# Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations

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**Categories:**

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**Authors:**

Scott W. Dolson

Section 1202 provides for a substantial exclusion of gain from federal income taxes if a stockholder transfers qualified small business stock (QSBS) in a taxable sale or exchange.[1] But this gain exclusion is available only if each of Section 1202's eligibility requirements are satisfied. A useful rule of thumb is that Section 1202's gain exclusion is only applicable if a stockholder is reporting capital gain resulting from a taxable sale or exchange of QSBS.[2]

This article focuses on Section 1202's critical "sale or exchange" requirement. In addition to transfers of QSBS that qualify as a taxable sale, redemptions of QSBS and partial and complete corporate liquidations can also trigger a stockholder's right to claim Section 1202's gain exclusion. The tax rules governing these various transfers must be understood in order to ensure that stockholders benefit from the best possible tax treatment in liquidity events.

*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 since 2017 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 Section 1202's eligibility requirements and Section 1202 and Section 1045 tax planning can be found on our* ***QSBS & Tax Planning Services page***.

## Key takeaways from this article include:

- Section 1202's gain exclusion is available only when a taxpayer is reporting capital gain in connection with a taxable sale or exchange of QSBS.
- A distribution treated as a dividend does not qualify for Section 1202's gain exclusion.


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- Any portion of a payment for QSBS that is not treated as capital gain from the sale of stock (e.g., a portion of the payment is treated as compensation), cannot be excluded from taxable gain under Section 1202.
- Redemption consideration can be treated as taxable gain eligible for Section 1202's gain exclusion or a dividend excluded from the benefits of Section 1202.
- If the purchaser of QSBS is a corporation, and the selling stockholder(s) and purchasing corporation are related parties, Section 304 may require the payment to be treated as a dividend that cannot be excluded from taxable gain under Section 1202.[3]
- Stockholders may be eligible to claim Section 1202's gain exclusion in connection with corporate distributions (even pro-rata distributions) that qualify as a "partial liquidation" of the corporation's assets.
- Stockholders who have held QSBS for more than five years are generally eligible to claim Section 1202's gain exclusion in connection with the complete liquidation of the issuing corporation.

## Exploring the "sale or exchange" requirement.

The right to claim Section 1202's gain exclusion is generally triggered when there is taxable gain arising out of a "sale or exchange" of QSBS. A good rule of thumb is that Section 1202's gain exclusion applies when a sale or exchange results in the reporting of gain on a stockholder's Schedule D (Capital Gains and Losses).[4] Not all amounts paid with respect to QSBS qualify for Section 1202's gain exclusion. A payment treated as a dividend does not qualify and any portion of the consideration that is characterized as compensation income does not qualify.

- ***Amounts treated as dividends are not eligible for Section 1202's gain exclusion***. Dividends often qualify for taxation at capital gains rates but are not eligible for Section 1202's gain exclusion. Section 316 defines a "dividend" as a distribution of property made by a corporation to a stockholder out of the


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corporation's earnings and profits. If a corporation does not have earnings and profits, a distribution is first treated as a return of a stockholder capital (tax basis in the stock) and then is eligible for sale treatment, including Section 1202's gain exclusion. The tax treatment of distributions in redemption of QSBS and the tax treatment of partial liquidations (which may or may not involve the redemption of stock) are governed by Section 302. See the section ***Stock redemptions, partial corporate liquidations and complete corporate liquidations*** below.

- ***The potential for compensation (W-2 or Form 1099 income) treatment in connection with a secondary sale or redemption of QSBS***. If a stockholder-employee sells QSBS in a secondary sale, any premium over fair market value paid for the QSBS could be characterized a compensation, and as such would not be eligible for Section 1202's gain exclusion.[5] The same treatment would apply if a corporation redeemed common stock at a premium, which often is the case when common stock is sold or redeemed in conjunction with a preferred stock round.[6] A position commonly taken by corporations is that any price above the then-current Section 409A valuation should be treated as compensation if paid to current employees (and sometimes to former employees). There are tax authorities supporting the conclusion that amounts paid directly or indirectly to employees in excess of fair market value should be characterized as compensation.[7] But there are no tax authorities directly supporting the position that a corporation's Section 409A valuation establishes the fair market value of employee-owned stock sold in a secondary sale or redemption. The tax authority that would generally govern is Revenue Ruling 59-60, which states that fair market value is, *"The amount at which the property would change hands between a willing buyer and willing seller, when the former is not under any compulsion to buy, and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."*[8] As a practical matter, if a corporation determines the split between capital gain and ordinary income and issues a W-2 (or Form 1099-


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NEC) treating a portion of the payment as compensation, it will be difficult (but not impossible) for an employee to challenge the corporation's reporting.

