Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045

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Section 1045 allows stockholders to reinvest on a pre-tax basis, proceeds from the sale of qualified small business stock (QSBS) into replacement QSBS.[i] As discussed below, there are several reasons why stockholders take advantage of Section 1045. Often, holders of QSBS who are selling before satisfying Section 1202's five-year holding period requirement want to reinvest the sales proceeds in replacement QSBS on a pre-tax basis so that they eventually claim Section 1202's gain exclusion by combined holding periods for their original and replacement QSBS. Some stockholders may have reached Section 1202's gain exclusion cap ($10 million for holders of low tax basis stock) with respect to their original QSBS investment and want to reinvest excess sales proceeds on a pre-tax basis into replacement QSBS. Other stockholders want to invest in start-ups and see Section 1045 as a useful tool for selling one QSBS investment and replacing it on a pre-tax basis with another QSBS investment.

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.

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This is a two-part article. This first installment introduces Section 1045 and focuses on Section 1045 as a planning tool. The second installment focuses on steps that should be taken to place a stockholder in the best position to secure the benefits of Sections 1045 and 1202. A separate article focuses on the overall options available when dealing with the good news-bad news situation when QSBS is sold before satisfying Section 1202's five-year holding period requirement: Are You Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?

Section 1045 allows stockholders to defer gain on a sale of "original" QSBS by reinvesting sales proceeds into "replacement" QSBS

Section 1045 permits stockholders to defer otherwise taxable gain on the sale of QSBS (referred to in this article as "Original QSBS") held for at least six months by reinvesting their sales proceeds into shares of qualified small businesses (referred to in this article as "Replacement QSBS"). If a stockholder reinvests sales proceeds under Section 1045, some or all of the gain that would otherwise be recognized on the sale of the Original QSBS will be deferred until the Replacement QSBS is sold. This deferral of gain recognition applies regardless of whether the stockholder ultimately claims Section 1202's gain exclusion when the Replacement QSBS is sold. In this way, Section 1045 functions independently of Section 1202, although Section 1202 governs whether the Original QSBS and Replacement QSBS qualify as QSBS for purposes of Section 1045.

Section 1045 also acts as a companion provision to Section 1202, allowing stockholders who have reinvested Original QSBS proceeds into Replacement QSBS the opportunity to claim Section 1202's gain exclusion when the Replacement QSBS is sold, but only if the stockholders have at least a five-year combined holding period for the Original QSBS and Replacement QSBS and all other Section 1202 eligibility requirements are met with respect to both the Original QSBS and the Replacement QSBS.

When a stockholder reinvests proceeds from the sale of Original QSBS into Replacement QSBS, the tax basis in the Replacement

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QSBS is reduced by the amount of deferred gain. For example, if the stockholder purchases Replacement QSBS for $5 million, which represents a gain deferral of $4,950,000, the stockholder's tax basis in the Replacement Stock will be reduced to $50,000.[ii] When the replacement QSBS stock is sold, the gain recognized will either be taxed at capital gains rates or excluded to the extent Section 1202 applies.[iii]

Section 1045's gain exclusion operates independently to permit a pre-tax reinvestment of QSBS proceeds, whether Section 1202's gain exclusion is ultimately claimed with respect to the Replacement QSBS

In situations where a stockholder sells the Original QSBS prior to achieving the required five-year holding period, Section 1045 is available to defer gain if the stockholder reinvests the sales proceeds into Replacement QSBS. The deferral of gain on the initial sale of Original QSBS works, whether or not the stockholder ultimately claims Section 1202's gain exclusion with respect to the Replacement QSBS. Section 1045 provides that Section 1202(c)(2)'s active business requirements need only be met for six months after issuance of Replacement QSBS. Once the six-month mark passes, the corporation issuing the Replacement QSBS could make an S election, begin engaging in business activities that don't qualify under Section 1202, or accumulate excessive cash, investment assets or non-operating real estate, in each case without adversely affecting the tax-deferral afforded by Section 1045. But if the corporation issuing Replacement QSBS ceases to meet Section 1202's active business requirements, the stockholder will not be eligible to claim Section 1202's gain exclusion with respect to the Replacement QSBS.

Section 1045 planning opportunities

As discussed above, Section 1045 has two significant tax benefits. First, it allows shareholders to reinvest an amount equal to a stockholder's sales proceeds on a pre-tax basis into Replacement

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QSBS. Second, a stockholder purchasing Replacement QSBS might qualify for Section 1202's gain exclusion when the Replacement QSBS is subsequently sold. As mentioned above, the holding period for a stockholder's Original QSBS is tacked onto the holding period for the Replacement QSBS.

