The Intersection Between Equity Compensation Planning and Section 1202

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Authors:

Scott W. Dolson

There are numerous tax and business issues associated with equity compensation planning for employees and other service providers. [i] Numerous tax professionals focus on structuring compensation arrangements and many articles address the key planning issues. But at the same time, very little attention has been focused on structuring equity compensation arrangements for corporations that have issued qualified small business stock (QSBS) to founders and venture capitalists. This article focuses on the intersection between Section 1202's unique requirements and traditional equity compensation planning.[ii]

This article 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 entity of choice for start-ups. Much of this interest can be attributed to the reduction in the federal corporate income tax rate from 35% to 21%, but savvy founders and venture capitalists have also focused on qualifying for Section 1202's gain exclusion. Legislation proposed during 2021 sought to curb Section 1202's benefits, but that legislation stalled along with the balance of the Build Back Better Act. Finally, during August, 2022, Congress passed the Inflation Reduction Act, but that legislation did not amend Section 1202.

The Key Planning Points To Consider When Using QSBS as Equity Compensation.

Management of C corporation start-ups are frequently attracted to QSBS as a way of incentivizing their employees. When a corporation issues QSBS to an employee, the benefits include both the lure of equity ownership and the significant tax benefits reaped when selling QSBS. When considering whether to use QSBS as part

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of a corporation's compensation planning, there are two key points that should be kept in mind. First, the benefits of Section 1202 are available only if an employee sells "stock." Nonvested stock, stock options, warrants, phantom equity, and stock appreciation rights do not qualify as "stock" for federal income tax purposes, and they are generally not suitable instruments if management wants to utilize QSBS as a compensation planning tool. If the QSBS is nonvested, it will immediately qualify as "stock" if a Section 83(b) election is made. Making a Section 83(b) election is discussed in detail below. Second, the employee must have held the stock for more than five years at the time of sale in order to qualify for claiming Section 1202's gain exclusion.

Participating in Section 1202's Benefits Through Employee Stock Grants.

QSBS can be issued for services.

Under Section 1202, QSBS can be issued either for services or for services coupled with a minimal cash investment (*e.g.*, $0.001 per share for typical founder common stock) and founder stock is often issued for a combination of a nominal cash investment and services. Typically, non-founder stock is issued for services. Like any other stock grant, QSBS is often issued to founders and employees subject to time and/or performance vesting (*i.e.*, nonvested stock). During the early start-up phase, the amount of compensation triggered by a stock grant is usually minimal. In fact, founders often take the position that the fair market value of their stock acquired for $0.001 per share is, in fact, $0.001 per share. But once a corporation's enterprise value has increased, the grant of QSBS to employees will often trigger substantial compensation income.[iii] The balance of this section addresses the planning issues associated with granting nonvested QSBS, the making of Section 83(b) elections, and coping with the amount of compensation triggered by some grants of QSBS.

QSBS must be vested to commence the running of the required five-year holding period.

A critical planning point associated with QSBS compensation planning is that in order for an employee to claim Section 1202's benefits, the employee must sell "stock" with more than a five-year

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holding period. Under Section 83's rules, shares of nonvested stock are not treated as being owned for purposes of Section 1202 (or for other purposes under the Internal Revenue Code) until vesting occurs, which postpones the commencement of the five-year holding period unless a Section 83(b) election is filed.[iv] The benefits associated with immediately triggering the running of the five-year holding period places additional pressure on the employee to file a Section 83(b) election, even when the election will trigger substantial compensation income.[v] If an employee is holding a nonqualified stock option, ownership of "stock" does not commence until the option is exercised and either vested stock is issued or nonvested stock is coupled with a Section 83(b) election.

Filing the Section 83(b) election.

