Venture Studios and Qualified Small Business Stock

Mar 19, 2024

Categories:

Advanced QSBS Planning
Qualified Small Business Stock (QSBS)
Section 1045 Rollover Planning
Tax Law Defined™ Blog

Authors:

Scott W. Dolson

Section 1202 provides for a substantial exclusion of taxable gain from federal income taxes when stockholders sell qualified small business stock (QSBS).[1] This article addresses the opportunities presented by the intersection of venture studios and QSBS.

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 an entity of choice because of the 21% corporate tax rate and the potential for benefiting from Section 1202's gain exclusion. Additional information regarding the eligibility requirements and planning for Sections 1202 and 1045 can be found on our ***QSBS & Tax Planning Services page****.*

What is a venture studio?

A venture studio is usually a corporation or partnership (limited partnership or limited liability company), often backed by a venture fund or family office. The venture studio builds start-ups from scratch within the studio, usually side-by-side with founders who supply the original business concept. The combination of financial support, expertise and manpower assistance differs from studio to studio. Most venture studios provide financing and development advice and oversight, along with an array of services directed at taking a product to market. Typically, venture studios take a 20% to 40% equity ownership interest in a company developed within the studio.

What is qualified small business stock (QSBS)?

QSBS is stock issued by a qualified small business that meets all of the issuing-corporation level and stockholder level eligibility requirements of Section 1202. Those requirements have been addressed in a series of articles on the Frost Brown Todd website. If all eligibility requirements are met, a stockholder who sells QSBS in a

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

taxable sale or exchange is entitled to exclude up to a minimum $10 million of taxable gain at the federal level (i.e., $2.38 million in federal tax savings), and many states have a corresponding state income tax exclusion. Only domestic (US) C corporations can issue QSBS.

Can a venture studio acquire QSBS and take advantage of Section 1202's gain exclusion?

A venture studio taxed as a partnership (e.g., LP or LLC) can acquire preferred or common stock in a start-up and is eligible to claim Section 1202's gain exclusion.[2] A venture fund or family office can organize a single-member LLC to act as the venture studio. At an early stage in the development of a start-up, the venture studio and founders might contribute the assets developed in the studio to a newly-organized corporation, which has the benefit of starting the QSBS holding period (which must be greater than five years when the QSBS is sold). When QSBS is owned by a fund, each partner has a separate potential minimum $10 million gain exclusion when an issuer's QSBS is sold by the partnership. Alternatively, the venture studio might develop the business in partnership with its co-founders, and later incorporate the start-up, which has the potential benefit of allowing the owners to take advantage of Section 1202's "10X" gain exclusion cap, which can increase the potential gain exclusion. There are limitations on the sharing of Section 1202's gain exclusion among partners based on the "interest" held when the partnership acquires its QSBS. It is possible for the holder of a carried interest in a fund to claim Section 1202's gain exclusion with respect to that partner's "interest" represented by the carried interest.

How does Section 1045 work?

Section 1045 allows for the tax-free reinvestment of original QSBS sales proceeds into a replacement QSBS investment if the replacement stock is purchased within 60 days after the sale of the original QSBS. Proceeds can be reinvested under Section 1045 where the original QSBS has only a six-month holding period, which makes Section 1045 a useful tool for reinvesting proceeds when the

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

greater than five year holding period requirement of Section 1202 isn't met. Also, a stockholder whose original QSBS gain exceeds the typical $10 million gain exclusion cap can reinvest those excess proceeds in replacement QSBS under Section 1045.

Can a venture studio hold QSBS and reinvest sales proceeds in replacement QSBS under Section 1045?

When a fund/partnership sells original QSBS, either the partnership or individual partners can reinvest proceeds in replacement QSBS under Section 1045. Section 1045's regulations block holders of carried interests from taking advantage of Section 1045 with respect to the gain allocation attributable to the carried interest.[3]

Can a venture studio issue QSBS if it operates as a domestic (US) C corporation?

There are several reasons why owners would want to operate a venture studio through a C corporation. First, investors in a venture studio investors may not want to own an interest in an entity taxed as a partnership. Many investors are focused on acquiring preferred stock interests in C corporations rather than equity in pass-through entities such as LPs or LLCs. Second, corporations are currently eligible for a favorable 21% corporate tax rate. Third, investors may be interested in pursuing Section 1202's gain exclusion or focused on creating a C corporation that allows them to reinvest QSBS proceeds under Section 1045. Careful attention will need to be paid to meeting Section 1202's eligibility requirements if this route is taken. A key eligibility requirement is the "80% Test" – at least 80% (by value) of the issuing corporation's assets must be used in the "active conduct" of one or more qualified business activities for substantially all of a stockholder's QSBS holding period. The 80% Test provides two challenges for venture studios considering operating in a C corporation for the purpose of issuing QSBS:

- ***Engaging in qualified business activities***. The venture studio must focus on developing start-ups that are anticipated to

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

engage in qualified business activities. Sections 1202(e)(3) and (7) include a list of excluded activities. Many start-ups engage in qualified activities, including those focusing on software, biotech, pharma, manufacturing or sales. The venture studio must avoid developing start-ups that are engaged in excluded activities.

