A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion

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Categories:

One Big Beautiful Bill Act
QSBS Fundamentals
Qualified Small Business Stock (QSBS)
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**This article was updated in July 2025 to reflect the changes to Section 1202 under the One Big Beautiful Bill Act.*

Sections 1202 and 1045 were enacted by Congress to encourage investment in early-stage businesses operated as domestic (US) C corporations. Section 1202 permits a taxpayer to claim an exclusion from capital gains in connection with the sale or exchange (including redemption) of qualified small business stock (QSBS).[1] For QSBS issued prior to July 5, 2025, the per-taxpayer, per-issuing corporation ("**QSBS Issuer**") gain exclusion is generally capped at $10 million, which translates into $2,380,000 of tax savings at the federal level.[2] The One Big Beautiful Bill Act (**OBBBA**) increased the basic per-taxpayer gain exclusion cap from $10 million to $15 million for QSBS issued after July 4, 2025.[3] Needless to say, Section 1202's gain exclusion is among the most attractive tax benefits found in the Internal Revenue Code.

A further benefit of owning QSBS is that a taxpayer who sellers QSBS can make a Section 1045 election to roll proceeds tax-free into other QSBS investments. Section 1045 is usually used when a taxpayer sells QSBS before satisfying Section 1202's applicable holding period requirement (greater than five years for QSBS issued prior to July 5, 2025, or three to five years for QSBS issued after July 4, 2025). Some taxpayers, however, use Section 1045 when their gain exceeds the applicable gain exclusion cap (e.g., a taxpayer has $25 million in QSBS gain). See the following articles for further information regarding Section 1045 planning: *Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?*; *Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer*; *Part 1* and *Part 2* of *Reinvesting QSBS Sales Proceeds on a Pre-tax Basis under Section 1045*.

This article is intended to be a resource for those wanting an introduction to the requirements of Sections 1202 and related tax

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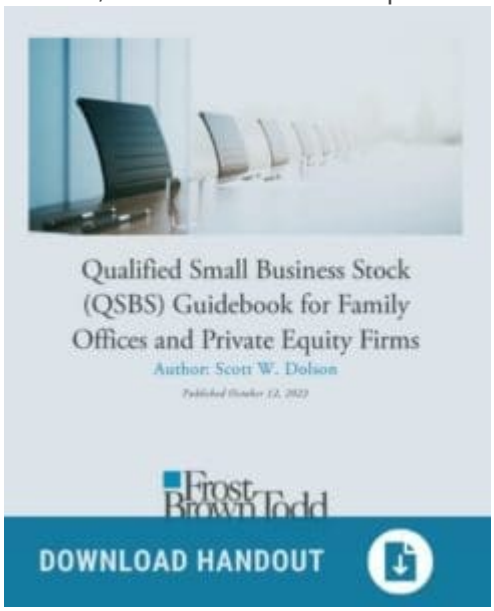
planning. Further detailed information can be found in other articles on the Frost Brown Todd's QSBS & Tax Planning Services page.

The importance of substantiating QSBS return positions; establishing and maintaining a "QSBS File"

Sections 1202 and 1045 have a number of requirements, each of which must be satisfied before a taxpayer is eligible to claim Section 1202's gain exclusion or roll original QSBS proceeds over tax-free under Section 1045 into replacement QSBS. Taxpayers must be prepared to substantiate their eligibility to claim QSBS benefits if challenged by the IRS. *Part 1* and *Part 2* of *Substantiating the Right to Claim QSBS Tax Benefits* focuses on the substantiation challenge, including the role of attestations, certificates from QSBS Issuers, tax advice and tax opinions.



Taxpayers bear the burden of proof with respect to substantiating satisfaction of each element of every eligibility requirement associated with Sections 1202 or 1045. Taxpayers should maintain an electronic and/or hard copy file containing all documentation that might be useful in substantiating their claimed QSBS benefits (referred to in this article as the "**QSBS File**"), including, for example, subscription, property contribution, and/or equity grant agreements, sale or exchange agreements, corporate and taxpayer

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returns, corporate financial statements QSBS Issuer certificates, third-party attestations, written tax advice and tax opinions.

As a sampling of what should be maintained in a QSBS File, Section 1202's "original issuance requirement" (discussed below), generally requires establishing that a taxpayer acquired QSBS directly from a QSBS Issuer for money, property (other than stock) or services. There are also several circumstances where a taxpayer would be selling QSBS received in exchange for other QSBS or as a transfer from the original holder.

- If the QSBS was issued for money, the QSBS File should include a copy of the subscription documents and evidence that the taxpayer funded payment of the subscription amount.
- If the QSBS was issued for contributed property, the QSBS file should include the contribution documents. If the property contribution was tax-free under Section 351, the QSBS file should include documentation of the fair market value of the contributed property.
- If the QSBS was issued for services, the QSBS file should include the incentive compensation documents, along with a copy of any Form W-2 or 1099-NEC issued by the QSBS Issuer, and any Section 83(b) election filed by the taxpayer.
- If the QSBS was transferred to the taxpayer as a gift, at death, as a distribution from a partnership, the QSBS file should include the transfer documents, and documentation relating to the issuance of the QSBS to the original holder (whether individual, trust or partnership).
- If the QSBS was received by the taxpayer in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization, the QSBS file should include all documents associated with the stock-for-stock exchange, and if possible, corporate level tax returns and financial statements addressing the transaction. The QSBS File should also include documentation confirming that the original stock was also QSBS.

