Conversions, Reorganizations, Recapitalizations, Exchanges, and Stock Splits Involving Qualified Small Business Stock (QSBS)

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Section 1202 provides for a substantial exclusion of gain from federal income taxes when stockholders sell qualified small business stock (QSBS).[1] A number of requirements must be satisfied before a stockholder is eligible to claim Section 1202's gain exclusion. Those requirements have been addressed in a series of articles on the FBT Gibbons website. One significant aspect of Section 1202 planning is understanding how various corporate recapitalizations, reorganizations and similar transactions can impact the QSBS status of a corporation's outstanding stock.[2]

*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. The C corporation has gained favor in recent years as the entity of choice because of the 21% corporate tax rate and the potential for benefiting from Section 1202's gain exclusion. This article has been updated to reflect changes made by the **One Big Beautiful Bill Act** (OBBBA), signed into law on July 4, 2025. Additional information regarding the eligibility requirements for Sections 1202 and 1045 can be found on our **QSBS & Tax Planning Services page***

This article focuses on the following discrete (and we think interesting) questions that we have seen in our mergers and acquisitions (M&A) practice involving QSBS:

- What are the consequences of converting convertible preferred QSBS?
- What are the consequences of exchanging QSBS for another corporation's stock in an acquisitive (Type A, B or C) tax-free reorganization?

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- What are the consequences of undertaking a divisive reorganization (dividing a corporation into multiple corporations in a Type D reorganization)?
- What are the consequences of exchanging QSBS in a Type E reorganization (recapitalization) for another class of stock of the same corporation?
- Can recapitalizations be used to solve Section 1202's S corporation problem?
- What are the consequences of exchanging QSBS in a Type F reorganization (mere change of form, identity or place of organization) for other equity of the corporation?
- What are the consequences of a "stock split" (e.g., where one share splits into 100 shares) involving QSBS?
- What are the consequences of a "reverse stock split" (e.g., where 100 shares are consolidated into one share) involving QSBS?
- What are the consequences of a stock dividend under Section 1202?
- What are the tax consequences of exchanging unrestricted QSBS for restricted stock?

A. What are the consequences of converting convertible preferred QSBS?

Convertible preferred stock is a common type of equity used by start-ups and closely-held corporations. Typically, the preferred stock will convert into common stock if a liquidity event occurs and holders would net more proceeds as holders of common stock. If the liquidity event doesn't net sufficient proceeds, the preferred stock would share the proceeds, if any, on a priority basis over the common equity. Section 1202(f) provides that if stock is acquired solely through the conversion of QSBS, then the stock so acquired is treated as QSBS, and the holding period for the original QSBS carries over to the holding period for the QSBS issued in the conversion.

Section 1202's legislative history includes the following statement: "*In the case of convertible preferred stock, the gross assets*

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determination is made at the time the convertible stock is issued, and the holding period of the convertible is added to that of the common stock acquired upon conversion."[3] This legislative history clearly supports the conclusion that there is no Aggregate Gross Assets retesting (see the definition below) when convertible QSBS converts.

Beyond the guidance provided in Section 1202(f), a conversion of preferred stock to common stock is also generally treated as a recapitalization for federal income tax purposes.[4] A single corporation recapitalization generally qualifies as a tax-free Type E reorganization (Section 368(a)(1)(E)). As discussed later in this article, there is support for the conclusion that when QSBS is exchanged in a recapitalization, the issuance must be retested to see if the issuing corporation would pass the Aggregate Gross Assets test at the time of the exchange. The reconciliation of that authority with the language of Section 1202(f) and Section 1202(f)'s legislative history is a Section 1202(f) conversion involves preferred stock which includes a conversion feature as part of its terms while other recapitalizations that fall within the scope of a Type E reorganization involve stock which is not convertible on its face.

B. What are the consequences of exchanging QSBS for another corporation's stock in an acquisitive (Type A, B or C) tax-free reorganization?

Section 368 includes Type A (merger), Type B (stock for stock) and Type C (stock for assets) reorganizations, and certain triangular mergers. These are reorganization provisions used to structure tax-free stock for stock and stock for assets acquisitions.