- ***Taxable "boot" in nonrecognition exchanges***. Transfers of QSBS that are governed by nonrecognition provisions such as Section 721 (transfers to a partnership), Section 351 (nonrecognition exchanges of property, including QSBS for stock) and Section 368 (tax-free reorganizations) may, in applicable part, satisfy the sale or exchange requirement if the consideration includes money or other property (boot). Where boot is included in an otherwise tax-free transaction, a further determination must be made whether the payment has the effect of a dividend distribution and whether the target corporation has earnings and profits (E&P) to support dividend treatment.[9]
- ***Some stockholders may prefer a fully taxable sale over a nontaxable exchange***. A stockholder who is eligible to claim Section 1202's gain exclusion may prefer a taxable sale or exchange over a nonrecognition exchange. This turns the typical planning associated with equity rollovers on its head. A number of factors go into the planning associated with a current sale or nontaxable rollover, including (i) whether the stockholder's gain will be fully sheltered by Section 1202 gain exclusion, (ii) whether the stockholder has achieved Section 1202's greater than five-year holding period requirement, (iii) whether the stockholder's state of residence follows the federal treatment of QSBS (e.g., California does not), (iv) the stockholder's level of concern over the possible future amendment or repeal of Section 1202, (v) whether the stockholder wants to reinvest original QSBS sales proceeds under Section 1045, and (vi) whether the form of an equity rollover is structured to keep alive the future ability of target stockholders to recognize Section 1202's gain exclusion with respect to acquiror equity received in the rollover.
- ***Dealing with equity rollovers when target stockholders hold QSBS***. Sale transactions often include an equity "rollover" component. A typical transaction might involve a "rollover" of


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20% of the target corporation's equity into purchaser equity. A rollover transaction is usually structured to avoid immediate sale treatment. But when QSBS is involved, consideration should be given to whether it is better to trigger immediate gain, allowing for the claiming of Section 1202's gain exclusion. If a transfer is structured to fail the requirements for a Section 351 nonrecognition exchange or Section 368 tax-free reorganization, the receipt of purchaser stock will trigger taxable gain allowing for the claiming of Section 1202's gain exclusion.[10] Structuring a failed contribution of QSBS to a partnership is more difficult and requires careful attention. Selling 100% of a stockholder's QSBS followed by a reinvestment in buyer equity is a commonly seen strategy when the rollover is structured to allow for claiming of Section 1202's gain exclusion. This approach may be particularly attractive if target stockholders must roll QSBS into a buyer limited partnership or LLC (in either case taxed as a partnership), since Section 1202's gain exclusion won't be available when the LP/LLC equity is later sold. If target stockholders don't have the required five year+ holding period for their QSBS, then the best strategy is often to structure the rollover as a Section 351 nonrecognition exchange or Section 368 tax-free reorganization, either of which allows a continuation of the original QSBS holding period.[11]

- ***Dealing with deferred payments (navigating Section 453's installment sale treatment)***. Many stock sale transactions involve deferred payments, including installments of purchase consideration, indemnification and other escrows, and earn-out arrangements. Typically, stockholders benefit from deferring gain using the installment method of reporting gain under Section 453. However, it may be advantageous for a stockholder selling QSBS to elect out of installment sale treatment, take into income in the year of sale both closing payments and the fair market value of the deferred payments, and offset the gain with Section 1202's gain exclusion. Obviously, this approach won't work for everybody since a stockholder's gain amount may exceed Section 1202's cap or the stockholder may reside in California or another state that


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doesn't follow the federal treatment of QSBS.

- ***Navigating Section 83 (unvested equity)***. QSBS that has not vested for purposes of Section 83 (i.e., the stock is subject to substantial risk of forfeiture) when sold or exchanged triggers compensation income not eligible to be excluded under Section 1202. This unfavorable treatment highlights the importance of careful planning when making grants of QSBS to employees and decision-making with respect to Section 83(b) elections.
- ***Taxable sales among related parties***. An issue that has arisen from time to time is whether there are any limitations on a stockholder's ability to trigger a taxable sale of QSBS through a transfer treated as a taxable sale, redemption or liquidation. Examples of this include a sale of stock to an affiliated party (e.g., to a family member or affiliated family entity) or a redemption by a controlled corporation. Outside of the situation where a stockholder can claim a Section 1202 gain exclusion when transferring stock, most provisions of the Internal Revenue Code are understandably focused on limiting the ability to trigger loss, not gain. There are no statutes dealing specifically with the sale of stock to an affiliated party, other than Section 304 (which is discussed below). In situations where Section 304 might not apply, the IRS could argue that Section 1202(k)'s reference to regulations dealing with "shell" corporations could encompass a transaction involving the forming an corporation to acquire QSBS from a related party, triggering the gain exclusion for the selling stockholder and positioning the buying corporation to claim that its stock qualifies as QSBS based on Section 1202's "parent-subsidiary" look-thru rules. Where the sale doesn't involve the purchase of stock by a related corporation, there doesn't appear to be any specific limitation in tax authorities on triggering the gain through a secondary sale or redemption. The IRS could argue that there was no business purpose for triggering a taxable exchange beyond the tax benefits of claiming Section 1202's gain exclusion.[12] The problem the IRS might have in making this argument is that a desire for