Section 1045 doesn't appear to limit the right to reinvest Original QSBS sales proceeds on a pre-tax basis to Original QSBS held for less than five years, so the proceeds from the sale of any Original QSBS can be reinvested into Replacement QSBS. One useful planning technique is to reinvest proceeds from Original QSBS sold with a holding period exceeding five years into Replacement QSBS because the stockholder has reached the gain exclusion cap. A stockholder can first purchase and sell Original QSBS, then purchase Replacement QSBS (making the Section 1045 election), then sell the Replacement QSBS, and again purchase Replacement QSBS (making another Section 1045 election). It is possible to take the proceeds from one Original QSBS investment and reinvest the aggregate proceeds into Replacement QSBS of 100 issuers.

Stockholders should keep in mind that if they have "lots" (blocks of shares purchased) of QSBS purchased on different dates (for example, some shares of QSBS with a five-year holding period and some shares with less than a five-year holding period) and they can identify those separate lots, they should consider selling shares by separate lots in a fashion that results in the most beneficial mix of Section 1202 gain exclusion and reinvestment under Section 1045. [iv]

This is a summary of some of the more useful Section 1045 planning opportunities:

Reinvesting QSBS sales proceeds when the stockholder hasn't satisfied Section 1202's five-year holding period requirement. Most stockholders take advantage of Section 1045 to reinvest an amount equal to their Original QSBS sales proceeds when they are selling the stock prior to satisfying Section 1202's five-year holding period requirement.

Reinvesting QSBS sales proceeds for the purpose of expanding Section 1202's gain exclusion cap. A stockholder who has reached

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the gain exclusion cap (often $10 million) with respect to Original QSBS might consider reinvesting some of the proceeds into Replacement QSBS, with the goal of claiming Section 1202 gain exclusion when the Replacement QSBS is sold. Under Section 1202, each issuer of Replacement QSBS would be treated as a separate issuer from the corporation issuing the Original QSBS. There are no tax authorities suggesting that the amount of gain exclusion taken with respect to the Original QSBS applies against the gain exclusion available when Replacement QSBS is sold. For example, a stockholder selling $15 million of Corporation A's original QSBS could claim a $10 million gain exclusion with respect to the sale of Corporation A's QSBS, and reinvest $5 million of proceeds into Corporations B and C. If the stockholder's investments in Corporations B and C are successful, the stockholder can potentially claim a $10 million gain exclusion in connection with the sale of Corporation B's Replacement QSBS and Corporation C's Replacement QSBS.

Reinvesting QSBS sales proceeds as a vehicle for investing in start-ups on a pre-tax basis. A stockholder might elect to reinvest Original QSBS proceeds into Replacement QSBS because the stockholder already intends to make QSBS investments, and it makes sense to switch from one QSBS investment to another on a pre-tax basis. As discussed elsewhere, Section 1045's tax deferral functions independently of whether the stockholder eventually claims Section 1202's gain exclusion with respect to the Replacement QSBS. If the Original QSBS investment turned into $100 million of public company stock, it should be possible to sell $10 million and claim Section 1202's gain exclusion and then sell the balance over time, reinvesting the proceeds into numerous Replacement QSBS investments. If the issuer of the QSBS went public in a traditional initial public offering, there generally won't be any limit on the potential Section 1202 gain exclusion. if the IPS was a SPAC transaction involving a merger with the SPAC or the issuer of the Original QSBS was acquired in exchange for public company stock, then the potential Section 1202 gain exclusion would be capped based on the gain deferred at the time of the exchange of the Original QSBS for non-QSBS, but the aggregate gain exclusion in the replacement QSBS would not appear to be capped based on

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the gain exclusion claimed with respect to the Original QSBS.

Where an M&A rollover is not structured to preserve the QSBS status of stock, reinvesting QSBS sales proceeds for the purpose of preserving the potential for benefiting from Section 1202's gain exclusion. If a target corporation's stockholders are required to roll over some or all of their QSBS in an M&A transaction, the typical goal if the stockholders' holding period is less than five years is to structure the rollover as a nonrecognition exchange under Section 351 or a tax-free reorganization under Section 368. In some transactions, however, the mix of cash and equity won't permit a Section 368 reorganization or the buyer will insist that the target stockholders' QSBS be rolled over in a Section 721 exchange for a limited partnership or limited liability company equity interest. A Section 721 exchange is a nonrecognition transaction, but it doesn't preserve the target stockholders' ability to claim Section 1202's gain exclusion in the future. A partial solution for this problem is for the target stockholders to sell all of their QSBS in a taxable sale rather than roll stock over under Section 721, and reinvest an amount equal to the sales proceeds into Replacement QSBS. This approach allows the stockholders to treat the sale and reinvestment as a nonrecognition event under Section 1045, thereby opening the door for potentially claiming Section 1202's gain exclusion. These target stockholders, however, will also be required to come up with additional funds to make their rollover investment in buyer equity.