If target stockholders exchange QSBS for buyer stock in a tax-free reorganization, then the stock issued to the target stockholders will qualify as QSBS, subject to the possible application of Section 1202(h)(4)(B)'s limitation on claiming Section 1202's gain exclusion. [5] Under Section 1202(h)(4)(B), if the acquiring corporation in a tax-free reorganization does not meet all of Section 1202's eligibility requirements for issuing QSBS at the time of exchange, the amount

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of gain exclusion available to the target stockholders when they sell their buyer stock received in the reorganization will be limited to the amount of gain deferred at the time of the reorganization.[6] An eligibility requirement that buyer corporations will often fail to meet is the requirement that the buyer's aggregate gross assets do not exceed $50 million immediately after the exchange (the "Aggregate Gross Assets Test"). If the reorganization takes place after July 4, 2025, $75 million replaces $50 million. [7] For example, if stockholders holding QSBS exchange their stock for stock of a public company in a Type B (stock for stock) reorganization, and the amount of gain deferred at the time of the exchange is $100 per share, when the public company stock is sold for $200 per share, the amount of a stockholder's Section 1202 gain exclusion would be limited to the $100 per share, with the excess gain taxed at capital gains rates.[8]

If QSBS is exchanged for stock in a tax-free reorganization, a target stockholder's holding period for buyer stock issued in the reorganization will include the holding period for the target corporation QSBS. This rule is helpful for stockholders looking to achieve the necessary five-year holding period for claiming Section 1202's gain exclusion.

Tax authorities have not addressed how the QSBS issuer's "aggregate gross assets" would be calculated in connection with a Type A, B or C reorganization. In connection with a Type A reorganization where the target corporation merges into the acquiror or a Type C reorganization (target assets exchanged for buyer stock), the likely approach would be to determine whether the aggregate money and tax basis of the consolidated assets exceeds the aggregate gross assets ceiling as of the effective date of the merger, subject to application of Section 1202(d)'s provisions.

Section 1202(d)(2)(B) provides that in connection with the contribution of property to a QSBS Issuer in exchange for QSBS where the property's basis is determined in whole or in part by reference to the adjusted basis of the contributed property (which would be true in a Type A or C reorganization), the basis of the contributed property for Section 1202 purposes equals the fair market value of the property at the time of contribution. So, the

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aggregate gross assets ceiling test would take the Section 1202 tax basis of the acquiring corporation's assets and add to them the fair market value of the target corporation's assets to determine whether the combined assets did not exceed the aggregate gross assets ceiling at the effective time of the merger.

In connection with a Type B reorganization (target stock exchanged for buyer stock) or a forward or reverse triangular reorganization, the acquiror ends up owning a subsidiary holding target assets with their historic tax basis. The "aggregate gross assets" of that new "parent-subsidiary controlled group" (see Section 1202(d)(3) would equal the aggregate money and tax basis of the consolidated assets (in each case ignoring the subsidiary's stock), again subject to application of Section 1202(d)'s provisions.

Where a stock for stock exchange or forward triangular merger (target merges into acquiror's subsidiary and is the survivor in the merger) is involved, the likely approach would be to aggregate the money and historic tax basis of the assets of the target and acquiring corporation to determine whether the aggregate gross assets of the post-reorganization parent-subsidiary exceeded the applicable ceiling. In the calculation, the value/tax basis of the target corporation's stock would be ignored. The IRS might argue that the target corporation's assets should be valued at their fair market value, but the plain language of Section 1202 doesn't support that position. A reverse triangular merger where the acquiror's subsidiary is the surviving corporation is functionally an asset acquisition where the assets retain their historic tax basis, so under Section 1202(d)(2)(B) the target corporation's assets would be valued at their fair market value for purposes of the ceiling test.

Even though the issuance of the target corporation's QSBS was subject to the $50 million ceiling, stock issued in a Type A, B or C reorganization after July 4, 2025, would likely be subject to the higher $75 million ceiling.

Section 1202(h)(4)(C) provides rules applicable to situations where there are multiple recapitalizations or reorganizations during a stockholder's QSBS holding period. In general, if QSBS is exchanged for other QSBS in a Section 368 reorganization, that stock can later be exchanged again for other QSBS in further tax-free

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reorganizations. In connection with each subsequent reorganization, the issue of whether the Aggregate Gross Assets Test was satisfied would need to be addressed if the stockholder was holding QSBS at the time of the reorganization.

Presumably, if QSBS is exchanged for non-QSBS in a tax-free reorganization subject to Section 1202(h)(4), and the stockholder is holding non-QSBS (e.g., the exchange for QSBS for public company stock), none of Section 1202's ongoing eligibility requirements should apply to the public company, other than the requirement that the company remain a C corporation through the date of sale of the stockholder's non-QSBS. The various stockholder level eligibility requirements such as the five year holding period requirement and the limitations on a stockholder's ability to transfer the stock other than by gift or at death would continue to apply. Finally, there are no tax authorities addressing how Section 1202's gain exclusion cap would apply in this situation, but the most reasonable approach might be to aggregate sales of the original corporation's QSBS with sales of the non-QSBS received in the reorganization to apply Section 1202's gain exclusion cap.

