business Test have been satisfied.[iii] In order to satisfy the "Active Business Test," we believe that a stockholder would need to show that the corporation actively pursued its start-up activities, most likely based on a standard of what would be reasonably expected for a similarly situated start-up. Under Section 1045(b)(4)(B), the 80% Test and the Active Business Test must be satisfied for "substantially all" of the six-month period commencing with the date the replacement

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QSBS is acquired in order for the stockholder to be eligible to claim Section 1045 benefits.[iv] Separately, if the stockholder ultimately sells the replacement QSBS and claims Section 1202's gain exclusion, the 80% Test and the Active Business Test must be satisfied for substantially all of the stockholder's combined holding period for the original and replacement QSBS.

A in-depth discussion of the 80% Test and the Active Business Test can be found in the article Part 2 – Reinvesting QSBS sales proceeds on a pre-tax basis under Section 1045.

5. Acquire replacement QSBS of a new corporation organized for the purpose of undertaking a search for and acquiring the assets or stock of an active business

Some stockholders selling their QSBS would rather purchase an active business than create a new business from scratch. We believe that the language of Section 1202 supports the position that stockholders do have the option under Sections 1045 and 1202 to organize corporations for the purpose of searching for and acquiring the assets or equity of a qualified active business.

As discussed in the preceding section, a critical eligibility requirement for stockholders organizing a new corporation as a vehicle for acquiring replacement QSBS is satisfying the 80% Test and the Active Business Test for at least six months after the date replacement QSBS is purchased. For purposes of determining whether the corporation has satisfied the 80% Test, Section 1202(e)(2)(A) provides that assets (in this case the cash) earmarked for use in connection with the corporation's start-up activities described in Section 195(c)(1)(A) are treated as being used in the active conduct of a qualified business. Section 195(c)(1)(A), which itself exists to address the deductibility of certain start-up expenditures, includes within its scope both the creation of an active business and investigating the creation or acquisition of an active business. We believe that the combination of Sections 1202(e)(2)(A), 195(c)(1)(A) and 1202(e)(6) supports the conclusion that the assets that fall within the scope of Section 1202(e)(2)(A)'s

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exception to the active business requirement include assets that are earmarked for the creation, investigation and acquisition of an active business, including cash earmarked for funding the corporation's capital investment and operating cash needs. We believe that in order to satisfy the Active Business Test, the corporation issuing replacement QSBS would need to actively pursue identifying and acquiring an active qualified business.

Note that there are a number of planning issues that must be considered before electing this option that are addressed in more detail in the article: Part 2 – Reinvesting QSBS sales proceeds on a pre-tax basis under Section 1045.

6. If QSBS is sold by a partnership, either the partnership or its partners can elect to reinvest QSBS sales proceeds in replacement QSBS.

Section 1045 provides flexibility when a partnership sells QSBS. Either the partnership or individual partners can reinvest the sales proceeds. But there is a fair amount of complexity that accompanies this flexibility, making it important for the parties involved to work with knowledgeable tax advisors.

The following article addresses investment in QSBS through Funds (limited partnerships and LLCs taxed as partnerships): Private Equity and Venture Capital Fund Investment in Qualified Small Business Stock (QSBS) — A Guide to Obtaining the Benefits of Sections 1202 and 1045.

7. Section 1045 appears to permit stockholders selling Original QSBS to reinvest sales proceeds through partnerships.

Although the language of Section 1045 isn't 100% clear on the issue, it does appear possible for a stockholder to pool Original QSBS sales proceeds with other investors in a limited partnership or limited liability company that purchases Replacement QSBS, but the LP or LLC must acquire the Replacement QSBS within 60 days after

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the stockholder sell the Original QSBS. Further, we believe that each stockholder reinvesting through a partnership should make sure that the stockholder's share of the partnership's investment in the Replacement QSBS at least equals the Original QSBS proceeds being reinvested under Section 1045.

8. Be sure to fully document satisfaction of the various eligibility requirements of Sections 1045 and 1202.

Stockholders who reinvest QSBS sales proceeds in replacement QSBS should fully document satisfaction of Section 1202's eligibility requirements for both their original and replacement QSBS investments. For a detailed discussion of Section 1202's eligibility requirements, see the article Dissecting Section 1202's 'Active Business' and 'Qualified Trade or Business' Qualification Requirements. If a stockholder elects to incorporate a new C corporation, the main challenge will be documenting compliance with all of Section 1202's requirements, including ongoing satisfaction of the 80% Test and the Active Business Test. With respect to satisfying Section 1045's requirements, the election to take advantage of that provision must be properly made on the stockholder's tax return for the year of the sale of the original QSBS, and reinvestment of the QSBS sales proceeds within the 60-day window should be fully documented.

More resources

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Section 1202 and Section 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:

Using Section 1045 to reinvest QSBS sale proceeds into replacement QSBS

- Section 1202 Qualification Checklist and Planning Pointers

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- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Dissecting 1202's Active Business and Qualified Trade or Business Qualification Requirements
- Recapitalizations Involving Qualified Small Business Stock
- Advanced Section 1045 Planning
- 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 any Section 1202 or Section 1045 issues by video or telephone conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[i] There are exceptions to the general rule when the stockholder receives QSBS as a gift, as a distribution from a partnership, upon the death of the original holder, or in connection with the receipt of replacement QSBS in connection with a tax-free exchange or reorganization. References to "Section" are to sections of the Internal Revenue Code.

[ii] In contract, when Original QSBS proceeds are being reinvested, the replacement stock must be QSBS.

[iii] For Section 1045, there is a requirement that the corporation issuing the replacement QSBS must meet Section 1202's active business activity requirements during the first six months after acquisition of the replacement QSBS, so it is important where a Section 1045 reinvestment of sales proceeds is involved that the 80% Test and Active Business Test is seen as being immediately satisfied based on the anticipated use (as set forth the business plan and budget) of the proceeds reinvested in replacement QSBS.

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[iv] The percentage applicable to satisfy the "substantially all" requirement is not addressed in tax authorities interpreting Section 1202, but it is likely that it would be determined to fall between 70% and 95% of a stockholder's holding period for the QSBS.

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