- ***Satisfying the "active conduct" requirement***. The venture studio must satisfy Section 1202's "active conduct" requirement. Fortunately, Section 1202(e)(2) provides that "active conduct" includes (1) start-up activities described in Section 195(c)(1)(A), and (2) activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under Section 174.

Section 195(c)(1)(A) encompasses the following start-up activities: "*(i) investigating the creation or acquisition of an active trade or business, or (ii) creating any active trade or business, or (iii) any activity engaged in for profit and for the production of income before the 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(a) defines research and experimental cost to include all costs incident to the development or improvement of a product and expenditures "*for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.*"

The scope of activities that are considered "active conduct" under Section 1202(e)(2) should provide a good fit with the typical start-up and R&D activities undertaken through venture studios. But assuming the venture studio is a C corporation, once a separate entity for the business is created and the venture studio owns equity rather than assets, the ownership of that equity position must itself qualify as "active conduct," or the value of the equity position will not count towards satisfying the 80% Test. Section 1202(e)(5) does explicitly provide a look-thru to activities of more than 50% owned corporate subsidiaries for purposes of establishing active conduct. Somewhat surprisingly, Section 1202 does not address how the ownership of a joint venture (LP/LLC) interest would be viewed for purposes of satisfying the "active conduct"

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

requirement and the 80% Test. When tax authorities addressing a particular Internal Revenue Code provision fail to define the meaning of a phrase, the standard approach of the IRS and courts is to look to tax authorities interpreting the phrase elsewhere in the Code.

Section 355's regulations and other tax authorities defining the scope of "active conduct" for purposes of Section 355 suggest that at least a one-third equity interest in a joint venture should be sufficient for a corporate partner to be considered as actively conducting the business of the joint venture.[4] Of course, a greater than 50% interest in a joint venture would bring the ownership in line with Section 1202's handling of corporate stock ownership for purposes of establishing "active conduct."

Does it make sense from a policy standpoint to permit venture studios to issue QSBS?

The activities of a venture studio appear to fit squarely with what Congress intended when it enacted Section 1202. The section's legislative history includes the statement that Section 1202 was designed to provide "*targeted relief for investors who risk their funds in new ventures [and] small businesses*," and that the potential for a substantial gain exclusion was intended to "*encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing*." In connection with increasing the gain exclusion to 100% in 2010, the legislative history noted that the "*increased exclusion and the elimination of the minimum tax preference for small business stock will encourage and reward investment in qualified small business stock*." Funds invested in a venture studio are used to fund and provide start-ups with additional valuable resources. The only difference between investing through a venture studio and investing directly in a start-up is that an additional activity of a venture studio is to first identify and select start-ups to support. As discussed above, Section 1202, by reference to Section 195(c)(1)(A), makes it clear that "active conduct" for purpose of the 80% Test includes not only creating a start-up but also investigating the creation or acquisition of a start-up.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

Problems with operating a venture studio as a C corporation

Operating a venture studio through a C corporation may seem to be an attractive way to issue QSBS, but the structure presents certain challenges. Section 1202's gain exclusion requires the taxable sale or exchange of QSBS. If the expectation is that there will be a sale of the venture studio itself, then issuing QSBS and operating a C corporation for more than five years is a viable option, although the venture studio's stockholders might experience some push back if they demand a stock deal, with the buyer proposing price adjustments based on the absence of an inside tax basis step-up. [5] Section 1202's gain exclusion is only available when venture studio's C corporation stock is sold or exchanged in a taxable transaction, not when the corporation's assets are sold. So, if the venture studio sells its equity position in a start-up, gain on the sale will be taxed at the 21% corporate federal tax rate. The distribution of the resulting sales proceeds by the venture studio to its stockholders might be treated as a taxable dividend that doesn't qualify as a taxable sale or exchange for purposes of Section 1202 or as a partial liquidation under Section 302(b)(4), which would qualify for taxable sale treatment for purposes of Section 1202.[6]

For a couple of reasons, businesses run through C corporations should avoid a build-up of undistributed cash not earmarked for satisfying the corporation's working capital. The accumulated earning tax can result in an extra 20% tax being imposed on the corporation's "accumulated taxable income."[7] Also, Section 1202(e)(6) presents an additional potential problem for operating in C corporation form, particularly for corporations organized in connection with the rollover of original QSBS sales proceeds under Section 1045. Section 1202(e)(6) provides that after a corporation has been in existence for at least two years, if the sum of the corporation's money and investment assets held for future working capital needs exceeds 50% of the corporation's assets (presumably the fair market value of all assets, including un-booked goodwill), the excess amount does not count towards satisfying the 80% Test.

Planning takeaways

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

Venture studios operating as LPs or LLCs taxed as partnerships should consider the benefits of structuring ownership of their start-ups through C corporations to take advantage of Section 1202's gain exclusion. In that regard, venture studios face the same considerations relevant to all founders and investors considering the potential benefits of Section 1202.