If QSBS is exchanged for QSBS, a reasonable conclusion is that all of Section 1202's eligibility requirements at both the corporate and stockholder level would continue to apply through the sale of the replacement QSBS. With respect to calculating Section 1202's gain exclusion cap, if the replacement QSBS is treated as having been issued by a new issuer for purposes of the Aggregate Gross Assets Test, then it seems reasonable to conclude that the corporation issuing the replacement QSBS would be treated as a separate corporation for purposes of Section 1202's gain exclusion cap (i.e., there would be no aggregating of gain exclusion of the corporations issuing the original and replacement QSBS).

C. What are the consequences of undertaking a divisive reorganization (dividing a corporation into multiple corporations in a Type D reorganization)?

The most common divisive reorganization (spinoffs, split-offs or split-ups) involves splitting a corporation into two or more

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corporations, with each corporation separately owned by some or all of the original stockholders.

Divisive reorganizations generally qualify as Type D reorganizations (Section 368(a)(1)(D)). A Type D reorganization requires the transfer of assets to a controlled subsidiary, followed by the distribution of the subsidiary's stock to parent stockholders. The stock distribution might be a pro rata spinout or a non-pro rata split-up of ownership among two stockholder groups holding separate corporations. A number of requirements under Section 355 must be met before splitting up a corporation into multiple corporations can be accomplished on a tax-free basis.[9]

There are several issues associated with structuring a divisive reorganization involving QSBS:

- A Type D reorganization falls within the scope of Section 1202(h)(4), which means that the stock of both divided corporations can be QSBS. A holder of parent corporation QSBS who receives subsidiary stock in an exchange should be able to treat the subsidiary stock as QSBS, subject to the potential limitations imposed by Section 1202(h)(4)(B). Section 1202(h)(4(B) provides that if QSBS is exchanged in a Section 368 reorganization for stock not meeting Section 1202's eligibility requirements, then while the stock is treated as QSBS, and the stockholder's parent QSBS holding period carries over into the stock received in the exchange, the amount of the stockholder's future Section 1202 gain exclusion will be limited to the amount of gain deferred at the time of the exchange. See the discussion in Section B above regarding exchanging QSBS for QSBS or non-QSBS in a tax-free reorganization.

Companies often cease to satisfy Section 1202's Aggregate Gross Assets Test as they grow, which is what happened to the corporation involved in Private Letter Ruling (PLR) 9810010 (3/6/1998). The IRS concluded in that PLR that although a Type D reorganization did qualify under Section 1202(h)(4), the limitation on future gain exclusion provided for in Section 1202(h)(4)(B) was applicable. PLR 9810010 confirmed that when the transaction involves a divisive reorganization, the distribution of the subsidiary's stock is treated for Section 1202 purposes as an issuance of stock

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by the subsidiary, triggering the application of the Aggregate Gross Assets Test, but focusing only on the aggregate gross assets of the subsidiary. Presumably, the holding period of the subsidiary's stock received in exchange for parent stock would include the holding period for the parent stock.

- Section 1202(h)(4) applies only if a division of a corporation falls within the scope of a Type D reorganization. If there exists a preexisting parent-subsidiary structure, the distribution of the subsidiary stock would be governed by Section 355, but not by Section 368. Neither Section 1202(h)(4) nor Section 1202(h)(3) references distributions of stock governed solely by Section 355. A Type D reorganization literally requires the formation of a new subsidiary, the contribution of assets by the parent corporation to that subsidiary and the distribution of the subsidiary's stock to parent corporation's stockholders. We are aware of no policy reason why a transaction governed by Section 368 would qualify for favorable treatment under Section 1202(h)(4), while a transaction governed by Section 355 would not be eligible for Section 1202(h)(4)'s beneficial treatment of QSBS, but there are no tax authorities suggesting that a literal reading of the statute doesn't govern. One potential workaround for this problem would be to form a new subsidiary and contribute the stock of the existing subsidiary to that new corporation, followed by the distribution of the new corporation's stock to parent corporation stockholders. These steps should bring the transaction literally within the requirements for a Type D reorganization. The IRS might argue that dropping the existing subsidiary's stock into a newco subsidiary lacks a business purpose beyond positioning stockholders for eventually claiming Section 1202's gain exclusion. But a two-tier corporate structure is often considered to provide meaningful non-tax benefits, including additional asset protection benefits and various other business benefits associated with a parent-subsidiary (holding company) structure.

