Transfer Planning With Qualified Small Business Stock

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

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

Why is transfer planning important for holders of QSBS?

There are several Section 1202 rules that make the issue of transfer planning particularly important for holders of QSBS:

- Subject to the various exceptions discussed in this article, the Section 1202 gain exclusion can only be claimed by the original holder of QSBS.
- A five-year holding period for QSBS shares is required to claim the Section 1202 gain exclusion.

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- The Section 1202 gain exclusion is generally capped at $10 million per taxpayer.

Circumstances frequently arise during the required five+ year holding period where QSBS is either voluntarily or involuntarily transferred. Beyond the typical reasons why non-QSBS shares are transferred, such as a desire for liquidity, the desire to make lifetime gifts or charitable contributions, or the death or divorce of the stockholder, the fact that the Section 1202 gain exclusion is typically capped at $10 million sometimes adds an additional incentive to transfer some of a holder's QSBS to a separate taxpayer who can claim their own $10 million gain exclusion with respect to the gifted QSBS.[4] For a further discussion of the issues associated with "multiplying" the Section 1202 gain exclusion, see the article "Maximizing the Section 1202 Gain Exclusion Amount."

The balance of this article looks at the consequences of various QSBS transfers, including transfers that preserve QSBS status and transfers that end QSBS status.

Sales of QSBS (including redemptions of QSBS and complete corporate liquidations)

The Section 1202 gain exclusion can only be claimed when shares of QSBS are sold, and then only after the shares of QSBS have been held for at least five years. A "sale" for Section 1202 purposes can result from a stock sale, a stock redemption, a taxable merger or exchange, and a complete corporate liquidation. If less than all of the stockholder's QSBS is redeemed, the redemption will need to qualify as a "sale" under Section 302 rather than a dividend in order to claim the Section 1202 gain exclusion. A secondary purchaser of QSBS (i.e., a purchaser from other than the issuing corporation) will not be able to claim the Section 1202 gain exclusion with respect to the purchased (former QSBS) stock. The Section 1202 gain exclusion won't be available if a holder sells QSBS with less than a five-year holding period, but a rollover of proceeds into replacement QSBS may be possible under Section 1045. For an in-depth discussion of Section 1045, see the article "Advanced Section 1045 Planning."

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Where a corporation issuing QSBS is being sold and the purchase consideration includes equity of the acquiring company, it might make sense to structure the transaction as a taxable exchange rather than the typical tax-free rollover of seller equity if the holder qualifies for claiming the Section 1202 gain exclusion. See the article "Equity Rollovers in M&A Transactions involving Section 1202 Qualified Small Business Stock."

A sale or other transfer of QSBS to a grantor trust as a part of an individual's estate planning will not be treated as a "sale" for Section 1202 purposes, as the grantor is treated as continuing to own the QSBS for federal income tax purposes. But if the trust's status is converted to that of a non-grantor trust, an earlier sale transaction (in contrast to a gift) will trigger a loss of QSBS status for the transferred shares. Note that a grantor trust may be converted to a non-grantor trust under a variety of voluntary and involuntary circumstances.

A potential planning idea involves claiming Section 1202's gain exclusion in connection with the sale of QSBS (where the necessary five-year holding period has been satisfied) to a related party. This idea arises out of the realization that it can make sense to trigger a sale of QSBS after five years, since it remains possible after the five-year mark for the issuing corporation to destroy the QSBS status of its outstanding stock. But note that if a "premature" sale of QSBS is triggered, any future appreciation will not qualify for the Section 1202 gain exclusion. Section 1041 blocks this plan from working where the sale is from one spouse to another.[5]

Section 1202(j) prevents holders of QSBS from successfully creating an offsetting short position if their QSBS has less than a five-year holding period. Prior to achieving a five-year holding period, the provision triggers a deemed sale transaction for Section 1202 purposes when the short sale occurs or the holder (or a related party) acquires an option to sell shares of the issuing corporation's stock at a fixed price, or the holder enters into any other transaction which reduces the risk of loss from holding the QSBS.[6]

Gifting QSBS

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In our articles, we have discussed planning techniques for increasing, and in some cases multiplying, the standard gain exclusion cap through gifting QSBS to other taxpayers.[7] Increased awareness of this planning technique has contributed to a flurry of stockholders seeking last minute tax planning help. This section looks at whether you can "multiply" Section 1202's gain exclusion by gifting qualified small business stock (QSBS) when a sale transaction is imminent.

Section 1202(h)(1) provides that if a stockholder gifts QSBS, the recipient of the gift is treated as

having acquired such stock in the same manner as the transferor, and (B) having held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under this subsection by the transferor.