Operating the venture studio itself as a C corporation may work from the standpoint of satisfying Section 1202's eligibility requirements, but as discussed above, there are potential tax issues that must be carefully considered.

One potential use for a C corporation venture studio might be in connection with reinvesting original QSBS proceeds in replacement QSBS under Section 1045. A stockholder selling QSBS would form a corporation for the purpose of starting a venture studio. Presumably, the corporation would undertake to satisfy the "active conduct" requirement from and after the issuance of replacement QSBS by first investigating and then commencing the creation or acquisition of start-ups – activities which closely fit those of the typical venture studio.

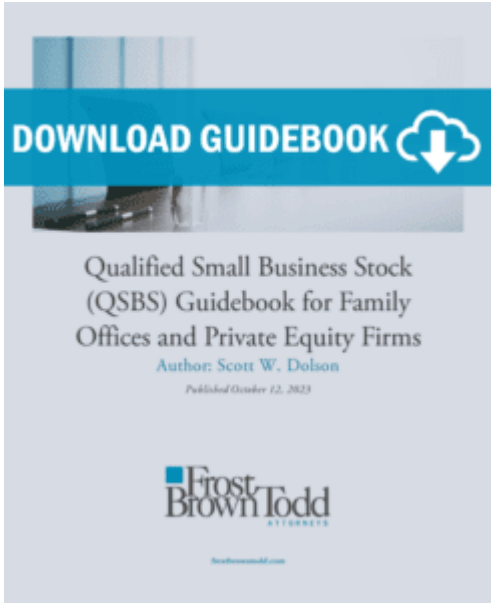
Closing Remarks

Despite the potential for extraordinary tax savings, many experienced tax advisors are not familiar with QSBS planning. Venture capitalists, founders and investors who want to learn more about Sections 1202 and 1045 planning opportunities are directed to several articles on the Frost Brown Todd website, or reach out to the author, Scott Dolson, of Frost Brown Todd's Tax Practice.

More QSBS Resources

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

FBT Gibbons



- 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?
- 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

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

FBT Gibbons

- 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

Contact Scott Dolson at sdolson@fbtlaw.com or 502.568.0203 if you want to discuss QSBS issues by telephone or video conference.

---

[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. Each taxpayer can exclude up to at least $10 million of gain upon the sale of a particular C corporation's QSBS, provided all of Section 1202's eligibility requirement have been satisfied. Many, but not all, states follow the federal income tax treatment of QSBS.

[2] Section 1202 refers to an entity taxed as a partnership as a "flow-thru" entity and permits the entity to acquire and sell QSBS and take advantage of Section 1202's gain exclusion and reinvestment of QSBS proceeds under Section 1045.

[3] See Treasury Regulation Section 1.1045-1(d)(1), which provides that a partner's Section 1045 nonrecognition limitation is his "smallest percentage interest in partnership capital" determined at the time of the acquisition of the QSBS. This limit on the availability of Section 1045's benefit to interests in "capital" versus profits interests issued in exchange for services appears to be inconsistent with Section 1202's reference to the sharing of Section 1202's gain exclusion based on each partner's "interest."

[4] See Proposed Regulation 1.355-3; Revenue Ruling 92-17, 1992-1 CB 142; Revenue Ruling 2002-49, 2002-2 CB 288; Revenue Ruling 2007-42, 2007-2 CB 44. There are also arguments based on Section 702(b) that any partnership interest should impute "active conduct" of the partnership's activities to its partners.

[5] One of the reasons that buyers like asset purchases is the tax basis step-up of the acquired assets triggered by the taxable purchase. When stock of a corporation is purchased, the inside basis of the corporation's assets are unaffected unless an election is made to treat the acquisition as a deemed asset purchase, which won't work for the target corporation's stockholders seeking to

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.

treat the transaction as a taxable sale for Section 1202 purposes.

[6] Whether the distribution would qualify as a partial liquidation depends on whether the determination is made that the distribution stems from a corporate contraction. Sections 302(e)(2) and (3) provide that a distribution qualifies as a partial liquidation if the distribution consists of sales proceeds of a qualified trade or business and the corporation is actively engaged in another qualified trade or business immediately after the distribution. Section 302(e)(3) defines a qualified trade or business as one that (1) was actively conducted throughout the five-year period preceding the redemption221 and (2) was not acquired by the distributing corporation within that period in a transaction in which gain or loss was recognized in whole or in part. The relative sizes of the distributed and retained businesses are irrelevant.

[7] See Sections 531 through 537 and the Frost Brown Todd article, "*How Corporations may run afoul of the Accumulated Earnings Tax – A Section 1202 Planning Brief*." The personal holding company surtax of Sections 541 through 547 is another surtax that is potentially applicable when owning a business through a C corporation but unlikely to apply to the ownership and eventual sale of an operating company that qualifies for active conduct treatment under Section 1202.

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.

2026 FBT Gibbons LLP. All rights reserved. ADVERTISING MATERIAL.