- Section 1202(h)(4) literally applies to transactions qualifying as a Section 368 tax-free reorganization involving an "exchange" of stock. In a divisive reorganization, stock can either be exchanged in a split-up or split-off, or merely distributed with respect to existing stock in a pro rata spinoff. So, although a pro rata spinoff qualifies

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for tax-free treatment under Section 355 and Section 368(a)(1)(D), a pro rata spinoff where no stock is "exchanged" falls outside of the literal scope of Section 1202(h)(4). Although we have identified no policy reason for distinguishing between a divisive reorganization involving an "exchange" versus a mere pro rata distribution, the reference in Section 1202 to "exchange" cannot be ignored. A possible workaround might be to couple the Type D reorganization with a Type E recapitalization where parent stockholders literally "exchange" each share of parent corporation stock for a new class of parent corporation stock and stock in the spun-out corporation. Given the apparent absence of a reason to distinguish between different types of Section 355 transactions for Section 1202 purposes, this approach should work, but there are no tax authorities expressly addressing this approach. Another possible workaround involves reliance on Section 1202(h)(3), which states that "*rules similar to the rules of section 1244(d)(2) shall apply for purposes of this section*" (Section 1202). Section 1244(d)(2) references stock, "*the basis of which (in the hands of the taxpayer) is determined in whole or in part by reference to the basis in his hands of stock in such corporation.*" Treasury Regulation Section 1.1244(d)-3(b)(1) specifically references a stock dividend as a transaction where "*common stock is received by an individual or partnership in a nontaxable distribution under section 305(a) made solely with respect to stock owned by such individual or partnership which meets the requirements of section 1244 stock determinable at the time of distribution.*" The workaround would involve taking the position that a pro rata spinoff qualifies as stock received with respect to stock held, bringing it within Section 1202(h)(3). Since the basis of subsidiary stock received in a pro rata spinoff is determined by reference to the basis of a stockholder's parent corporation's stock, there is at the very least a reasonable argument that Sections 1202(h)(3) and 1202(h)(4) can be read in combination to treat the stock distributed in a spinoff as qualifying Section 1202(h)(4). Section 1244 specific aspects of the regulation would be ignored when applying its principles to Section 1202 (e.g., the requirement that Section 1244 stock be common stock, the reference to Section 305(a) and the reference to stockholders being limited to individuals and partnerships).

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- Section 1202(b) provides that "*if a taxpayer has eligible gain for the taxable year from 1 or more dispositions of stock issued by any corporation, the aggregate amount of gain from dispositions of stock issued by such corporation which may be taken into account under subsection (a) for the taxable year shall not exceed the greater of the applicable dollar limit for the taxable year ($10 million for QSBS issued prior to July 5, 2025, and $15 million for QSBS issued after July 4, 2025).* An unanswered question is whether "any corporation" literally should be read to mean each of the two corporations resulting from a divisive reorganization. Based on the reasoning and logic of PLR 9810010, which treated the divisive reorganization as an issuance of stock by the subsidiary corporation for purposes of the Aggregate Gross Assets Test, each corporation should be treated as an issuer of stock for purposes of Section 1202(b)'s gain exclusion caps. This would mean that the stock of each of the "parent" and "subsidiary" corporations would have their own separate gain exclusion caps.

Given the analysis and conclusions adopted by the IRS in PLR 9810010, if a divisive reorganization occurs, holders of "parent" stock should be able to claim the gain exclusion without application of Section 1202(h)(4)'s limitations and should also be entitled to a full gain exclusion based on the "parent" corporation being an issuing corporation. Holders of "subsidiary" stock should also be able to claim the gain exclusion, but it would be subject to application of Section 1202(h)(4)'s limitation on gain exclusion depending on whether the Aggregate Gross Assets Test was satisfied at the "subsidiary" level or not. The "subsidiary" stock should also be treated as stock of a separate issuer from the "parent" stock for purposes of the gain exclusion cap.

D. What are the consequences of exchanging QSBS in a Type E reorganization (recapitalization) for another class of stock of the same corporation?