This statute literally allows a holder of $100 million of QSBS to gift $10 million (or $15 million, if applicable) worth to each of nine friends, with the result that the holder and his nine friends each having the right to claim a separate $10 million gain exclusion. Under Section 1202, a taxpayer with $20 million in expected gain upon the sale of founder QSBS can increase the overall tax savings from approximately $2.4 million (based on no Federal income tax on $10 million of QSBS gain) to $4.4 million (based on no Federal income tax on $20 million of QSBS gain) by gifting $10 million worth of QSBS to friends and family.

A reasonable question to ask is whether it is ever too late to make a gift of QSBS for wealth transfer or Section 1202 gain exclusion cap planning? What about when a sale process is looming but hasn't yet commenced? Is it too late to make a gift when a nonbinding letter of intent to sell the company has been signed? What about the situation where a binding agreement has been signed but there are various closing conditions remaining to be satisfied, perhaps including shareholder approval? Finally, is it too late to make a gift when a definitive agreement has been signed and all material conditions to closing have been satisfied?

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The gifting of stock, including QSBS, occurs frequently in connection with family wealth planning or charitable giving planning. Fortunately, Section 1202(h)(2)(A) provides a "gift" exception to the usual rule that QSBS must be sold by the original holder in order to claim the benefits of Section 1202's gain exclusion. When QSBS is gifted, the transferee of the stock steps into the shoes of the transferor with respect to the stock's tax basis and holding period (including for Section 1202 purposes). For Section 1202 purposes, a "gift" means a gift for federal income tax purposes, not estate and gift tax purposes.[8] Generally, a transfer of QSBS will be considered to be a gift for purposes of Section 1202 if (i) the transferee is a different taxpayer than the transferor, (ii) the transfer is treated as a gift for purposes of Section 1015, and (iii) the facts and circumstances suggest that the transfer is a gift rather than a sale transaction, a payment of compensation, or element of some other business transaction. As discussed below, the ability to do incomplete gift, non-grantor trust planning presents opportunities for QSBS owners.

QSBS is often gifted to individuals (e.g., children) or trusts with family beneficiaries. QSBS can be gifted to spouses, but the gifting of QSBS to a spouse for the purpose of multiplying Section 1202's $10 million gain exclusion cap may not be the best planning strategy.[9] A holder of QSBS should also be able to gift QSBS to a tax partnership (limited liability company or limited partnership), but take note that the Section 1045 regulations provide that stock loses its QSBS status if it is "transferred" to a partnership.[10] That regulation specifically references a transfer where Section 721 applies, which should mean that the regulation's reach is limited to situations where QSBS is exchanged for an interest in the LLC/LP, not situations where the QSBS is gifted and nothing is received in exchange. In order to qualify for "gift" treatment, the LLCs or LPs equity owners would need to be family members or other individuals or entities for whom the contributor would be making gifts or charitable transfers to, rather than persons with whom the QSBS holder would be deemed to be engaging in business transactions or entering into compensation arrangements.

Some commentators take the position that a "gift" for Section 1202 purposes includes (i) a distribution of QSBS from a grantor or non-

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grantor trust to an individual beneficiary other than the grantor, and (ii) a distribution of QSBS from a grantor or non-grantor trust to another non-grantor trust that is a separate taxpayer from the distributing trust.[11] In both cases, it appears that the reasoning behind this position is that the transferee's basis in the QSBS would be the same as it would be in the hands of the transferor under Section 1015. QSBS may be appointed from a grantor or non-grantor trust pursuant to inter vivos powers of appointment granted to persons under the relevant governing instruments or pursuant to a statutory or common law ability of a trustee to decant assets from original governing instruments to new governing instruments. We agree that there is support for treating such transfers as "gifts" for Section 1202 purposes, but caution that there are no tax authorities expressly supporting this position, which leaves the door open for the IRS to argue that while these trust distributions might have some of the same characteristics as a "gift", they are not themselves "gifts" but rather non-taxable "distributions" that end QSBS status.[12]

In general, Section 83 treats as compensation any transfer of property from employer to service provider/employee. Said another way, there is basically no such thing as a "gift" under Section 83 where there is a transfer of property from an employer to a service provider. Transfers of QSBS that are treated as compensation payments are not gifts and, in fact, will generally trigger a deemed sale of the QSBS by the employer in addition to being treated as compensation to the recipient. This could also be the result if the "gift" is from a business owner to a service provider.

Although neither Section 1202 nor any other tax authorities interpreting Section 1202 address whether there are any exceptions to Section 1202's favorable treatment of gifts based on timing, the IRS is not without potential weapons in its arsenal.