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- If the QSBS was issued upon exercise of convertible debt, warrants, non-qualified options, or stock conversion, then the QSBS File should include all documentation associated with the issuance of the stock-right and conversion into QSBS or the conversion of convertible QSBS into another class of QSBS.

If a taxpayer sells shares of QSBS and reinvests proceeds under Section 1045, the QSBS File should include documentation substantiating that (i) the original stock was QSBS, (ii) the rollover into replacement QSBS met Section 1045's requirements, and (iii) the replacement stock was QSBS. The QSBS File should be created when the taxpayer's first acquires QSBS and should be maintained until at least three years after the transfer of QSBS is reported on a taxpayer's return.[4]

Additional information addressing substantiating the right to claim QSBS benefits and creating and maintaining a QSBS File can be found in *Substantiating the Right to Claim QSBS Tax Benefits | Part 1* and *Part 2*.

A walkthrough of Section 1202's eligibility requirements

The following is an introduction to Section 1202's various eligibility requirements. For a more in-depth discussion of QSBS eligibility requirements, see the articles on the Frost Brown Todd website.

Stock must be issued by a domestic (US) C corporation.

Only a domestic (US) C corporation is eligible to issue QSBS. An LLC that has "checked-the-box" to be taxed as a corporation can issue QSBS.[5] The QSBS Issuer must generally remain a domestic (US) C corporation for "substantially all" of a taxpayer's QSBS holding period and be a C corporation when the QSBS is sold.[6] Obviously, it is a significant decision to operate a business through a C corporation and forgo the tax benefits of operating as a pass-through entity (i.e., S corporation or partnership (LLC/LP)). But pass-through entities are not eligible to take advantage of the 21% corporate tax rate and cannot issue QSBS. For information

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addressing how to maximize QSBS benefits when converting from an S corporation to C corporation, see *Advanced Section 1202 (QSBS) planning for S corporations*.

Section 1202 contemplates that a QSBS Issuer can hold the stock of a corporate subsidiary.[7] If a corporation is a "subsidiary," there is a look-through to the business activities and assets of the subsidiary for purposes of Section 1202's eligibility requirements. Section 1202 is silent on the issue of whether a corporate subsidiary must be a domestic (US) corporation and whether there are any limits on the ownership of foreign assets. Section 1202 is also silent with respect to the ownership of joint ventures and other pass-through entity interests.

Taxpayers who are eligible to claim Section 1202's gain exclusion.

Individuals and trusts are eligible owners and "pass-thru" entities such as partnerships (usually, LPs and LLCs) and S corporations are eligible to hold QSBS and pass-thru the gain to owners who in turn can claim the gain exclusion. C corporation stockholders are not eligible to claim Section 1202's gain exclusion.[8] The rules regarding ownership through LPs, LLCs and S corporations ("pass-thru entities") are complicated, and preserving all of the available QSBS gain exclusion may be difficult if there are shifting interests in the pass-thru entities. For further information regarding the ownership of QSBS by entities taxed as partnership, see *Part 1* and *Part 2* of *Converting Partnerships into C corporation Issuers of QSBS*.

Anyone other than a C corporation who is subject to US capital gains taxes when QSBS is sold can benefit from Section 1202's gain exclusion. Neither non-resident foreign stockholders nor tax-exempt stockholders benefit from Section 1202 because they are not subject to US taxation on capital gains. Investing in QSBS through a traditional IRA is tax inefficient because while the IRA doesn't pay taxes when it sells QSBS (and it wouldn't pay taxes whether or not the stock was QSBS), distributions to IRA beneficiaries are taxed at high ordinary income rates. Roth IRAs work, but taxpayers might find it more tax efficient to own equities in the Roth IRA that are not eligible for Section 1202's gain

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exclusion. Gain on the sale of QSBS by a Roth IRA isn't taxable, but the Roth IRA only improves the tax situation where the gain amount exceeds the taxpayer's Section 1202 gain exclusion cap. For more detail on the intersection of IRAs and QSBS, see *Structuring the Ownership of Qualified Small Business Stock (QSBS) – Is There a Role for Roth IRAs?*

The original issuance requirement – QSBS must generally be acquired directly from the QSBS Issuer for cash, property (other than stock) or services.

Cash consideration for QSBS ranges from $0.0001 for shares of founder common stock to $1.00 or more per share of preferred stock. "Property" contributed in exchange for QSBS might consist of anything from intellectual property to the equity or assets of an LLC or LP converting into a C corporation. For an in-depth discussion of converting partnerships to C corporations, see *Part 1* and *Part 2* of *Converting Partnerships into C corporation Issuers of QSBS*. QSBS purchased from a stockholder loses its status because it fails the original issuance requirement in the hands of the buyer. QSBS can also be issued in exchange for services. If the QSBS is restricted (subject to vesting) at the time of issuance, the employee's holding period won't commence until the QSBS vests, unless the employee files a timely Section 83(b) election.

Exceptions to the original issuance requirement include QSBS transferred as a gift, at death or as a distribution from a partnership. [9] Also, if QSBS is exchanged for stock (QSBS or non-QSBS) in a Section 351 or Section 368 stock-for-stock exchange, the new stock will retain some or all of the benefits of Section 1202's gain exclusion, depending on whether the new QSBS Issuer was a qualified small business at the time of the exchange.[10] Finally, Section 1202 contemplates that QSBS Issuers may have corporate subsidiaries but is silent regarding whether subsidiaries must be created *de novo* or can be acquired through a stock purchase.