If QSBS is nonvested at the time of issuance (*e.g.*, the QSBS is subject to time and/or performance vesting, forfeiture of nonvested QSBS upon employment termination and subject to transfer restrictions), the employee can get the clock running on the required five-year holding period by filing a Section 83(b) election within 30 days after issuance of the QSBS.[vi] When the election is filed, the employee is treated as owning the QSBS as of the date of issuance for tax purposes, regardless of whether the QSBS can still be forfeited pursuant to the stock grant plan or grant agreement. If QSBS is vested when issued or if the Section 83(b) election is filed, the employee must report as compensation income the difference between the amount paid (if any) for the QSBS and its fair market value on the date of issuance.[vii] The resulting compensation is typically run through payroll and is subject to withholding. Companies often require participants to file the Section 83(b) election as a condition to receipt of a stock grant. If the QSBS is nonvested and no Section 83(b) election is made, the employee will be treated as receiving compensation when the QSBS vests, is transferable or is transferred – none of this compensation income will qualify for Section 1202's gain exclusion. Also, the five-year holding period will not commence until the QSBS vests.

The amount of compensation triggered by a grant of QSBS can present a significant planning issue. Employees are often reluctant to pay taxes triggered by a grant of QSBS that isn't coupled with a

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guaranteed liquidity event, and, in fact, where the QSBS could decrease in value or become worthless. Some companies address these issues by coupling stock grants with bonus payments to cover the tax liability. Another approach is for the company to loan employees amounts required to pay taxes or to acquire the QSBS. These employee loans must be recourse to the employee (*i.e.*, not just secured by the QSBS), fully documented with a promissory note that includes appropriate terms (including payment terms and interest) and adequately secured, or the arrangement runs the risk of being characterized as taxable compensation advances or taxable deferred compensation.[viii] The IRS could also potentially argue that the QSBS should be treated as an option under the authority of Section 83, which would cause the employee to fail Section 1202's "stock" requirement.[ix]

Minimizing the taxable compensation triggered when making grants of QSBS.

There are several possible strategies for minimizing the amount of taxable compensation triggered by grants of QSBS. The most obvious approach is to grant stock to employees before it becomes valuable. The same valuation factors applicable to pricing early issuances of founder stock should generally apply to early employee stock grants. If cash and/or other property (including intangible assets) is contributed to the company by founders or investors, the value of employee common stock should be reduced if preferred stock is issued to the contributors of cash and property. [x]

Most early-stage start-ups skip obtaining a valuation of QSBS granted to employees and instead rely on establishing internally a reasonable value for the stock being issued. Later, when the start-up has developed valuable intellectual property or has acquired valuable assets or cash, the company often seeks a valuation of QSBS granted to employees, which generally is based on valuation methodologies similar to those used in Section 409A valuations. Typically, an appraiser first determines the company's enterprise value, and then offsets against that enterprise value an amount equal to the aggregate liquidation preferences associated with the company's outstanding preferred stock, with the net result being

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the value of the company's QSBS.

Nonvested Stock, Stock Options, Stock Appreciation Rights, Phantom Equity and Other Non-stock Rights and Bonus Arrangements Don't Mix Well With Section 1202.

It is worth mentioning again the point that in order for stock to qualify for Section 1202's gain exclusion, an employee must hold "stock" for federal income tax purposes and sell stock with more than a five-year holding period. None of the following compensation instruments qualify as "stock" for federal income tax purposes: nonvested stock, nonqualified stock options (NQSOs), incentive stock options (ISOs), stock appreciation rights (SARs), restricted stock units (RSUs), phantom equity or other deferred compensation or bonus arrangements. In spite of their shortcomings, non-stock compensation instruments continue to be used for a variety of reasons by corporations that could issue QSBS. The reasons for continuing to use non-stock compensation arrangements include the desire on the part of employees to avoid up-front compensation income; the desire by the corporation's management to take advantage of a tax deduction for compensation paid; the desire to avoid introducing employees into the shareholder fold; and the desire to avoid the need for valuations of stock grants and the administrative complexity of living with numerous stockholders subject to varying economic rights, buy-sell restrictions and information rights.