A recapitalization where stockholders exchange one class of stock for another class of stock of the same corporation is generally

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treated as a Type E reorganization (Section 368(a)(1)(E)).[10] Section 1202(h)(4)(A) provides that stock received in a Type E reorganization will be "*treated as qualified small business stock acquired on the date on which the exchanged stock was acquired*," so the holding period of the original QSBS will include the holding period for the stock received in the exchange.

Under Section 1202(h)(4), stock received in a Type E recapitalization for QSBS should qualify as QSBS if the corporation satisfies all of Section 1202's eligibility requirements. But what if the issuing corporation fails the Aggregate Gross Assets Test at the time of the recapitalization? This raises the question of whether Section 1202(h)(4)(B) functions to limit the future Section 1202 gain exclusion in a single-corporation transaction. The answer may be found in Section 1202(e)(3), which provides that "*rules similar to the rules of section 1244(d)(2) apply for purposes of this section*." Treasury Regulation Section 1.1244(d)-3(c) provides "*if, pursuant to a recapitalization described in section 368(a)(1)(E), common stock of a corporation is received by an individual or partnership in exchange for stock of such corporation meeting the requirements of section 1244 stock determinable at the time of the exchange, such common stock shall be treated as meeting such requirements* ." Example 1 in those regulations make it clear that the stock that must meet the requirements of Section 1244 determinable at the time of the exchange is the original Section 1244 stock given up in the exchange. A reasonable position would be that "meeting the requirements determinable at the time of the exchange" means that only those eligibility requirements that apply on a continuous basis to outstanding Section 1244 stock (or in the context of Section 1202, QSBS) must be met at the time of exchange in order for the stock received in the exchange to qualify as Section 1244 stock (or QSBS). In the Section 1202 context, this position would mean that in the context of a Type E reorganization (a recapitalization), QSBS treatment for stock received in the exchange would not depend on whether the corporation was continuing to pass the Aggregate Gross Assets Test. Although this result seems reasonable when dealing with a single corporation reorganization, there are currently no tax authorities addressing the issue.

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As discussed in Part A above, Section 1202(f) deals specifically with the Section 1202 consequences of converting convertible preferred QSBS into common stock QSBS. Section 1202's legislative history provides that when convertible preferred QSBS is converted, there is no Aggregate Gross Assets retesting. The legislative history to Section 1202(f) opens the door for the argument that there should be no retesting in any Type E recapitalization, but a distinction can be made between recapitalizations involving stock that is expressly convertible preferred stock and other conversions that fall within the scope of a Type E recapitalization but do not involve stock that is expressly convertible.

As noted above, we believe that Section 1202 supports the conclusion that there should be no ceiling test triggered by the consummation of a Type E or F reorganization. Presumably, if the Tax Court determined that a retesting of the ceiling was necessary, that conclusion would base that determination that there was, in fact, a deemed issuance of new equity. In that case, the likely result would be to simply determine whether the corporation's money, plus historic aggregate tax basis of other assets exceeds the aggregate gross assets ceiling, subject to application of Section 1202(d)'s provisions. It follows that a deemed issuance of new equity in exchange for old equity would be subject to the current $75 million ceiling if the Type E or F reorganization occurred after July 4, 2025, even in circumstances where the original QSBS issued prior to July 5, 2025, and subject to the $50 million ceiling.

E. Can recapitalizations be used to solve Section 1202's S corporation problem?

One recurring issue involves working with the owners of S corporations who are considering converting their companies to C corporations, usually with an eye towards eventually taking advantage of Section 1202's gain exclusion. The challenge is that only stock issued by a C corporation can qualify as QSBS, which means that merely converting to a C corporation won't turn the founders' outstanding S corporation stock into QSBS. A fair question is whether the outstanding S corporation stock problem can be cured by exchanging stock that was historically S corporation stock

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for new C corporation stock. Unfortunately, this plan doesn't work because under Section 1202(h)(4) stock received in the recapitalization is not QSBS unless it is issued in exchange for QSBS. Even if the position was taken that the recapitalization was governed by Section 1202(h)(3), this wouldn't change the result because Treasury Regulation Section 1.1244(c)(3), Example (1) confirms that the original stock (i.e., the non-QSBS S corporation founder stock) must meet the requirements of Section 1244 stock (here substitute Section 1202 for Section 1244), in order for favorable treatment under Section 1244(d)(2) to apply.

One workaround addressing this problem involves a contribution by the S corporation of assets or a single-member LLC interest to a newly-formed C corporation in exchange for stock. The C corporation should be eligible to issue QSBS to the S corporation, additional investors and employees (if an equity plan is adopted), so long as there exists bona-fide business reasons for adopting this plan.