Only "stock" qualifies as QSBS.

"Stock" generally includes both voting and nonvoting common and preferred stock. Convertible debt and "stock rights," such as

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nonqualified options, warrants and stock appreciation rights (SARs) do not qualify as "stock" until conversion or exercise triggers the issuance of stock. Phantom equity and other contractual arrangements that track the economic rights of stock ownership are not stock. Employee stock that is "restricted" under Section 83 will not be treated as "stock" in the employee's hands until the stock becomes "unrestricted," unless the employee makes a timely Section 83(b) election. LLC units or partnership interests can be treated as "stock" if a "check-the-box" election on form 8832 is made to treat the business entity as an association taxable as a corporation.[11]

Simple agreement for future equity (SAFE) instruments might qualify as "stock" applying a traditional debt versus equity analysis, but there is a risk that the IRS will take the position that a SAFE is a hybrid instrument and not "stock" for federal income tax purposes. For further information about Section 1202 and SAFE instruments, see *Guide to the Federal Income Tax Treatment of SAFEs*.

The stockholder who originally acquires QSBS as an original issuance must generally be the ultimate seller in order to take advantage of Section 1202's gain exclusion.

Because of the original issuance requirement discussed above, the original holder is usually is the ultimate seller of QSBS. The most common exception to this general rule is where the original holder gifts QSBS to another taxpayer. Transfers of QSBS to non-grantor trusts are generally treated as gifts, positioning the non-grantor trust to sell the QSBS as a separate taxpayer and separately claim Section 1202's gain exclusion. The use of multiple taxpayers, including non-grantor trusts, for the purpose of expanding the aggregate gain exclusion amount is referred to as "stacking" in the tax planning world.[12] Other exceptions to the general rule include QSBS transferred "at death" or from a partnership to a partner.

The purchaser of QSBS from the original holder cannot later resell the stock and claim Section 1202's gain exclusion because the stock in the hands of the purchaser fails the original issuance requirement.

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If stock is transferred to a partnership other than as a gift, the partnership cannot subsequently claim Section 1202's gain exclusion if it sells the QSBS. Transfers of QSBS as "rollover equity" to a partnership is a common feature of a part-cash part-equity sale transaction. The transfer of the QSBS to the partnership (LLC/LP) will generally be nontaxable under Section 721, but the LLC/LP equity interest received in the exchange won't qualify as QSBS, and the stock transferred to the partnership loses its QSBS status in the hands of the partnership.[13] In these scenarios, target stockholders should consider structuring a taxable rollover of their QSBS, and either claim Section 1202's gain exclusion if available or elect to reinvest proceeds under Section 1045.

QSBS must be transferred (sold or exchanged) in a taxable transaction for federal income tax purposes.

The potential for a future stock sale is a critical choice-of-entity consideration when comparing operating through a C corporation versus a pass-through entity. The instructions to Form 8949 and Schedule D address how to report and treat installments sales of QSBS. A "sale" does not include a tax-free exchange of QSBS for a partnership interest under Section 721 or stock-for-stock exchanges under Sections 351 or 368.

An "exchange" includes the redemption of QSBS, if the redemption is treated under Section 302 as an exchange rather than a dividend. The tax treatment of redemption payments is a common planning issue when founders participate in secondary sales. Also, an exchange of QSBS for proceeds distributed in a complete or partial liquidation can trigger the right to claim Section 1202's gain exclusion.

Stock redemptions may adversely affect the QSBS status of prior or future stock issuances.

When considering whether to redeem stock, the potential impact on QSBS status for prior and future issuances of stock should be considered. Treasury Regulation Section 1.1202-2 addresses Section 1202's redemption rules in detail and includes several *de minimis* exceptions to the triggering of the anti-churning rule.

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Stock issued to a particular stockholder, or a person who is related that stockholder, may not qualify as QSBS if the QSBS Issuer has redeemed, or subsequently redeems, any of such stockholder's or a related person's stock during the four-year period beginning on the date two years before the issuance of QSBS. Also, a particular issuance of stock may not qualify as QSBS if the QSBS Issuer has redeemed, or subsequently redeems, during the two-year period beginning on the date one year before the such stock issuance, stock with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of the QSBS Issuer's stock as of the beginning of such two-year period.

Treasury Regulation Section 1.1202-2 provides that the redemption of shares issued in connection with the performance of services as an employee or director does not constitute a "significant redemption" for Section 1202 purposes if the redemption of such shares was incident to a bona fide termination of the stockholder's services.

The QSBS Issuer must not have the tax status of any of the following: a domestic international sales corporation (DISC) or former DISC, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit (REMIC), or a cooperative.

The Aggregate Gross Assets Test (AGA Test): the QSBS Issuer's consolidated group (i.e., consisting of the QSBS Issuer and any corporate parent or subsidiary) must not have had more than $50 million in "aggregate gross assets" at any time prior to or immediately after the issuance of the stock being tested for QSBS eligibility, or for QSBS issued after July 4, 2025, $75 million in "aggregate gross assets."[14]

The AGA Test focuses on whether the QSBS Issuer's consolidated group had "aggregate gross assets" exceeded the applicable limit at any time prior to the stock issuance being tested, or exceeds the appliable limit as a result of the issuance of the shares being tested (taking into account any cash or property contributed to the QSBS Issuer in connection with the issuance of the tested shares).