The shares issued when NQSOs and ISOs are exercised qualify as "stock" for purposes of Section 1202, so long as the shares are vested (*i.e.*, not subject to a substantial risk of forfeiture under Section 83 or transferable). If the shares issued when options are exercised qualify as nonvested QSBS, the employee will be faced with the decision of whether to file the Section 83(b) election. In many instances, the longer the employee waits to exercise stock options, the more compensation income (in the case of NQSOs) or alternative minimum tax (in the case of ISOs) is triggered, which could make exercising prohibitive from a tax standpoint, in the postponement of exercise until a sale event when the amount of compensation income may be even greater, but at least there will

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be cash to pay the taxes. Finally, an obvious point is that every day that passes without exercising an option increases the likelihood that an employee will not have satisfied the required five-year holding period when the QSBS is sold.

Equity Compensation Planning in Connection With the Conversion of LPs and LLCs to Corporations.

As part of initial choice-of-entity planning, founders often consider whether to start life as a C corporation or to instead convert from an LP or LLC to C corporation after the company has grown in enterprise value.[xi] Owners of companies that wait to convert to a corporation may be positioned to take advantage of Section 1202's 10X gain exclusion cap. For example, assuming that a partnership incorporates when its assets are valued at $40 million (including unbooked goodwill) and that the company's QSBS is eventually sold for $440 million, the first $40 million of taxable gain would be subject to capital gains (assuming a zero tax basis in the $40 million of assets at the time of conversion), but the next $400 million should qualify for Section 1202's gain exclusion. While the benefits of the 10X gain exclusion cap are obviously attractive, issuing QSBS when a company has significant enterprise value will present considerable challenges if there is also a desire to issue QSBS to employees. One possible solution to this problem is the "thin" common stock arrangement capital structure.

The "thin" common stock capital structure is one where there are one or more classes of preferred stock with liquidation preferences ahead of the company's common stock. If at the point when employee common stock is issued, the aggregate liquidation preferences in favor of outstanding preferred stock accounts for all or most of the company's enterprise value, the company's common stock (QSBS) should have a low or nominal value. Preferred stock can either be issued to contributors of cash and/or property at the outset, or if the company has all common stock outstanding prior to the issuance of employee QSBS, a company's capital can be recapitalized, with the outstanding common stock exchanged for convertible preferred stock with liquidation preferences, followed by the issuance of a class of employee common stock (the QSBS). [xii]

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Dealing with outstanding LP/LLC profits interests and employee equity.

In a partnership conversion, if an LP/LLC has issued capital or profits interests to service providers, those partnership interests would be exchanged for QSBS in connection with the entity's conversion, regardless of which conversion method is selected (*e.g.*, contribution of partnership interests, contribution of assets, check-the-box election on Form 8832 or state-law conversion to a corporation).[xiii] The first thing to note is that a partnership conversion may trigger compensation income to service providers if the fair market value of the corporate stock received in the exchange exceeds the value of the service provider's partnership interest. Strategies for addressing the subordinated economic rights associated with a profits interest's "distribution threshold" include: (i) issuing preferred stock to holders of capital interests or adjusting the number of shares of common stock issued to holders of profits interests to take into account the distribution threshold; (ii) converting the tax partnership to a corporation by checking-the-box and retaining the distribution waterfall established in the partnership's LP or LLC agreement; or (iii) keeping the LP/LLC and its capital and profits interests intact and contributing the assets of the business to a newly-formed corporation.

One practical aspect of structuring LP/LLC conversions is that venture capitalists usually expect a straightforward capitalization arrangement (*i.e.*, one that has not retained the LP/LLC distribution waterfall), with convertible preferred stock issued to investors and nonvested common stock issued to founders and employees. Venture capitalists generally expect that founders will be issued common stock instead of preferred stock in consideration of their contribution of enterprise value. But if only common stock is issued to the pre-conversion owners and preferred stock to contributors of new capital, this arrangement may result in profits interests holders (with zero or minimal capital in the LP/LLC) not being entitled to a meaningful share of the newly-organized corporation's common stock. This issue can be addressed by issuing additional employee stock or by issuing convertible preferred stock in the conversion, which should allow for the issuance of more common stock to holders of profits interests.[xiv] Down the road, when

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venture funding comes in, there is the option of converting the convertible preferred stock to common stock, leaving the contributors of venture money with the only outstanding preferred stock.