Reinvesting QSBS sales proceeds in the situation where a stockholder's shares of Original QSBS don't qualify for long-term capital gains treatment. The holding period required to reinvest Original QSBS proceeds under Section 1045 can be as short as six months, which means it is possible to structure a reinvestment of Original QSBS sales proceeds into Replacement QSBS for the purpose of avoiding short-term capital gains on the sale of the Original QSBS.

Options for reinvesting Original QSBS sales proceeds

Stockholders selling Original QSBS and desiring to take advantage of Section 1045 have several options available to

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them that can be mixed and matched:

Purchasing minority investments in Replacement QSBS. The most straightforward option is to make minority investments in an unaffiliated company's Replacement QSBS. At any given time, there are numerous opportunities to invest in start-ups, particularly for investors with connections to their venture investment community. Obviously, the reference to a minority investment might not always be the case if the investment is significant enough. This choice can be a problem for stockholders who have large amounts that need to be reinvested within the short 60-day window afforded by Section 1045, and those stockholders who have concerns about recommitting their funds to minority investments in speculative start-ups.

Incorporating a start-up to create an active business. A popular alternative for stockholders electing to go the route outlined in the preceding paragraph is to fund a de novo start-up with a plan of creating an active qualified business. This option is discussed in detail in Part 2 of this Article.

Incorporating a start-up to seek and acquire the assets or stock of an active business. A third alternative is to fund a newly-formed corporation with a play of undertaking a search that culminates in the acquisition of the assets or stock of an active business. This option is discussed in detail in Part 2 of this Article.

Section 1045 planning for partnerships

Partnerships (including venture capital funds and private equity funds) can invest in QSBS. If the partnership sells QSBS held for at least six months, Section 1045 and applicable Treasury Regulations allow for a reinvestment of QSBS proceeds by either the partnership or eligible partners.[v] 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.

Section 1045's regulations appear to permit stockholders to reinvest an amount equal to some or all of their Original QSBS sales

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proceeds through a partnership (i.e., contributing QSBS sales proceeds to a partnership).[vi] If a stockholder decides to contribute the sales proceeds to a partnership, those funds must be reinvested by the partnership into Replacement QSBS during the investor's 60-day window under Section 1045, and each reinvesting stockholder's share of the Replacement QSBS should be, as of the date of the partnership's purchase of the Replacement QSBS an amount equal to the stockholder's Original QSBS proceeds being reinvested through the partnership. Stockholders should consult with their tax advisors and review Section 1045's regulations before adopting this or any other Section 1045 planning strategy.

Stockholders who share in Original QSBS sales proceeds through the holding of a carried interest in a partnership won't share in those Original QSBS sales proceeds for Section 1045 purposes

Section 1045's regulations made it clear that partners share in the partnership's QSBS proceeds for Section 1045 purposes based on the smallest capital interest held by the partner during the partnership's holding period for the applicable QSBS. This means that if a partner holds a pure carried interest on the date a partnership acquires Original QSBS (meaning that the partner would be deemed to hold a profits interest under Revenue Ruling 93-27 and not be entitled to share in the proceeds of the sale of the QSBS on day one), then the partner would be entitled to no share of the proceeds from the sale of the Original QSBS for Section 1045 purposes, regardless of whether the partner actually shares in proceeds from the sale of the Original QSBS under the terms of the applicable partnership agreement. We believe that there is a different result with respect to the sharing by profits interest in Section 1202's gain exclusion passed through by a "pass-thru" entity, as Section 1202(g)(3) references that a partner's sharing is "determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was acquired."

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Reinvesting Original QSBS sales proceeds from an installment sale

QSBS can be sold in an installment sale transaction under Section 453,[vii] and the instructions to Schedule D provide clear guidance regarding how to report and take the Section 1202 gain exclusion. But what happens if there is an installment sale of QSBS where the stockholder desires to roll over the sales proceeds under Section 1045 because the doesn't have the five-year holding period necessary to qualify for the Section 1202 gain exclusion? Both the language of Section 1045 and the instructions to Schedule D suggest that the safest interpretation of the language would be for the stockholder to buy replacement QSBS during the 60-day period beginning on the date of the sale of his Original QSBS.[viii] An election must be made to take advantage of Section 1045 no later than the due date (including extensions) for filing the stockholder's tax return for the tax year in which the original QSBS is sold. Stockholders should consider electing out of installment sale treatment and reinvesting sales proceeds in Replacement QSBS during the 60-day period after the sale of the original QSBS. This plan should be implemented even though some of the actual payment installments are in subsequent years. The fact that a stockholder may not have the funds available to roll over into replacement QSBS until later installment payments are received is a problem without a clear solution.