Once the QSBS Issuer's consolidated "aggregate gross assets" exceed the applicable limit, no additional QSBS can be issued by that QSBS Issuer. But the fact that a QSBS Issuer's "aggregate gross assets" exceeds the appliable limits sometime after a QSBS

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issuance will not affect the QSBS status of previously issued stock.

Property contributed to a QSBS Issuer in a tax-free contribution is valued for purposes of the AGA Test at the property's fair market value at the time of contribution. The rule can be especially important when incorporating a partnership.

The 80% test: at least 80% (by value) of the QSBS Issuer's assets must be used in the operation of a qualified trade or business during a taxpayer's QSBS holding period.

Section 1202(e)(3) provides that a taxpayer's stock is QSBS only if the QSBS Issuer satisfies the "active business requirement" during substantially all of a taxpayer's holding period for his stock. The most critical "active business requirement" is that the QSBS Issuer must use at least 80% (by value) of the corporation's assets in one or more qualified business activities. When vetting stock for QSBS eligibility, whether a corporation is engaged in qualified business activities is often the eligibility requirement that requires the most attention.

The determination of whether a QSBS Issuer's business activities (or if the activities are those of a start-up, then the anticipated activities upon commercialization) are qualified or excluded under Section 1202 ranges from clear to grey and from straightforward to complicated, often requiring a deep dive into the "facts and circumstances." A general rule based on available tax authorities is that an activity should qualify even if it involves providing products and services to businesses engaged in excluded activities. For example, QSBS Issuers focused on providing software solutions or surgical tools for healthcare providers should not be considered to "*provide services in the field of health*."

Section 1202(e)(3) provides that the term "qualified trade or business" means any trade or business other than –

> (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or

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business is the reputation or skill of 1 or more of its employees,

(B) any banking, insurance, financing, leasing, investing, or similar business,

(C) any farming business (including the business of raising or harvesting trees),

(D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and

(E) any business of operating a hotel, motel, restaurant, or similar business.

Section 1202(e)(7) provides that the "*ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business*." Also, generally excluded from "good" assets for purposes of the 80% Test are cash accumulations and investment assets that do not fall within the scope of "good" working capital under Section 1202(e)(6).[15]

Activities involving the ownership of real property essential for the operating business (e.g., Amazon warehouses or Augusta National's golf properties) should generally qualify if the real property is used in the course of qualified activities, although an IRS might be expected to take a close look where real property represents a significant percentage of the assets of the business. In some instances, where QSBS Issuers are engaged in multiple activities, the QSBS analysis will be focused on whether the assets used in excluded activities cause the QSBS Issuer to fail the 80% Test.

Section 1202(e) provides that a corporation that is engaged in certain start-up activities and/or research and development activities that are anticipated to lead to engaging in qualified business activities satisfy Section 1202's "active business requirement," meaning that assets used in such activities would count towards satisfying the 80% Test.

The QSBS Issuer will not satisfy the active business requirement during any part of a taxpayer's QSBS holding period where the QSBS Issuer holds stock or

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securities with an aggregate value exceeding 10% of the value of QSBS Issuer's assets (in excess of liabilities), other than (i) stock or securities of a subsidiary which is defined as being a more than 50% owned corporation, or (ii) stock being held for investment and which is reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increase in working capital needs of the QSBS Issuer's qualified business activities (i.e., falling within the scope of Section 1202(e)(6)).

The QSBS Issuer will not satisfy the active business requirement during any part of a taxpayer's QSBS holding period where more than 10% of the total value of the company's assets consisted of real property not used in the QSBS Issuer's qualified business activities.

As noted above, Section 1202(e)(7) provides that the "*ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business.*"

Forward or reverse stock splits, recapitalizations, Section 351 nonrecognition exchanges, Section 368 tax-free reorganizations can potentially affect the QSBS status of outstanding stock.

The status of stock as QSBS can be affected by various QSBS Issuer level actions taken during a taxpayer's QSBS holding period. The potential consequences should be analyzed first if any of these events are expected to occur while QSBS is outstanding.

Section 1202's "active conduct" requirement.

Section 1202(c)(2)(A) provides that stock will not be treated as QSBS unless the QSBS meets the active business requirements of Section 1202(e). Section 1202(e)(1)(A) provides that satisfying the active business requirement includes the requirement that at least 80% (by value) of the assets of the QSBS Issuer were used in the active conduct of one or more qualified business activities. So, a QSBS Issuer's principal business activities must be qualified and the QSBS Issuer must "actively conduct" those activities. If a stockholder ultimately sells or exchanges original or replacement QSBS, then the active conduct requirement applies for the totality of the QSBS's holding period. But in order to qualify for making a Section 1045 election, the QSBS Issuer of the replacement QSBS is only required to meet the active business requirement (including

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active conduct) for the first six months after the issuance of the replacement QSBS.

Neither Sections 1202 or 1045 define what is meant by "*actively conducting*" a corporation's business activities For purposes of Section 355, the determination of whether an activity is "actively conducted" is an "*all the facts and circumstances*" test.[16] The Tax Court would likely consider the actions of the QSBS Issuer, and compare those actions to those of a "reasonable man" under similar circumstances who is not motivated by tax avoidance purposes. The Tax Court would also likely consider whether the taxpayer's plans and actions evidence a bona-fide business purpose to start-up and develop a successful and profitable business engaged in qualified business activities, or instead evidence actions driven by tax avoidance motives and/or lacking economic substance.