Filing a Section 83(b) election if employee stock is nonvested when issued in the conversion.

If employee stock issued in connection with a partnership conversion is nonvested, those employees receiving the stock in exchange for their LP/LLC interests should file Section 83(b) elections, regardless of whether the interest exchanged for the corporate stock is a capital or profits interest or is vested or nonvested. Revenue Ruling 2007-49 supports the conclusion that if vested employee equity is exchanged for nonvested employee equity, the filing of the Section 83(b) election is necessary to avoid the triggering of future compensation income when the stock vests, even if the values of the LP/LLC interest and the corporate stock issued in the exchange are the same.[xv] In the typical scenario addressed in Revenue Ruling 2007-49, there would be no taxable compensation income triggered by the filing of the Section 83(b) election.

If the LP/LLC interest is a nonvested capital interest in the tax partnership, then the issuance of an economic equivalent amount of nonvested corporate stock in the conversion should not trigger compensation income.[xvi] But as discussed above, nonvested stock doesn't forfeit the benefits of holding QSBS. On the other hand, if the LP/LLC interest is a nonvested capital interest in the tax partnership and the employee stock received in the conversion is vested, the conversion will trigger compensation income equal to the spread between the amount paid for the LP/LLC interest and the fair market value of the stock received by the employee in the conversion.

If the LP/LLC interest is a profits interest in the tax partnership, then the issuance of an economic equivalent amount of vested or nonvested corporate stock in the conversion should not trigger compensation income, but if the corporate stock received in the conversion is nonvested, the employee should file a protective

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Section 83(b) election based on the principles outlined in Revenue Ruling 2007-49.[xvii]

Carried Interests Issued by Investment Funds or Their Sponsors Acquiring QSBS.

Section 1202 permits QSBS to be issued to and held by tax partnerships, including LPs and LLCs. If a fund invests in QSBS, there is often indirect ownership of QSBS by holders of the fund's profits interests (carried interests). One question that is not fully answered by existing Section 1202 tax authorities is whether the holder of a carried interest in a fund that in turn holds QSBS shares in Section 1202's gain exclusion. We believe that holders of carried interests should be entitled to share in Section 1202's gain exclusion when the fund sells the QSBS.[xviii] The investment by tax partnerships in QSBS must be carefully orchestrated at the time of issuance, and the fund ownership while the QSBS is held must be carefully handled, as the right to claim Section 1202's gain exclusion can be reduced or lost by ownership shifts at the fund level.

Other Tax and Securities Law Considerations.

Deduction at the corporation level for QSBS issued to employees

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Under Section 83(h), the employer-corporation is entitled to a deduction for compensation paid in the form of stock grants equal to the compensation amount included in the employee's income.

Section 409A.

Stock grants are generally outside the scope of Section 409A's draconian deferred compensation rules and penalties. Nevertheless, it usually makes sense for a Section 409A expert to review compensation arrangements and either confirm that the arrangement falls outside of the scope of Section 409A or that the arrangement complies with Section 409A's requirements.[xix]

Rule 701 of the Securities Act of 1933.

Stock grants are usually structured to fit within Rule 701 of the Securities Act of 1933 (generally involving the adoption of a plan),

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and both federal and state securities law compliance must be addressed. The maximum number of securities that can be issued in any 12-month period in reliance on Rule 701 is the greater of the following: (i) $1,000,000; (ii) 15% of the total assets of the issuer measured at the issuer's most recent balance sheet date; or (iii) 15% of the outstanding amount of the class of the issuer's securities being offered and sold in reliance on Rule 701, measured at the issuer's most recent balance sheet date. Rule 701 does not exempt the issuance of securities from the other provisions of the federal securities laws, such as the duty to provide disclosure sufficient to satisfy the antifraud provisions of the securities laws. Finally, under Rule 701, the issuance of employee equity must also comply with the requirements of the securities laws of each of the states in which the employees reside.