A second possible workaround would be to terminate the S election and recapitalize the now-C corporation by exchanging the outstanding common stock for a class of preferred stock and issuing additional shares of common stock to investors, employees and to existing stockholders for new consideration. The rules of Section 306 governing the issuance of preferred stock in Type E recapitalizations would need to be contended with and the initial preferred stock would not qualify for Section 1202's gain exclusion. This workaround might also be a useful tool where an S corporation has already converted to a C corporation before there is an opportunity to consider the first planning method addressed in the preceding sentence.

F. What are the consequences of exchanging QSBS in a Type F reorganization (mere change of form, identity or place of organization) for other equity of the corporation?

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QSBS held by stockholders participating in a Type F reorganization is subject to the same treatment applicable to QSBS in a Type E reorganization discussed in Section D above. A typical Type F reorganization includes redomiciling a corporation from Colorado to Delaware or converting an Delaware LLC taxed as a corporation (i.e., an LLC that has filed a "check-the-box election") to a Delaware state-law corporation. Although it may make little sense, a mere change of a corporation's name for state law purposes (i.e., through filing of an amendment to a corporation's Certificate of Incorporation) may fall within the scope of a "mere change of identity" for purposes of a Type F reorganization, meaning that it is possible that the Aggregate Gross Assets Test would need to be retested in connection with a mere name change (see the discussion in Section D above).

G. What are the consequences of a "stock split" (e.g., where one share splits into 100 shares) involving QSBS?

In a forward stock split, a share is split into multiple shares of the same corporation. A stock split can be accomplished by actually "splitting" a share of stock into multiple shares (e.g., the corporation's articles/certificate of incorporation is amended to provide that each share of stock splits into multiple shares of stock) or by means of a stock distribution with respect to an outstanding share (e.g., 99 shares are distributed with respect to each outstanding share). The effect of a forward stock split on the QSBS status of outstanding stock is addressed below:

- A stock split accomplished through an amendment to the certificate/articles should be treated as falling within the scope of Section 1202(h)(4) because that transaction qualifies as a Type E reorganization (Section 368(a)(1)(E)), and the articles/certificate can reference the exchange of the one share for multiple shares (meeting Section 1202(h)(4)'s literal requirement for an "exchange." [11] There are no tax authorities addressing the issue of whether the corporation must be treated as "issuing" replacement stock for purposes of Section 1202, triggering application of the Aggregate Gross Assets Test at the time of the stock split, but Section

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1202(h)(4) does not distinguish between participation in a single-corporation transaction versus rolling QSBS up into a larger corporation in an acquisitive transaction under Sections 368 or 351.

- A second method for accomplishing a stock-split is a stock dividend, where the corporation distributes additional shares with respect to each outstanding share of QSBS. Section 1202(h)(3) provides that rules similar to those in Section 1244(d)(2) apply for purposes of defining the scope of QSBS transfers and issuances of stock with respect to QSBS that do not adversely affect QSBS status. Treasury Regulation Section 1.1244(d)-3(b) provides the following in respect to excluded stock distributions, *"[i]f common stock is received by an individual or partnership in a nontaxable distribution under section 305(a) made solely with respect to stock owned by such individual or partnership which meets the requirements of section 1244 stock determinable at the time of the distribution, then the common stock so received will also be treated as meeting such requirements*." The regulation also notably provides that Section 1244's "gross receipts test" *is not includable among the requirements of Section 1244 "determinable at the time of the distribution or exchange."* The language of this regulation supports an argument that for purposes of Section 1202, a stock dividend falls favorably within the scope of Section 1202(h)(3) (i.e., if the stockholder holds QSBS, then the additional shares distributed pursuant to the stock dividend would also qualify as QSBS) and as a result, the corporation would not be subject to Aggregate Gross Assets Test retesting when the dividend occurs.

With certain modifications, Section 1202 follows the general holding period rules of Section 1223. With respect to a Type E reorganization (a reorganization governed by Section 368), Section 1202(h)(4) provides that with respect to stock received in an exchange governed by Section 368, the *"stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired."* With respect to a stock dividend, Section 1223(4)(A) provides that, *"[i]n determining the period for which the taxpayer has held stock or rights to acquire stock received on a distribution, if the basis of such stock or rights is determined under Section 307, there shall (under regulations prescribed by the*

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Secretary) be included the period for which he held the stock in the distributing corporation before the receipt of such stock or rights upon such distribution." Section 307 controls the allocation of basis for any tax-free stock distribution under Section 305(a). Based on this authority, the holding period for the QSBS issued in the stock distribution should include the holding period for QSBS held by the stockholder.