Potential application of the assignment of income doctrine

If QSBS is gifted in close proximity to a sale, the IRS might claim that the donor stockholder was making an anticipatory assignment of income.[13]

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As first enunciated by the Supreme Court in 1930, the anticipatory assignment of income doctrine holds that income is taxable to the person who earns it, and that such taxes cannot be avoided through "arrangement[s] by which the fruits are attributed to a different tree from that on which they grew."[14] Many assignment of income cases involve stock gifted to charities immediately before a prearranged stock sale, coupled with the donor claiming a charitable deduction for full fair market value of the gifted stock.

In Revenue Ruling 78-197, the IRS concluded in the context of a charitable contribution coupled with a prearranged redemption that the assignment of income doctrine would apply only if the donee is legally bound, or can be compelled by the corporation, to surrender shares for redemption.[15] In the aftermath of this ruling, the Tax Court has refused to adopt a bright line test but has generally followed the Revenue Ruling's reasoning. For example, in *Estate of Applestein v. Commissioner*, the taxpayer gifted to custodial accounts for his children stock in a corporation that had entered into a merger agreement with another corporation.[16] Prior to the gift, the merger agreement was approved by the shareholders of both corporations. Although the gift occurred before the closing of the merger transaction, the Tax Court held that the "right to the merger proceeds had virtually ripened prior to the transfer and that the transfer of the stock constituted a transfer of the merger proceeds rather than an interest in a viable corporation."[17] In contrast, in *Rauenhorst v. Commissioner*, the Tax Court concluded that a nonbinding letter of intent would not support the IRS' assignment of income argument because the stockholder at the time of making the gift was not legally bound nor compelled to sell his equity.[18]

In *Ferguson v. Commissioner*, the Tax Court focused on whether the percentage of shares tendered pursuant to a tender offer was the functional equivalent of shareholder approval of a merger transaction, which the court viewed as converting an interest in a viable corporation to the right to receive cash before the gifting of stock to charities.[19] The Tax Court concluded that there was an anticipatory assignment of income in spite of the fact that there remained certain contingencies before the sale would be finalized.

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The Tax Court rejected the taxpayer's argument that the application of the assignment of income doctrine should be conditioned on the occurrence of a formal shareholder vote, noting that the reality and substance of the particular events under consideration should determine tax consequences.

Guidelines for last-minute gifts

Based on the guidelines established by Revenue Ruling 78-197 and the cases discussed above, the IRS should be unsuccessful if it asserts an assignment of income argument in a situation where the gift of QSBS is made prior to the signing of a definitive sale agreement, even if the company has entered into a nonbinding letter of intent. The IRS' position should be further weakened with the passage of time between the making of a gift and the entering into of a definitive sale agreement. In contrast, the IRS should have a stronger argument if the gift is made after the company enters into a binding sale agreement. And the IRS' position should be stronger still if the gift of QSBS is made after satisfaction of most or all material closing conditions, and in particular after shareholder approval. Stockholders should be mindful of the Tax Court's comment that the reality and substance of events determines tax consequences, and that it will often be a nuanced set of facts that ultimately determines whether the IRS would be successful arguing for application of the assignment of income doctrine.

Transfers of QSBS incident to divorce

The general guidelines discussed above may not apply to transfers of QSBS between former spouses "incident to divorce" that are governed by Section 1041. Section 1041(b)(1) confirms that a transfer incident to divorce will be treated as a gift for Section 1202 purposes. Private Letter Ruling 9046004 addressed the situation where stock was transferred incident to a divorce and then the issuing corporation immediately redeemed the stock. In that ruling, the IRS commented that

under section 1041, Congress gave taxpayers a mechanism for determining which of the two spouses will pay the tax upon

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the ultimate disposition of the asset. The spouses are thus free to negotiate between themselves whether the 'owner' spouse will first sell the asset, recognize the gain or loss, and then transfer to the transferee spouse the proceeds from the sale, or whether the owner spouse will first transfer the asset to the transferee spouse who will then recognize gain or loss upon its subsequent sale.

Thus, while there are some tax cases where the assignment of income doctrine has been successfully asserted by the IRS in connection with transfers between spouses incident to divorce, Section 1041 and tax authorities interpreting its application do provide divorcing taxpayers an additional argument against application of assignment of income doctrine, perhaps even in cases where the end result would be a multiplication of Section 1202's gain exclusion.