Summary of Planning Considerations.

The potential benefits of claiming Section 1202's gain exclusion are substantial. But Section 1202's benefits are available only to employees who are issued QSBS that is either vested or coupled with a Section 83(b) election, hold their QSBS for more than five years, and then sell their QSBS. Not surprisingly, the desire to structure compensation arrangements that position employees to claim Section 1202's gain exclusion usually tips the scale towards stock grants and away from other compensation arrangements. A significant planning issue is the potentially large amount of compensation income triggered when there is a grant of vested QSBS. As outlined above, there are methods for reducing the amount of compensation income, but there is never a perfect solution unless the QSBS is issued in connection with the creation of a start-up. Finally, even when QSBS is available as a compensation tool, there are a number of additional tax and non-tax issues are typically addressed as a part of the planning process.

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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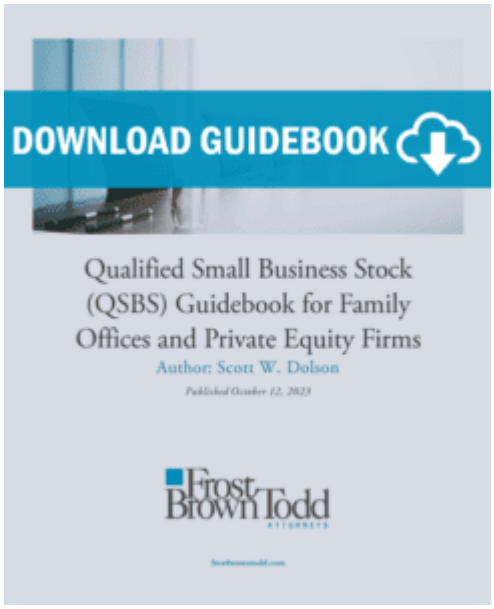
More Resources

Despite the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Section 1202 and Section 1045 planning. Founders and investors who want to learn more about QSBS planning opportunities are directed to several articles on the Frost Brown Todd website:



- 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
- Can Stockholders of Employee Leasing Companies Claim Section 1202's Gain Exclusion?
- 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?
- How Corporations May Run Afoul of the Accumulated Earnings Tax – A Section 1202 Planning Brief

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- How Section 1202's $50 Million Aggregate Gross Assets Test Works
- 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
- 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
- Dissecting 1202's Active Business and Qualified Trade or Business Qualification Requirements
- Recapitalizations Involving Qualified Small Business Stock
- The 21% Corporate Rate Breathes New Life into IRC § 1202

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[i] This article generally refers to "employees," but the scope of service providers covered generally includes directors and independent contractors, along with the employees, directors and independent contractors of subsidiaries being issued parent corporation stock.

[ii] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended.

[iii] This statement assumes that the QSBS is issued for less than fair market value consideration and that a Section 83(b) election is made if the QSBS is nonvested.

[iv] Under Treasury Regulation Section 1.83-3(b), stock is substantially nonvested for purposes of Section 83 when it is nontransferable and subject to a "substantial risk of forfeiture," which is defined to generally mean that "*rights to the stock are conditioned upon the future performance (or refraining from performance) of substantial services, or upon the occurrence of a condition related to a purpose of the transfer if the possibility of forfeiture is substantial.*" Stock is treated as being substantially vested when it is either transferable or no longer subject to a substantial risk of forfeiture. Generally, stock is nonvested if upon

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termination of employment, the stock must be forfeited for no consideration or for a payment that does not approach the then-fair market value of the stock. Treasury Regulation Section 1.83-3(c) provides that for purposes of Section 83, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances.