Section 1202 contemplates that not only profitable or unprofitable businesses at the commercial stage can be considered to be engaging in qualified business activities, but also QSBS Issuers engaging in start-up, research and development (R&D) and associated development activities, so long as those activities are reasonable anticipated to develop into qualified activities.[17] Section 1202(e)(2)(A) provides that for purposes of Section 1202(e)(1) (i.e., the "active business requirement" generally), "*if, in connection with any future qualified trade or business, a corporation is engaged in—(A) start-up activities described in section 195(c)(1)(A), (B) activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174, or (C) activities with respect to in-house research expenses described in section 41(b)(4), assets used in such activities shall be treated as used in the active conduct of a qualified trade or business. Any determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination.*"

Section 195(c)(1)(A) focuses on activities associated with investigating the creation or acquisition of an active trade or business, creating an active trade or business, or any activity engaged in for profit and for the production of income before the

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day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business. Treasury Regulation Section 1.174-2 includes within the scope of Section 174 experimental or laboratory research and development activities. In connection with the determination of whether a corporation engaged in the "active conduct" of its activities, it is possible that a different and less stringent standard would apply to a corporation that is engaged in start-up or research and development activities, as Section 1202(e)(2) provides that the assets of a corporation engaged in start-up activities or research and development activities are "*treated as used in the active conduct of a qualified trade or business*." Presumably, the QSBS Issuer would be held to some reasonable standard of "actively conducting" start-up and/or research and development activities, but it is unclear what level of activities might be required.

As a practical matter, the question of whether the QSBS Issuer engaged in "active conduct" seems less likely to be an issue pursued by the IRS where the QSBS is sold for a substantial gain. Where the "active conduct" requirement and the pervasive judicial doctrines discussed below are more likely to be an important consideration is where a taxpayer rolls original QSBS proceeds over into replacement QSBS, with the QSBS Issuer ceasing operation and liquidating after the taxpayer satisfies the applicable Section 1202's holding period requirement.

Establishing "offsetting short positions" will adversely affect the status of QSBS.

Stockholders wanting to lock in the right to exit from their holdings of QSBS received as rollover equity often consider whether a put option should be negotiated. But establishing an "offsetting short position" can trigger a loss of QSBS status. An "offsetting short position" is defined to mean any of the following: (i) where the stockholder has made a short sale of substantially identical property; (ii) where the taxpayer has acquired an option to sell substantially identical property at a fixed price; or (iii) to the extent provided in regulations, the taxpayer has entered into any other transaction which substantially reduces the risk of loss from holding

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the QSBS. In the absence of Treasury Regulations, it isn't clear that item (iii) would be deemed applicable by the Tax Court or how to define the scope of what might be considered a transaction substantially reducing the risk of loss (e.g., a put right at a fixed valuation?). A violation of this rule during the first five years of a taxpayer's holding period will terminate the QSBS status of the affected stock. After a holding period greater than five years is achieved, Section 1202's gain exclusion would not be available unless the taxpayer elects to recognize gain as if the QSBS were sold for its fair market value.

Section 1202's holding period requirement.

Prior to OBBBA's amendment, Section 1202's 100% gain exclusion was available for QSBS issued after 2010 if a taxpayer's holding period exceeded five years. Now, for QSBS issued after July 4, 2025, taxpayers can take advantage of a tiered exclusion based on the applicable holding period:[18]

Holding Period	Applicable Exclusion %	Estimated Federal Income Tax Savings[19]
3 years	50%	($119,000 tax savings per $1 million of gain)
4 years	75%	($178,500 tax saving per $1 million of gain)
5 years or more	100%	($238,000 tax saving per $1 million of gain)

New Section 1202(a)(6)(B) references determining a taxpayer's holding period applying the rules in Section 1223, which generally means that stock-for-stock exchanges and other QSBS transfers won't allow taxpayers holding QSBS issued prior to the Effective Date to exchange their stock for QSBS subject to the modified holding period rules. Further, Section 1223(13) should prevent taxpayers from taking advantage of the modified holding period rules where replacement QSBS is purchased using proceeds from the sale of a taxpayer's QSBS under Section 1045.[20]

The ratcheted holding period amendment will give taxpayers another planning option when they sell QSBS if their holding period

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falls short of the five-year mark. Other available planning options include structuring a QSBS sale as a tax-free stock-for-stock transaction or reinvesting QSBS proceeds in replacement QSBS under Section 1045. The advantage of the Section 1045 rollover option is that taxpayers are able to both reinvest original QSBS proceeds tax-free and tact their original and replacement QSBS holding periods when the replacement QSBS is sold. The new tiered exclusions are helpful, but structuring secondary sales and M&A transactions to allow taxpayers to satisfy the five-year holding period requirement should be a goal given the significant additional tax savings.

Preparing for the possible assertion of judicial doctrines such as the absence of bona-fide business purpose (a/k/a tax avoidance) and lack of economic substance.