H. What are the consequences of a "reverse stock split" (e.g., where 100 shares are consolidated into one share) involving QSBS?

A reverse stock split is a transaction where multiple shares of outstanding stock are converted into one share (e.g., a reverse split where 30 shares are converted into one share). The transaction is accomplished through an amendment to the corporation's articles or certificate of incorporation providing that multiple shares are converted into a single share. Corporations describing the federal income tax consequences of a reverse split usually exclude disclosure of the effect of transaction on the corporation's outstanding QSBS.

A reverse stock split should qualify as a tax-free Type E reorganization (Section 368(a)(1)(E)), and as such, participating stockholders should not be taxed when their 100 shares are reduced to one share (assuming they don't receive any cash for fractional shares). A reverse stock split, as a Type E reorganization, should fall within the scope of Section 1202(h)(4). The good news under Section 1202(h)(4) is that QSBS status should be preserved. But as discussed in Section D above, the bad news is that if the issuing corporation fails the Aggregate Gross Assets Test at the time of the reverse stock split, it appears likely that the gain exclusion limitation provided for in Section 1202(h)(4)(B) would apply. But should the transaction be subject to retesting when a stockholder is merely consolidating multiple shares of a single corporation? There doesn't appear to be a reason why Congress would intentionally impose the requirement that the corporation be a qualified small business when a single-corporation reverse stock

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split occurs. Although a reverse stock split does fall within the scope of a Type E reorganization, there is a chance that the IRS and the courts would not treat the reverse stock split as an "issuance" of QSBS for purposes of the application of the Aggregate Gross Assets Test. A reverse stock split might be viewed as closer in nature to a conversion of outstanding stock, bringing the transaction within the friendly scope of Section 1202(f). Finally, if a stockholder starts with 100 shares and post reverse stock split holds on shares, should that stockholder be viewed as exchanging the 100 shares for one shares or should the transaction be viewed merely as effecting a cancellation of 99 shares, leaving the remaining share outstanding? Given the fact that Section 1202's regulations provide that a redemption should be ignored if the consideration paid is less than $10,000, another possible way to view the transaction would be one where a stockholder has 99 out of his 100 shares redeemed for no consideration. Existing tax authorities have not resolved or addressed these issues.

I. What are the consequences of a stock dividend under Section 1202?

A stock dividend involves the distribution by a corporation of shares to existing shareholders with respect to their outstanding shares. Section 305(a) generally provides that a distribution made by a corporation to its shareholders in its stock is nontaxable. As discussed elsewhere in this Article, Section 1202(h)(3) provides that rules similar to those in Section 1244(d)(2) apply to Section 1202. Treasury Regulation Section 1.1244(d)-3 provides that stock dividends generally fall within the scope of Section 1244(d)(2). Under the authority of Section 1202(h)(3), a dividend of stock with respect to outstanding QSBS should also qualify as QSBS. As discussed in more detail in Section G above, there are arguments based on the language of Section 1244 and Treasury Regulation Section 1.1244(d)-3 that the corporation should not be required to satisfy the Aggregate Gross Assets Test a second time when the stock dividend is made. The only Section 1202 eligibility requirements that should be applicable at the time of the stock dividend would be those ongoing Section 1202 eligibility

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requirements that would need to be satisfied for the original stock to maintain its QSBS qualification (e.g., the continuing use of at least 80% of the corporation's assets [by value] in the active conduct of a qualified business activity).

With respect to the holding period for shares received in the stock dividend, Section 1223(4)(A) provides that, "[i]n determining the period for which the taxpayer has held stock or rights to acquire stock received on a distribution, if the basis of such stock or rights is determined under Section 307, there shall (under regulations prescribed by the Secretary) be included the period for which he held the stock in the distributing corporation before the receipt of such stock or rights upon such distribution." Section 307 controls the allocation of basis for any tax-free stock distribution under Section 305(a). Based on this authority, the holding period for the QSBS issued in the stock distribution should include the holding period for QSBS held by the stockholder.