Section 643(f)'s limitation on increasing the gain exclusion cap through gifting and multiple non-grantor trusts

In many instances, gifting involves transfer of QSBS to non-grantor trusts, and sometimes to multiple non-grantor trusts. Overly aggressive use of multiple trusts, however, may run afoul of Section 643(f). Section 643(f) addresses the treatment of multiple trusts for federal income tax purposes. Its primary purpose is to prevent taxpayers from establishing multiple trusts with substantially similar characteristics in order to avoid higher tax rates that would apply if the assets were held in a single trust.

Section 643(f)(1) provides that two or more trusts will be treated as one trust if: (i) they have substantially the same grantor or grantors. For purposes of determining whether trusts have the same grantor, spouses are treated as one person; (ii) they have substantially the same primary beneficiary or beneficiaries; and (iii) a principal purpose for establishing one or more of such trusts, or for contributing additional cash or property to such trusts, is the avoidance of federal income tax.

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Note that if the trusts do not have substantially the same grantor(s) and primary beneficiary(ies), or if tax avoidance is not a principal purpose, the trusts will not be aggregated. And, if after a division, each resulting trust has a different primary beneficiary and is separately managed and administered, Section 643(f) generally does not require aggregation.

In PLR 9004007, the IRS ruled that the division of a trust into three equal parts, each for a different beneficiary, did not result in aggregation under Section 643(f) because the successor trusts had different beneficiaries and were separately managed. The principal purpose was not tax avoidance. And in PLRs 201133007 and 201021010, the IRS confirmed that, where trusts are divided and each resulting trust is separately managed for a different beneficiary, and there is no principal purpose of tax avoidance, the trusts are not aggregated under Section 643(f).

Gifting non-QSBS obtained in a tax-free exchange or reorganization for QSBS

Section 1202(h)(4) provides that a holder of QSBS can exchange QSBS for another issuer's QSBS or non-QSBS in a tax-free exchange under Section 351 or a tax-free reorganization under Section 368. If the original QSBS is exchanged for non-QSBS, that exchange is tax-free under Sections 351 or 368, and Section 1202(h)(4)(B) provides that the amount of the Section 1202 gain exclusion available to the holder of the non-QSBS is limited to the gain that would have been triggered if the transaction would have been taxable at the point of the exchange (i.e., the "Built-in-Gain"). If the non-QSBS appreciates after the exchange, that further appreciation would be eligible to be taxed at capital gains rates, but the Section 1202 gain exclusion cannot be claimed with respect to such further appreciation. We believe that there are a couple of implications that can be drawn from these rules as they would apply to the gifting of non-QSBS.

We believe that if a holder of non-QSBS with Built-in-Gain gifts those shares, the "giftee" of such non-QSBS should be treated under Section 1202(h)(4) as follows:

- holding shares with a carryover Section 1202 holding period;

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- should be subject to a carryover of the Built-in-Gain limitations applicable to the stock; and
- applying the identity of the original QSBS issuer as it applies to the giftee's issuer-by-issuer Section 1202 gain exclusion limitation.

For example, assume QSBS in XYZ Corporation is exchanged for non-QSBS in a Section 368 reorganization on the date when the original holder would have Built-in-Gain of $1,000 per share and the holder subsequently gifts the non-QSBS, and thereafter the non-QSBS subsequently appreciates an additional $1,000 before the giftee sells the non-QSBS. Given those facts, the holding period for the non-QSBS for purposes of Section 1202's five-year requirement would include the combined holding period of the giftor and giftee, (ii) the giftee would be treated as selling XYZ Corporation's QSBS for purposes of applying the giftee's overall $10 million gain exclusion with respect to XYZ Corporation, and (iii) the giftee's per-share Section 1202 gain exclusion with respect to such shares would be limited to the $1,000 Built-in-Gain amount associated with such shares.

We assume that the same rules described in the preceding paragraph that apply to gifted Section 1202(h)(4) non-QSBS would also apply to non-QSBS transferred at death, or from a partnership to a partner.

Is it possible to gift interests in partnerships (LLC/LP) holding QSBS?

Situations arise where individuals desire to gift interests in a fund (i.e., a tax partnership – LP/LLC) that holds QSBS. As discussed below, one safe approach would be for the partnership to distribute to each partner the applicable share (for Section 1202 purposes) of the partnership's QSBS. Each partner could then directly gift the shares of QSBS. Both steps of this approach are permitted by the express language of Section 1202. A second approach would be to gift the partnership interest itself (i.e., at a time when the partnership is holding QSBS). Section 1202 expressly permits gifting of QSBS but is silent on gifting of a partnership interest. Treasury

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Regulation Section 1.1045-1(g)(3)(ii) provides that for purposes of determining whether a taxpayer is eligible to share in a partnership's QSBS gain exclusion, "a taxpayer who acquires from a partner (other than a C corporation) by gift or at death an interest in a partnership that holds QSB stock is treated as having held the acquired interest in the partnership during the period the partner (other than the C corporation) held the interest in the partnership." The Section 1045 regulations do constitute a tax authority for purposes of Section 1202, and it seems entirely reasonable to conclude that if the transferee of a partnership interest is treated as sharing in that partnership's QSBS for purposes of Section 1045, the same treatment should apply for Section 1202 purposes. That said, the safest approach would be to distribute the QSBS out of the partnership and then gift the shares of QSBS directly.