Calculating the amount of the gain deferral when reinvesting sales proceeds under Section 1045

Section 1045 provides that when Original QSBS is sold, gain from the sale is recognized only to the extent that the "amount realized" (which is the total consideration paid) exceeds the amount reinvested in Replacement QSBS. If a stockholder has tax basis in the Original QSBS, the tax deferral under Section 1045 won't equal the amount of proceeds reinvested in Replacement QSBS unless the stockholder reinvests 100% of the Original QSBS proceeds. For example, assume the following: (a) the stockholder has a basis of $100,000 in Original QSBS; (b) the "amount realized" on the sale of

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the Original QSBS is $1 million, and (c) the amount reinvested in Replacement QSBS is $200,000. In this example, the amount of gain recognized (taxable gain) would be $800,000 instead of $900,000, which means that the reinvestment of $200,000 resulted in a $100,000 tax deferral. If you assume that the same stockholder has a zero basis in the Original QSBS and reinvests $200,000 in Replacement QSBS, then the amount of gain recognized would be $800,000 rather than $1,000,000. If the stockholder has a zero tax basis in Original QSBS (or effectively, where the tax basis is something like .0001 per share), the entire amount reinvested in Replacement QSBS results in the deferral of gain recognition.

Note that there could be a planning opportunity to avoid Section 1045 tax deferral computation issue discussed in the preceding paragraph if a stockholder can identify separate lots of original QSBS (e.g., a lot of common stock with no tax basis and a lot of preferred stock with a substantial tax basis), although there are no tax authorities addressing the application of stock lots for purposes of Sections 1045 or 1202.

Closing remarks

The details of advanced Sections 1202 and 1045 planning are not commonly understood. Founders, investors, advisors, and return preparers engaging in advanced planning should consider seeking the advice of tax professionals who regularly handle QSBS issues. In particular, stockholders and other participants in the planning process should want to know whether there is substantial authority for their income tax return positions. Finally, stockholders and other participants in the planning process should also seek advice regarding potential penalties and the IRS's disclosure rules.

Using Section 1045 to reinvest QSBS sale proceeds into replacement QSBS

- 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

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- 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
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- 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] References to "Section" are to sections of the Internal Revenue Code. An important aspect of Section 1045 planning is confirming that a stockholder was entitled to claim Section 1202's gain exclusion with respect to the Original QSBS (excluding Section 1202's gain exclusion cap, which doesn't limit a stockholder's ability to roll QSBS proceeds over under Section 1045) and that the Replacement QSBS meets Section 1202's eligibility requirements applicable at the time of issuance.

[ii]This assumes that the $5 million represents all of the Original QSBS proceeds, if not, refer to the section "**Calculating the amount of the gain deferral when reinvesting proceeds under Section 1045**" for an explanation of how the calculation of Section 1045's deferral functions.

[iii] A "sale" for federal income tax purposes can include a redemption of stock treated as a sale under Section 302, or a deemed sale triggered by the complete liquidation of a corporation.

[iv] See Treasury Regulation Sections 1.1223-1(i) and 1.1012-1(c).

[v] Treasury Regulation Section 1.1045-1.

[vi] Treasury Regulation Section 1.1045-1(c)(1) provides that "[a] taxpayer other than a C corporation that sells QSB stock held for more than 6 months at the time of the sale may elect in accordance

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with paragraph (h) of this section to apply section 1045 if replacement QSB stock is purchased by a purchasing partnership (including a selling partnership.)"

[vii] Installment sale treatment under Section 453 generally applies if there is a sale in one tax year and one or more payments are made in taxable years after the year of sale.

[viii] Other tax commentators have suggested that the language of Sections 1202 and 1045 can be read to provide a 60 day window after the receipt of each installment payment to effect a Section 1045 rollover, based on the rules set forth in Section 1400Z-2 for the reinvesting capital gains from an installment sale transaction in qualified opportunity zone investments, but given the plain language of Section 1045 and the lack of express guidance on the issue (and, unlike in Section 1400Z-2, in the absence of helpful Treasury Regulations), we believe that the safe approach is to assume that a stockholder has 60 days after the "sale" to roll proceeds over under Section 1045, not 60 days after each payment.

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