In addition to documenting that each of Section 1202's or Section 1045's expressly stated eligibility requirements are satisfied, a taxpayer must be prepared for the possible assertion by the IRS of judicial doctrines to attack the taxpayer's QSBS-related return positions. Judicial doctrines include the requirement that taxpayers have a bona-fide business purpose for undertaking transactions and the requirement that transactions have economic substance apart from tax benefits (more recently codified at Section 7701(o)). The role and nature of these judicial doctrines is discussed in additional detail in *Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer* and *Advanced Section 1045 Planning*. The preceding article discusses theories why judicial doctrines should not apply to the reinvestment of proceeds under Section 1045 or the subsequent claiming of Section 1202's gain exclusion. But until there are tax authorities clarifying whether judicial doctrines should apply to rollovers, taxpayers should operate under the assumption that judicial doctrines will be asserted if the facts suggest a lack of active conduct or the use of Section 1045 as a mere conduit to obtaining the benefits of Section 1202. For those reasons, taxpayers should fully document the business reasons for rolling funds over into replacement QSBS, for each material actions taken during the life of the QSBS Issuer of replacement QSBS, and any decision to cease operations and

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dissolve.

Section 7701(o) codified the judicially created economic substance doctrine (generally first attributed to *Gregory v. Helvering*, 293 U.S. 465 (1935)) that a transaction

> *to which the economic substance doctrine is relevant . . . shall be treated as having economic substance only if – (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apparent from Federal income tax effects) for entering into such transaction.*

Before investing in replacement QSBS, taxpayers should focus on whether the activities of the QSBS Issuer, if successful, should reasonably be expected to be sufficiently profitable to attract investors not motivated by Section 1202's tax benefits. A taxpayer should not be required to have a successful QSBS Issuer of replacement QSBS, but the taxpayer's efforts should include adopting and following a business plan and budget that an independent non-biased industry expert would consider economically viable if successful, and engaging on an ongoing basis in actions that the expert would consider those of a "reasonable man" under similar circumstances.

One fact scenario that might be particularly vulnerable to an IRS challenge is where a taxpayer sells original QSBS, purchases replacement QSBS, operates the business and then liquidates the corporation claiming Section 1202's gain exclusion. The IRS would argue that the taxpayer had no bona-fide business intent or purpose for rolling proceeds over into the corporation issuing the replacement QSBS. The taxpayer has the burden of proof to substantiate that the business was actively conducted, was undertaken for bona-fide business reasons and had economic substance. See *Substantiating the Right to Claim QSBS Tax Benefits (Part 1)*; *Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section* 1045; and *Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis under Section 1045*.

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Dealing with Section 1202's gain exclusion caps

The $10 million (or $15 million for QSBS issued after July 4, 2025) gain exclusion cap (the "Standard Cap").

Section 1202 limits the amount of capital gain that can be excluded from tax for any taxpayer in a given year with respect to a particular QSBS Issuer. Basically, Section 1202 provides that each taxpayer enjoys a minimum $10 million exclusion (or $15 million for QSBS issued after July 4, 2025) for gain triggered by the sale or exchange of a particular QSBS Issuer. The same taxpayer can also qualify for gain exclusion that exceeds the applicable Standard Cap when the 10X Cap discussed below applies. The Standard Cap amount can be multiplied through gifting QSBS to separate taxpayers, each of whom generally has their own separate Standard Cap and 10X Cap. Gain from the sale of Corporation A's QSBS is not aggregated with gain from different QSBS Issuers' QSBS.

The 10X gain exclusion cap (the "10X Cap").

The 10X Cap provides that, for a particular tax year, a taxpayer's gain exclusion cap equals 10 times the amount of cash or the value of property contributed to a corporation in exchange for QSBS. If an LLC with assets worth $30 million incorporates, for purposes of Section 1202, the QSBS issued in the incorporation would carry a $30 million 10X Cap. When the QSBS issued in the conversion sells for $330 million, some or all of the first $30 million would be subject to long-term capital gains tax (depending on the real tax basis in the contribute property), with the balance of $300 million potentially eligible in full for Section 1202's gain exclusion. For stockholders who do not have sufficient tax basis in their QSBS to take advantage of the 10X Cap but anticipate that their QSBS will sell for more than the applicable Standard Cap, it is possible to expand the aggregate gain exclusion beyond the Standard Cap through the careful structuring of gifts to trusts or individuals. The normal tax basis rules for stock apply outside of the 10X Cap context (e.g., if the stock is sold and the capital gains tax applies).

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The 10X Cap is associated with a taxpayer's aggregate tax basis in the QSBS sold in a given year, and does not differentiate in making that calculation whether the QSBS sold with tax basis has met the applicable holding period requirement. So, in a situation where a QSBS Issuer has a bona-fide business reason for needing additional funding or to acquire property held by a stockholder, the stockholder can exchange the money or property for QSBS that will give the stockholder additional tax basis for purposes of the 10X Cap. This planning strategy is sometimes referred to as "stuffing," i.e., "stuffing" a QSBS Issuer with money or property in exchange for QSBS that adds to a taxpayer's aggregate QSBS tax basis. See *Maximizing the Section 1202 Gain Exclusion Amount*.

It's not always an either/or situation with the Standard Cap and 10X Cap.

It is possible to take advantage of both gain exclusion caps if a taxpayer holding a QSBS Issuer's QSBS that is sold over multiple years. The Standard Cap amount burns off after the first $10 or $15 million gain excluded, leaving a taxpayer in subsequent years either no additional gain exclusion associated with the particular QSBS Issuer or the potential for the 10X Cap if the taxpayer is holding additional QSBS with tax basis. For example, a taxpayer who sells founder stock of Corporation A with a *de minimis* tax basis and preferred QSBS of Corporation A with a $5 million aggregate tax basis for $60 million in year 2025 has a potential $50 million gain exclusion. The aggregate gain exclusion amount increases to $60 million if the same taxpayer sells Corporation A's common stock in year 2025 for $10 million (offset in full by the Standard Cap) and then sells Corporation A's preferred stock in year 2026 for $50 million.