Another approach would be to gift the partnership interests to family members prior to the partnership's acquisition of QSBS. In those circumstances, the giftee will be a partner when the QSBS is acquired by the partnership and will share in any Section 1202 gain exclusion. This planning concept applies to family LLCs/LPs acquiring QSBS investments and profits interests in investment funds obtained through providing services. For example, subject to any contractual transfer restrictions, consideration should be given to transferring a carried interest or other interest in an LLC/LP to family members or a family LLC/LP prior to the acquisition of QSBS by the fund. This transfer planning in advance of the applicable QSBS acquisition potentially allows families to multiply the $10 million gain exclusion cap. Of course, in many cases this advance planning won't occur as a practical matter because QSBS holders often don't worry about multiplying the gain exclusion or undertaking family wealth transfer planning until it is clear that an investment is highly successful.

Is it possible to gift stock in S corporations holding QSBS?

None of Section 1202, Section 1045 or the Section 1045 regulations, or any other tax authority address the consequences for Section 1202 purposes of gifting stock in an S corporation holding QSBS.

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But unlike the situation discussed above with respect to partnerships, it isn't possible to distribute QSBS out of the S corporation without triggering a deemed sale, so the two-step distribution and gift option isn't available as a planning tool. We don't see any policy reason why the gifting of S corporation stock should be treated differently than the gifting of partnership interests for Sections 1202 and 1045 purposes. Both S corporations and partnerships are "pass-thru" entities for Sections 1202 and 1045 purposes. Nevertheless, given the fact that the Treasury Regulation Section 1.1045-1(g)(3)(ii) doesn't address the gifting of S corporation stock, the safest approach would be to gift shares of S corporation stock prior to the S corporation's acquisition of QSBS. If that isn't possible, then another possibility would be structuring a "corporate freeze" transaction involving the corporation issuing the QSBS (obviously, this only works if the corporation is under family control), where the S corporation ends up with preferred stock and other family members end up holding common stock. For information about business freeze transactions, see the article "Exploring the Benefits of the Corporate Freeze Transaction."[20]

Charitable contributions of QSBS

Transfers of QSBS can be made to organizations described in Section 170(c), including public charities, donor advised funds and private operating foundations.[21] The transfer should be treated as a gift for purposes of Section 1202(h)(2), but charities and private foundations do not need to rely on Section 1202's gain exclusion as they are not taxed on capital gains realized from stock sales. The donor's charitable deduction is generally the fair market value (FMV) of the stock (whether public company or nonpublic company stock) at the time of the contribution to a Section 170(c) organization, provided the stock is capital gain property (i.e., including stock held for more than one year). But if the QSBS is contributed to a "private nonoperating foundation," the donor's charitable deduction is limited to the donor's tax basis in the stock, unless the stock is "qualified appreciated stock," which is stock for which market quotations are readily available on an established securities market. The typical private nonoperating foundation is a family foundation or grantmaking foundation. There are also

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substantiation requirements and additional limitations on charitable deductions applicable at the donor level. Section 2522 provides that a qualifying charitable contribution, which would include the transfer of QSBS to a charity, does not use up any of the donor's lifetime gift tax exemption (i.e., it is excluded from the calculation of taxable gifts).

