Transfers “At Death” of Qualified Small Business Stock

Sep 29, 2021

Categories:

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

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This article addresses the consequences of “transfers at death” of qualified small business stock (“QSBS”) under Section 1202.

Generally, in order to qualify for Section 1202’s gain exclusion, the stockholder who sells QSBS must be the same stockholder who was issued the QSBS by the qualified small business corporation. There are several exceptions to this requirement, including Section 1202(h)(2)(B), which provides that when there is a transfer “at death,” the transferee is treated as the original stockholder for Section 1202 purposes and is treated as having held the transferred QSBS for the original stockholder’s holding period.

This is one in a series of articles and blogs addressing planning issues relating to qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Internal Revenue Code.[i] 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 corporate rate from 35% to 21%, but savvy founders and investors have also focused on qualifying for Section 1202’s generous gain exclusion. Any future increases in capital gains rates may result in QSBS eligible investments being even more attractive by comparison.[ii]

What does transferred at death mean?

“At death” is not defined for Section 1202 purposes or in any other tax authority expressly interpreting Section 1202.

Section 1245(b)(2) provides that no gain shall be recognized under Section 1245(a)(1) upon a “transfer at death.”

Treasury Regulation Section 1245-4(b) defines the terms “transfer at death” to mean a “transfer of property which, in the hands of the transferee, has a basis determined under the provisions of Section 1014(a) (relating to basis of property acquired from a decedent) because of the death of the transferor.” Example (1) explaining Treasury Regulation Section 1245-4(b) refers to inherited property;

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Example (3) refers to property transferred pursuant to a bequest in a will; and Example (4) refers to property transferred by the trustee of a trust created by a will in satisfaction of a specific bequest.

Section 1014(b)(1) provides that property will be considered to have been acquired from, or to have passed from, a decedent for purposes of Section 1014(a), if the property was "acquired by bequest, device, or inheritance, or by the decedent's estate from the decedent." The Supreme Court has held that when Congress used the terms "bequest, devise, or inheritance," it intended to embrace all acquisitions in the devolution of a decedent's estate." [iii] Section 1245(b)(2)'s reference and Treasury Regulation Section 1245-4(b)'s explanation suggest that when Congress used "at death," it intended the same broad scope of transfers. QSBS transfers "at death" include: (a) QSBS left to a recipient pursuant to a specific bequest or as a residual distribution from an estate or a decedent's inter vivos revocable trust, (b) QSBS distributed from the estate of an intestate decedent, (c) QSBS held by an estate or a decedent's inter vivos revocable trust when sold, (d) QSBS held in a testamentary trust or a decedent's inter vivos revocable trust when sold, and (e) QSBS received in compromise of a claim as an heir of an estate.

QSBS holding period.

When there is a transfer "at death," the transferee is treated as the original stockholder for Section 1202 purposes and is treated as having held the transferred QSBS during the entire original stockholder's holding period. So, if a holder of QSBS dies after holding the stock for four years and leaves the QSBS to her daughter, the daughter commences her ownership with a four-year holding period, plus any period during which the QSBS was in the mother's estate.

Applicable percentage exclusion limitation.

For purposes of the several percentage exclusion limitations in Section 1202, a recipient of QSBS transferred at death steps into the shoes of the deceased stockholder with respect to the

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applicable percentage limitation – i.e., if the original holder acquired the stock during 2001, the recipient would be entitled to only a 50% gain exclusion.

How does the step-up in basis to the date-of-death value affect the $10 million gain exclusion cap?

Section 1202(b)(1)(A) generally allows each taxpayer to claim up to $10 million of gain exclusion with respect to an issuing corporation's QSBS.[iv] When a stockholder holding QSBS dies, the basis of the QSBS for federal income tax purposes increases to fair market value on the date of death under Section 1014(a). In light of these two rules, how does the $10 million gain exclusion cap function when a founder with fully vested penny (zero basis) QSBS dies and leaves the QSBS with a $10 million date of death value to his daughter who later sells the QSBS for $20 million? Does the daughter have a $10 million stock basis, $10 million of gain and a full $10 million Section 1202 gain exclusion, or does she have a $10 million stock basis, $10 million of gain and a zero Section 1202 gain exclusion?

Section 1202(b)(1) provides that "the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued," but this provision only applies to Section 1202(b)(1)(B), which is the separate 10X gain exclusion cap discussed in more detail below, not Section 1202(b)(1)(A), which is the $10 million gain exclusion cap. We believe that the fact that this limitation in additions to basis applies explicitly to the 10X gain exclusion cap, but does not reference the $10 million gain exclusion cap, is helpful support for the conclusion that the daughter would be entitled to claim a $10 million gain exclusion. We haven't identified any language in Section 1202 or discussion in other tax authorities interpreting Section 1202 that suggests a different and less favorable result.[v]

No step-up in basis for purposes of the 10X gain exclusion cap.

Presumably, the step-up in basis of the QSBS upon the death of the original stockholder will not increase the recipient's 10X gain exclusion cap under Section 1202(b)(1)(B), because of the rule in

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Section 1202(b)(1) that "the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued."

Estate and gift planning with QSBS.

There can be some potential benefits associated with holding QSBS until death, but that will depend on specific facts associated with the stockholder's QSBS, how the holding or gifting of the QSBS fits into the stockholder's overall estate and wealth transfer plans, and whether Congress acts to change the estate tax exemption amount and associated income tax consequences triggered by the death of a stockholder. In order to determine the best plan for handing a substantial holding of QSBS, we recommend that stockholders work with estate and financial advisors who are familiar with QSBS planning.

More Resources

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Code Section 1202 and Code Section 1045 planning. Venture capitalists, founders and investors who want to learn more about Code Section 1202 and Code 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
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202

Contact Scott Dolson or Melanie McCoy (QSBS estate and trust planning) 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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[i] References in this article to "Section" are to sections of the Internal Revenue Code, as amended. Section 1202 makes available to eligible stockholders a gain exclusion when selling qualified small business stock (QSBS). The available gain exclusion is generally capped at a $10 million per stockholder per-issuer exclusion, although the exclusion can exceed that amount under certain circumstances. Section 1045 allows the proceeds from the sale of QSBS to be rolled over on a tax-free basis into replacement QSBS.

[ii] Although it is possible that the corporate tax rate will increase from the current 21% rate, it is also possible that the capital gains rate for high-income individuals will increase dramatically, potentially making the seeking of Section 1202 gain exclusion an even more compelling planning option.

[iii] Lyeth v. Hoey, 305 U.S. 188 (1938).

[iv] Stockholders who pay for their shares may also benefit from the 10X gain exclusion in Section 1202(b)(1)(A), particularly if the stockholder either pays more than $1 million for an issuing corporation's stock or sells stock over two or more years. See the Scott Dolson article "Maximizing the Section 1202 Gain Exclusion Amount."

[v] Section 1202(b)(1)(B) provides for a Section 1202 gain exclusion cap equal to 10 times the aggregate adjusted basis of QSBS disposed of by a taxpayer during a taxable year. Effectively, if a taxpayer's aggregate tax basis in QSBS sold in a single tax year exceeds $1 million, or a taxpayer sells QSBS over two or more years, he will often be able to take advantage of the "10X" gain exclusion cap, which function both in conjunction with and separately from the $10 million gain exclusion cap in Section 1202(b)(1)(A).

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