The percentage exclusion of capital gains applicable to a sale of QSBS depends on the date of the QSBS's issuance.

If QSBS is issued after July 4, 2025, the stockholders can take advantage of a tiered exclusion based on the applicable holding period:

Holding Period	Applicable Exclusion %	Estimated Federal Income Tax Savings[21]

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3 years	50%	($119,000 tax savings per $1 million of gain)
4 years	75%	($178,500 tax saving per $1 million of gain)
5 years or more	100%	($238,000 tax saving per $1 million of gain)

QSBS originally issued after September 27, 2010, but prior to July 5, 2025, is potentially eligible for a 100% gain exclusion. QSBS originally issued after February 17, 2009, and before September 28, 2010, is potentially eligible for a 75% gain exclusion. QSBS originally issued before February 18, 2009, but after August 10, 1993, is potentially eligible for a 50% gain exclusion. For QSBS issued prior to September 28, 2010, the portion (i.e., 50% or 25%) of the gain not eligible for Section 1202's gain exclusion is subject to a 28% tax rate, a 3.8% net investment income tax, and is subject to the alternative minimum tax. Stock issued prior to August 11, 1993, is not QSBS.

A brief introduction to QSBS planning in connection with the sale of a business

Acquiring rather than starting de-novo a business activity.

Section 1202 does not require a QSBS Issuer to start a de novo business for the purpose of engaging in qualified business activities. Section 1202's parent-subsidiary look-through rule may allow buyers to organize a new C corporation, issue QSBS to founders and investors, and subsequently either start a business *de novo* or purchase target company assets or equity. Careful attention should be paid to whether the AGA Test (i.e., the $75 million limit) impacts the ability of the purchasing QSBS Issuer to issue additional QSBS to investors and target stockholders in connection with the acquisition.

The general preference for taxable stock sale transactions.

Most stockholders who have satisfied Section 1202's holding period requirement will generally want to structure taxable sales or exchanges (sales, taxable mergers, redemptions or liquidations) of

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their QSBS, rather than tax-free transactions, unless their aggregate QSBS sales proceeds would exceed the applicable gain exclusion caps. In connection with the sale of QSBS issued after July 4, 2025, planning at the taxpayer level will include not only consideration of the applicable gain exclusion caps, and potential gifting of QSBS, but also the different percentage exclusions of gain applicable when the holding period is at least three years but fall short of five years. Taxpayers who haven't met the holding period requirements often gravitate to structuring nonrecognition exchanges of stock-for-stock under Section 351 or Section 368. See *Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)*.

Although stock sales are generally preferred when stockholders are holding QSBS, some sale transactions are nevertheless structured as asset sales. Target stockholders can reduce or avoid double taxation triggered by an asset sale by adopting a plan of complete liquidation and distributing the net proceeds in liquidation. The distribution of proceeds in a complete liquidation is treated as a taxable exchange of QSBS, triggering the right to claim Section 1202's gain exclusion. If the QSBS Issuer has more than one activity, it is also possible to adopt a plan of partial liquidation and dispose of the net proceeds from the sale of an activity, which also triggers the right to claim Section 1202's gain exclusion.

In many sale transactions, buyers expect target stockholders to roll 20% to 30% of their target equity into buyer equity. Target stockholders generally expect the rollover to be structured to defer gain and permit the stockholders to claim Section 1202's gain exclusion when the rollover equity is eventually sold. In order to accomplish these goals, most rollovers are structured as tax-free exchanges under Section 351 or 368. If the buyer stock is QSBS, then the target stockholder's holding period carries over and the full benefits of QSBS remain available. But if the buyer stock is non-QSBS, the future Section 1202 gain exclusion will be limited to the gain deferred in the stock-for-stock exchange.[22] See *Equity Rollovers in M&A Transations Involving Section 1202 Qualified Small Business Stock (QSBS)*.

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Founders often participate in secondary sales or redemptions of their QSBS, either of which can trigger the right to claim Section 1202's gain exclusion, but redemptions must be tested under Section 302 and there is a risk that some portion of the gain may be recharacterized as non-excludible compensation.[23] Section 1202's gain exclusion is also available if the purchase consideration is paid in installments under Section 453.

Although an exchange of QSBS for a partnership interest is treated as a Section 721 nonrecognition exchange (stock for LLC units), the target stockholders forfeit the potential for a future Section 1202 gain exclusion.

Where stockholders have not satisfied the applicable holding period requirement.

The options available for preserving QSBS status if the applicable holding period requirement isn't met include exchanging QSBS for buyer stock in tax-free exchanges under Sections 351 or 368, or selling the target QSBS in a taxable sale or exchange and reinvesting the proceeds in replacement QSBS under Section 1045.[24] Stock issued after July 4, 2025, will be able to take advantage of the shorter holding period requirements for partial gain exclusions. See *One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors*.

Please 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 for more QSBS-related analysis curated by topic, from the choice of entity decision and Section 1202's gain exclusion to Section 1045 rollover transactions.

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[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. Many states follow the federal income tax treatment of QSBS. California, Pennsylvania, Alabama, Mississippi, and New Jersey (until January 1, 2026) do not follow federal treatment.