A contribution of QSBS may not make the most sense from a tax standpoint if a taxpayer has other stock or property that could be contributed and Section 1202's gain exclusion could eliminate the taxpayer's gain when QSBS is sold. Also, if a sale of the QSBS is imminent, a taxpayer should consider selling the QSBS, offsetting the resulting gain with Section 1202's gain exclusion, and then making a charitable contribution of proceeds, as gifts of capital gain assets are subject to limitations not applicable to contributions of money. Making a charitable contribution of QSBS is tax efficient if the anticipated gain on the sale of QSBS will exceeds a taxpayer's Section 1202 gain exclusion, the planning to increase the gain exclusion cap has been exhausted, and the taxpayer does not want to make a Section 1045 election to roll over his original QSBS proceeds into replacement QSBS. For example, if a taxpayer anticipates selling $50 million worth of QSBS during the succeeding year, the taxpayer could make a charitable contribution of $10 million worth of the QSBS. When the QSBS sale occurs, the taxpayer will claim a $10 million gain exclusion and the charity will pocket $10 million of proceeds from its sale of QSBS. This charitable contribution strategy achieves a double tax benefit – a fair market value tax deduction (subject to applicable limitations) and the elimination of the capital gains taxes. An exception to the double tax benefit applies if the stock is gifted to a private nonoperating foundation and is not 'qualified appreciated stock" – under those circumstances the charitable deduction is limited to the taxpayer's tax basis in the stock. Finally, in order to avoid a possible IRS "assignment of income" argument, the charitable contributions should be made before signing a definitive sale agreement.

Gifting QSBS for the purpose of multiplying the $10 million gain exclusion cap

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One of the principal reasons why holders of QSBS want to gift stock is their realization that the QSBS' value upon sale will exceed the usual $10 million exclusion cap. Under those circumstances, lifetime gifts and transfers upon death are the only ways available to move QSBS into the hands of additional taxpayers, each of whom should qualify for their own $10 million gain exclusion cap. Section 1202 doesn't limit the number of taxpayers a holder can gift stock to, nor does it provide guidelines regarding the timing of such transfers. For example, a holder of $100 million in a single issuer's QSBS could potentially gift $10 million in QSBS to each of nine adult children, with each child then qualifying for a separate $10 million gain exclusion. For an in-depth discussion of multiplying the Section 1202 gain exclusion cap, see the article "Maximizing the Section 1202 Gain Exclusion Amount."

Transfers of QSBS to grantor trusts are not gifts for Section 1202 purposes as they are not treated as completed transfers for federal income tax purposes.[22] Use a non-grantor trust if you want to "gift" QSBS to a trust and have it owned by a separate taxpayer. Any non-grantor trust that is a separate taxpayer from the stockholder gifting the stock to the trust should work in terms of putting some of the holder's QSBS in the hands of a separate taxpayer, so long as the grantor is not a beneficiary of the trust. Where the grantor wants to be a beneficiary of the trust, we recommend that holders of QSBS consider using Delaware or Nevada non-grantor asset protection trusts as the vehicle for their trust planning. Under the federal income tax trust statutes (Sections 671 through 679), a donor can be named as a discretionary beneficiary only when the trust is formed under asset protection statutes such as those applicable to Delaware and Nevada trusts. Further, Nevada and Delaware asset protection trusts are useful tools for Section 1202 planning because there are a number of long-standing and often compelling non-tax business reasons for creating those asset protection trusts.[23]

We recommend that any holder of QSBS considering undertaking planning to "multiply" the Section 1202 gain exclusion consult with advisors who have expertise working with QSBS and the holder's personal trust and estate attorney, because it is important to make

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sure that any trusts holding QSBS function properly within the taxpayer's overall estate plan. See the article "Maximizing the Section 1202 Gain Exclusion Amount." Further, the use of more than one trust in conjunction with a taxpayer's overall estate plan should consider the application of certain doctrines and rules in the transfer and income tax planning context, such as the reciprocal trust doctrine and the multiple trust combination statute.[24]

Transfers of QSBS between spouses or incident to divorce

Spouses can gift QSBS to each other and preserve the QSBS status of the shares for Section 1202 purposes.[25] Under those circumstances, the transferee spouse will be treated as an original owner of the QSBS and step into the shoes of the transferor spouse with respect to his or her holding period.

A spouse can sell QSBS to his or her spouse or pay the other spouse compensation in the form of shares of QSBS, but at least in the case of using the shares as compensation, the QSBS status would terminate. Under Section 1041, no gain or loss is recognized in connection with a sale between spouses, but this rule doesn't apply to payment for services. Although there isn't any clear authority on the issue, it would appear that a sale of QSBS from a spouse to the other spouse would be treated as a "gift" for Section 1202 purposes, although the IRS could argue, given the lack of specific Section 1202 authority on the issue, that the sale would result in the termination of QSBS status. The transfer of QSBS as compensation for services, including services provided by a spouse, appears to terminate the QSBS status for the stock, and would also appear to be a deemed sale of the QSBS for purposes of the paying spouse claiming the Section 1202 gain exclusion.

Section 1041 provides that no gain or loss is recognized on a transfer of QSBS from one spouse to a former spouse incident to divorce, unless the spouse is a nonresident alien. Presumably, a transfer incident to a divorce would be treated as a "gift" for Section 1202 purposes, although there is no tax authority expressly confirming that conclusion.