J. What are the tax consequences of exchanging unrestricted QSBS for restricted stock?

Acquisitive Section 351 stock-for-stock exchanges, acquisitive nontaxable stock-for-stock exchanges governed by Section 368, and acquisitive taxable stock-for stock exchanges can involve an exchange of unrestricted stock (i.e., stock not subject to vesting requirements) for restricted stock (as defined by Section 83). Revenue Ruling 2007-49, 2007-2 CB 237, addresses the tax consequences associated with the exchange, including the need to file a Section 83(b) election in spite of the fact that there is an exchange of stock for stock of equal value. The article "*Exploring the Tax Consequences of Exchanging Unrestricted QSBS (Section 1202 Stock) for Restricted Stock*" addresses the various issues associated with a stock-for-stock exchange, including potential holding period issues arising out of language in Section 83 and its Treasury Regulations.

Closing Remarks

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

Contact Scott Dolson if you want to discuss any Section 1202 or Section 1045 issues by video or telephone conference. You can also visit the **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. Each taxpayer can exclude at least $10 million ($15 million for QSBS issued after July 4, 2025) of gain upon the sale of a particular C corporation's QSBS, provided all of Section 1202's eligibility requirements are satisfied. Many but not all states follow the federal income tax treatment of QSBS.

[2] This Article focuses on Section 1202 and doesn't go into detail regarding the various steps necessary to structure the tax-free reorganizations, recapitalizations and other corporate actions mentioned in the Article. This Article generally assumes that the corporation issuing QSBS and its stockholders are meeting all of Section 1202's qualification requirements prior to undertaking the applicable transaction. Finally, note that even assuming post-transaction that stock retains its QSBS status, there continues to be additional Section 1202 requirements that must be satisfied either on an on-going basis or at the time of sale before the stockholder qualifies for claiming the gain exclusion.

[3] H.R. Rep. No. 103-111 (P.L. 103-66) at page 603.

[4] See Revenue Ruling 77-238, 1977-2 CB 115 and Revenue Ruling 56-179 1956-1 CB 187.

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

[6] See 1202(h)(4)(B). As discussed elsewhere in this Article, Type E reorganizations (recapitalizations) and Type F reorganizations (mere change of identity, form or place of organization of one corporation, however effected) are excluded from the treatment described in the preceding sentence.

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[7] See Section 1202(d)(1) and the Scott Dolson article "*How Section 1202's Aggregate Gross Assets Test Works*."

[8] This example assumes that the stockholder had satisfied the five-year holding period requirement when the stock was sold and that all Section 1202 eligibility requirements were met through the time of the exchange if the QSBS was exchanged for non-QSBS and if QSBS was exchanged for QSBS, that all of Section 1202's eligibility requirements were satisfied through the date of the sale of the QSBS.

[9] Section 355's requirements include the active conduct of business activities in each of the two corporations, a five-year holding period for the activities and a valid business purpose for dividing the corporation's assets into two separate corporations. Examples of valid business purposes might include the existence of two incompatible business activities or feuding stockholders. If the reason behind dividing a business into two separately owned corporations involves selling or shifting ownership, planning must deal with Section 355(e). The complex rules of Section 355 are outside of the scope of this Article.

[10] Neither the Code nor the regulations define what qualifies as a recapitalization. The Supreme Court and the Second Circuit has defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation." *Helvering v. Southwest Consol. Corporation*, 315 US 194 (1942). The Third Circuit has determined that the term recapitalization signifies: … an arrangement whereby the stock and bonds of the corporation are readjusted as to amount, income, or priority, or . . . an agreement of all shareholders and creditors to change and increase or decrease the capitalization or debts of the corporation, or . . . both of the above. *United Gas Improvement Co. v. Commissioner*, 142 F.2d 216 (3rd Cir. 1944).

[11] The forward stock split is also treated as a Section 305 transaction, thereby bringing it within the scope of Section 1202(h)(3).

More QSBS Resources

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- Exploring Section 1202's Active Business Requirement
- Substantiating the Right to Claim QSBS Tax Benefits | Part 1
- Substantiating the Right to Claim QSBS Tax Benefits | Part 2
- One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors
- To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)
- Advanced Section 1202 (QSBS) Planning for S Corporations
- Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 2
- Structuring the Ownership of Qualified Small Business Stock (QSBS) – Is There a Role for Roth IRAs?
- Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide
- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations
- Can Stockholders of Employee Leasing or Staffing Companies Claim Section 1202's Gain Exclusion?
- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms
- How Section 1202's Aggregate Gross Assets Test Works
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion
- A SPAC Merger Primer for Holders of Qualified Small Business Stock
- Determining the Applicable Section 1202 Exclusion Percentage When Selling Qualified Small Business Stock

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- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- 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
- The 21% Corporate Rate Breathes New Life into IRC § 1202

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