[2] This example assumes a 20% capital gains rate, plus a 3.8% net investment income tax. Additional tax saving may be available at

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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 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] Sections 6501(a) and (b) provide that, generally, the IRS has three years from the date a tax return is filed or the date the return is due to assess any additional tax owed. However, Section 6501(e) provides that if the taxpayer omits more than 25% of their gross income, the statute extends to six years. A properly reported Section 1202 gain exclusion or tax-free rollover under Section 1045 should not be considered an omission from gross income. See Chief Counsel Advisory (CCA) 200509024 (2006).

[5] See the article, *To Be Clear. . .LLCs Can Issue Qualified Small Business Stock (QSBS)*.

[6] Section 1202 allows for the exchange of QSBS for non-QSBS in a transaction qualifying as a Section 351 nonrecognition exchange or Section 368 tax-free reorganization. So, it is possible that the surviving corporation may not be a domestic (US) C corporation when the QSBS is sold. Section 1202's gain exclusion can also be triggered by an exchange of QSBS for redemption consideration or proceeds from the partial or complete liquidation of the corporation.

[7] A corporation is a "subsidiary" for purposes of Section 1202 if the QSBS Issuer owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock.

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[8] Although C corporations cannot directly claim Section 1202's gain exclusion upon the sale of stock owned by the C corporation, a C corporation can issue QSBS to stockholders and at the same time own stock of a subsidiary. While the C corporation can't directly take advantage of Section 1202 by selling the subsidiary's stock, the stockholders of the parent C corporation can sell their stock and claim Section 1202's gain exclusion, which indirectly gives the parent C corporation the benefit of Section 1202 with respect to the value of the subsidiary and its stock.

[9] See Section 1202(h)(2).

[10] See Section 1202(f).

[11] Treasury Regulation Section 301.7701-3(g)(1)(i) provides the following regarding the deemed treatment of an elective change from partnership to C corporation status:

Partnership to association. If an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

[12] Taxpayers should be aware of Section 643(f), which provides that if there are two or more trusts, they are going to be treated as one trust if the trusts have substantially the same grantors and substantially the same primary beneficiaries, and the principal purpose of the multiple trusts is avoidance of income tax.

[13] It may be possible under some circumstances for the partnership to redistribute the contributed QSBS to the original stockholders who would then sell the stock and claim Section 1202's gain exclusion.

[14] Section 1202(d)(2) defines "aggregate gross assets" as the amount of cash and the aggregate adjusted basis of other property held by the Issuer; provided, however, that Section 1202(d)(2)(B) provides that when property is contributed to the Issuer in a

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Section 351 nonrecognition exchange, a Section 368 tax-free reorganization, or a capital contribution governed by Sections 118 and 362, the property goes onto the Issuer's tax books for purposes of the AGA Test as if the aggregate tax basis of the property contributed to the Issuer (immediately after the contribution) was equal to the fair market value of the contributed assets as of the time of such contribution. The OBBBA increased the "aggregate gross assets" threshold from $50 million to $75 million for QSBS issued after July 4, 2025.

[15] Section 1202(e)(6) provides that asset which "(A) are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or (B) are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business, shall be treated as used in the active conduct of a qualified trade or business." Section 1202(e)(6) provides that after the first two years of a company's existence, no more than 50% of a company's assets (by value) can consist of cash and investment assets held for the future working capital needs of the company and still qualify towards satisfying the 80% Test. Corporations that have build-ups of cash might also be candidates for accumulated earnings tax or personal holding company tax issues.

[16] Treasury Regulation Section 1.355-3(b)(ii) provides that:

A corporation shall be treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses" and that *for purposes of section 355(b), the determination whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by*

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persons outside the corporation, including independent contractors. A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others.

[17] Basically, Section 1202(e)(2) allows companies in the start-up phase to qualify as engaging in the active conduct of the anticipated future business for purposes of Section 1202's 80% Test.

[18] If a taxpayer takes advantage of the 50% or 75% exclusion, the portion not eligible for the Section 1202 gain exclusion would be taxed at a 28% tax rate but would not be treated as a preference item for purposes of the alternative minimum tax. OBBBA does not change the tax treatment under Section 1202 of QSBS acquired prior to September 27, 2010. If a taxpayer takes advantage of the new OBBBA three year or four year holding period gain exclusions, the portion of the gain that isn't excluded under the 50% or 75% exclusions would also be subject to the 28% rates, but would not be treated as a preference item for purposes of the alternative minimum tax.

[19] Assumes a combined effective federal tax rate of 20% (long-term capital gains) plus 3.8% (net investment income tax rate).

[20] Section 1223(13) provides that:

Except for purposes of subsections (a)(2) and (c)(2)(A) of section 1202, in determining the period for which the taxpayer has held property the acquisition of which resulted under section 1045 or 1397B in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period for which such other property has been held as of the date of such sale.

[21] Assumes a combined effective federal tax rate of 20% (long-term capital gains) plus 3.8% (net investment income tax rate).

[22] See Section 1202(h)(4).

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[23] The consideration paid in some redemptions is treated as a dividend, which is not eligible to be offset against by Section 1202's gain exclusion.

[24] See the following articles for further information regarding Section 1045 planning: *Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?*; *Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer*; *Part 1* and *Part 2* of *Reinvesting QSBS Sales Proceeds on a Pre-tax Basis under Section 1045*.

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