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Transfers of QSBS at death

Section 1202(h)(2)(B) provides that the transferee of QSBS at death is treated as having acquired the QSBS in the same manner as the transferor, including stepping into the transferor's holding period. Presumably, both transfers to an estate and to beneficiaries from an estate would fall within the scope of this provision, but there are no tax authorities addressing this issue.

Transfers of QSBS from partnerships to partners

Section 1202(h)(2)(C) provides that a transferee of QSBS from a partnership to a partner may result in the partner being treated as having acquired the QSBS in the same manner as the partnership, including stepping into the partnership's holding period. This beneficial treatment is available only to the extent that the partner held an interest on the date the QSBS was acquired by the partnership and then only to the extent of such interest.[26]

There is a debate as to what "interest" the holder of a profits interest (carried interest) holds in a partnership for Section 1202 purposes, assuming for simplicity of discussion that the profits interest is issued on the day the partnership acquires the QSBS. We believe that the "interest" referred to in Section 1202 encompasses the entire economic rights of a profits interest holder as set out in an LLC agreement or partnership agreement. That being said, given the complexity of distribution waterfalls and how profits interests are structured, it could be an issue among the partners to determine the sharing of QSBS on a liquidation basis in situations where ownership of the QSBS hasn't run its course (i.e., the QSBS hasn't fully appreciated).

No permissible transfer of QSBS from an S corporation to its shareholders

There is nothing in Section 1202, Section 1045 or the Section 1045 regulations suggesting that Section 1202(h)(2)(C)'s beneficial treatment of distributions by partnerships to partners extends to distributions by S corporations to its shareholders. In fact, a

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distribution of QSBS from an S corporation to its shareholders would trigger a deemed sale of the QSBS. Presumably, if QSBS with a five year holding period was distributed from the S corporation to its shareholders, the shareholders could claim the Section 1202 gain exclusion in connection with the deemed sale. This distribution, however, would cut off any additional Section 1202 gain exclusion if the stock appreciates.

Stock-for-stock transfers of QSBS

There are several provisions in Section 1202 which address the consequences of tax-free exchanges of QSBS for other stock. Section 1202(f) provides that stock in a corporation acquired upon the conversion of QSBS in such corporation (e.g., conversion of convertible preferred stock into common stock) will be treated as QSBS, with a holding period that includes the holding period for the original QSBS.

Sections 1202(h)(3) and (4) provide that certain tax-free exchanges and reorganizations (in particular those covered by Section 351 and 368 along with stock splits and reverse stock splits) allow the holder to preserve and maintain eligibility to claim the Section 1202 gain exclusion with certain limitations if the replacement stock isn't QSBS. See the article "Recapitalizations Involving Qualified Small Business Stock."

QSBS transferred in consideration of the payment of other QSBS or non-QSBS shares in a taxable transfer is treated no differently than the sale of QSBS for cash consideration. In a taxable exchange, the holder of QSBS should be able to claim the Section 1202 gain exclusion, subject to satisfying the five-year holding period and other applicable eligibility requirements.

Closing remarks

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Section 1202 and Section 1045 tax planning. Venture capitalists, founders and investors who want to learn more about QSBS planning opportunities are directed to several articles on the Frost Brown

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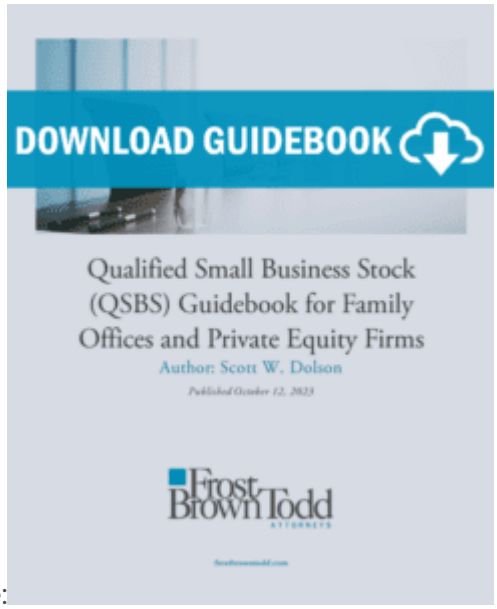
Todd website:



- Revisiting the Choice of Entity Decision After OBBBA's 2025 Tax Law Changes | Part 1
- Exploring Section 1202's Active Business Requirement
- Substantiating the Right to Claim QSBS Tax Benefits | Part 2
- Substantiating the Right to Claim QSBS Tax Benefits | Part 1
- To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)
- Advanced Section 1202 (QSBS) Planning for S Corporations
- Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 2
- Structuring the Ownership of Qualified Small Business Stock (QSBS) – Is There a Role for Roth IRAs?
- Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide
- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations
- Can Stockholders of Employee Leasing or Staffing Companies Claim Section 1202's Gain Exclusion?