[v] An employee includes on the Section 83(b) election form the amount paid for the stock and its fair market value at the time of issuance, and the difference is taxable compensation that is treated by the corporation as deductible compensation and run through its payroll system. A valid Section 83(b) election is made by filing the form with the IRS within 30 days after the date the property is transferred to the employee (*i.e.*, when the stock is issued). Treasury Regulation Section 1.83-2 provides detailed instructions for making a Section 83(b) election. The filing of the Section 83(b) election form is the employee's obligation.

[vi] See footnote iv.

[vii] Section 83 doesn't specify a particular method required for valuing stock. The Tax Court has cited the usual rule that fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of relevant facts. *Robinson v. Commissioner*, 82 T.C. 467 (1984) and Revenue Ruling 59-60, 1959-1 C.B. 237. Valuation discounts such as lack of marketability or minority interest discounts can be applied in the valuation process.

[viii] These arrangements are referred to in private equity circles as "leveraged co-investment" arrangements, particularly when upper-level management personnel are involved. The interest rate of the employee note should be set based on Section 7872's safe harbor rates.

[ix] Treasury Regulation Section 1.83-3(a)(2) provides that "*if the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is no personal liability to pay all or a substantial part of such indebtedness, such transaction may be in substance the same as the grant of an option. The determination of the substance of the transaction shall*

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be based upon all the facts and circumstances."

[x] The strategy of issuing preferred stock to reduce the value of employee common stock is sometimes referred to as a "thin common" arrangement. Under this arrangement, the common stock has attributes similar to options in terms of valuation but is treated as "stock" under Section 83 for purposes of qualifying for capital gains treatment and Section 1202's gain exclusion.

[xi] In some cases, venture capitalists will be included as early-stage investors, and because of their desire to acquire C corporation preferred stock, the company will be organized as a Delaware C corporation issuing preferred stock to investors and nonvested common stock to founders and employees.

[xii] The recapitalization can qualify as a tax-free Type E reorganization (Section 368(a)(1)(E)). The exchange of outstanding common stock for preferred stock in a Type E reorganization (a recapitalization) works for purposes of Section 1202, with the preferred stock issued in the recapitalization continuing to qualify as QSBS.

[xiii] See Revenue Ruling 84-111, 1984-2 C.B. 88.

[xiv] If new money is coming in the newly-formed corporation from venture capitalists or other investors and it is necessary to implement a plan to reduce the value of employee common equity, a possible solution is to issue a subordinated class of convertible preferred stock to the historic holders of capital interests in the converted partnership, senior preferred stock to the new cash investors and employee common stock to the partnership's employees and profits interest holders. Section 351's continuity of interest rules will need to be considered in connection with the staging of the incorporation and capital raises.

[xv] Revenue Ruling 2007-49, 2007-2 C.B. 237.

[xvi] This assumes that no Section 83(b) election was filed by the service provider upon receipt of the capital interest.

[xvii] For this purpose, the "profits interest" or "carried interest" would be an equity interest in the tax partnership meeting the requirements of Revenue Procedures 93-27, 1993-2 C.B. 343 and

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2001-43, 2001-2 C.B. 191. If a protective Section 83(b) election was made at the time of issuance of the LP/LLC profits interest, then the exchange of that interest for vested employee stock should not trigger any taxation event. Again, a protective Section 83(b) election should be filed based on Revenue Ruling 2007-49 if the profits interest for which a Section 83(b) was filed is exchanged for nonvested corporate stock.

[xviii] See the article "*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 Treasury Regulations make it clear that the holders of carried interests are not entitled to any allocation of gain for purposes of qualifying for claiming the reinvestment of QSBS sales proceeds under Section 1045.

[xix] Noncomplying employee compensation arrangements that fall within the scope of Section 409A will trigger the imposition of an additional 20% excise tax and a premium interest tax, among other applicable penalties.

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