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- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion
- A SPAC Merger Primer for Holders of Qualified Small Business Stock
- Determining the Applicable Section 1202 Exclusion Percentage When Selling Qualified Small Business Stock
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045

Contact Scott Dolson if you want to discuss any 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] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. Many but not all states follow the federal income tax treatment of QSBS.

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

[3] A discussion of the OBBBA can be found in "*One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors*." The

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amendments to Section 1202 include a reference to Section 1223 which has the effect of blocking the conversion of pre-OBBBA QSBS into post-July 4, 2025, QSBS through stock-for-stock exchanges or in connection with the reinvestment of pre-OBBBA sale proceeds into replacement QSBS under Section 1045.

[4] The "standard" gain exclusion cap is $10 per-taxpayer, per-QSBS Issuer for QSBS issued prior to July 5, 2025. For QSBS issued after July 4, 2025, the standard gain exclusion cap has been increased by OBBBA to $15 million.

[5] No gain or loss is recognized on a transfer of property from an individual (or in trust for the benefit of) a spouse. Treasury Regulation Section 1.1041-1T.

[6] This last category is referenced in the statute as being applicable to the extent that such additional transaction structures are addressed in regulations, none of which have been promulgated by the IRS. Nevertheless, the reference in the statute at least opens the door for the IRS taking the position that some variant working to the same end as the short sale arrangement falls within the scope of Section 1202(j).

[7] The planning technique of gifting QSBS recently came under heavy criticism in an article written by two investigative reporters. See Jesse Drucker and Maureen Farrell, "*The Peanut Butter Secret: A Lavish Tax Dodge for the Ultrawealthy*." *New York Times*, December 28, 2021.

[8] See *Hamberg v. Commissioner*, 400 F.2d 435 (9th Cir. 1968).

[9] There are certain tax authorities that provide support for a return position that for joint returns, each spouse should be entitled to a separate gain exclusion. From a planning standpoint, a clearer path involves gifting QSBS to other taxpayers, including nongrantor trusts. See the Scott Dolson article "*Maximizing the Section 1202 Gain Exclusion Amount*."

[10] Treasury Regulation Section 1.1045-1(f).

[11] See Lee, Comeau, Kwon and Long, *Qualified Small Business Stock: Quest for Quantum Exclusions*, Part 3, Tax Notes Federal, July 20, 2020, page 412.

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[12] Section 1202 doesn't provide that distributions of QSBS from a trust to a beneficiary is a transfer that permits the status and holding period of QSBS to continue in the hands of the transferee. There certainly is an argument that it should, but there is no explicit Section 1202 authority providing support to the position (unlike, for example, the transfer of QSBS from a partnership to a partner).

[13] This article assumes that the holder of the stock doesn't have sufficient tax basis in the QSBS to take advantage of the 10X gain exclusion cap – for example, the stock might be founder shares with a basis of .0001 per share.

[14] *Lucas v. Earl*, 281 U.S. 111 (1930). The US Supreme Court later summarized the assignment of income doctrine as follows: "A person cannot escape taxation by anticipatory assignments, however skillfully devised, where the right to receive income has vested." *Harrison v. Schaffner*, 312 U.S. 579, 582 (1941).

[15] Revenue Ruling 78-197, 1978-1 CB 83.

[16] *Estate of Applestein v. Commissioner*, 80 T.C. 331, 346 (1983).

[17] *Id.*

[18] *Gerald A. Rauenhorst v. Commissioner*, 119 T.C. 157 (2002).

[19] *Ferguson v. Commissioner*, 108 T.C. 244 (1997).

[20] The cited article doesn't discuss the impact of Section 2701 and other statutes and doctrines affecting the transfer of wealth among family members for gift and estate and income tax purposes.

[21] Section 170(c) organizations include corporations, trust and foundations that are organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals; No part of the net earnings inures to the benefit of any private shareholder or individual; and are not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and does not participate in, or intervene in, any

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political campaign on behalf of (or in opposition to) any candidate for public office.

[22] Section 671.

[23] See Section 643(f), the Section 643(f) regulations and various decisions addressing the reciprocal trust doctrine for the potential issue of consolidation of multiple trusts.

[24] See Section 643(f).

[25] See Section 1015(e).

[26] Section 1202(g).

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