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triggering a liquidity event and the desire of a buyer to acquire stock and the seller to sell stock are significant non-tax avoidance reasons that regularly drive transactions, regardless of whether QSBS is involved. That said, there could be facts and circumstances associated with the transaction (e.g., the purchase consideration structure) that would provide better support for an IRS argument that the liquidity transaction was merely a vehicle for achieving tax avoidance.

- ***Sale transactions involving QSBS require particular attention in order to maximize the target stockholders' Section 1202 gain exclusion***. Given that title terms of transactions and the circumstances of target stockholders differ dramatically, it isn't possible to address all of the possible material issues that should be considered if QSBS is involved. Suffice it to say that transaction planning should include careful consideration of the current and/or future availability of Section 1202's gain exclusion.

## Stock redemptions, partial corporate liquidations and complete corporate liquidations.

In addition to sales of QSBS to third parties, transfers that can trigger the right to claim Section 1202's gain exclusion include redemptions, partial liquidations and complete liquidations. Those transactions are discussed below.

## Redemption consideration may be eligible for Section 1202's gain exclusion or an ineligible dividend distribution.

A "redemption" of stock occurs when an issuing corporation purchases shares of its own stock.[13] Distributions in redemption of stock under Section 302, in connection with a partial liquidation under Section 302(b)(4), and in connection with a complete liquidation of a corporation under Section 331 can be treated as payments in exchange for QSBS, thereby triggering the right to claim Section 1202's gain exclusion. The portion of any sale or exchange consideration treated as a dividend is generally taxed at


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capital gains rates but is not eligible for Section 1202's gain exclusion.[14]

Section 302 governs whether the redemption consideration is treated as a dividend or as a payment in exchange for the redeemed stock. Under Section 302, a redemption is treated as a distribution in part or full payment for QSBS if:

- ***Under Section 302(b)(1), the distribution is not essentially equivalent to a dividend***. The US Supreme Court in *United States v. Davis* applied Section 302(b)(1) to a redemption of preferred stock from a stockholder who actually owned 25% of the common stock and whose spouse and children owned the other 75%. A majority of the Court held as follows regarding dividend equivalency: (1) constructive ownership rules necessarily apply (See Section 318); (2) redemptions from a sole stockholder (including constructively) are always fatal; (3) business purpose is irrelevant; and (4) a qualifying redemption must result in a "meaningful reduction" of the stockholder's proportionate interest in the corporation.[15]

  Whether there has been a "meaningful reduction" of a stockholder's proportionate interest in the corporation is the key test for determining whether a distribution qualifies for dividend or exchange treatment. In *Himmel v. Commissioner*, which is referred to as the leading authority for the identification of the specific rights which arise from owning stock in a corporation that are relevant in testing a redemption for dividend equivalence, the Second Circuit stated that "*ownership of stock can involve three important rights: (1) to vote and thereby exercise control, (2) to participate in current earnings and accumulated surplus, and (3) to share in net assets on liquidation.*"[16] The IRS has taken the position that a change in a stockholder's voting interest is a "key factor" in determining the applicability of Section 302(b)(1).[17] The Sixth and Eighth Circuit Court of Appeals have held that a loss of supermajority control warrants sale treatment.[18] In contrast, the IRS has declined to allow for sale treatment where the redeemed stockholder continued to own more than half of the voting stock.[19] But


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the IRS has ruled in favor of sale treatment once a stockholder's vote drops to 50% and his ability to control the corporation is adversely affected.[20] In most cases, a stockholder whose pre-redemption percentage interest is below 50% will be accorded sale (exchange) treatment even with a small reduction in percentage interest, but tax authorities addressing the treatment under Section 302(b)(1) of these redemptions are not entirely consistent.[21] A stockholder who intends to rely on Section 302(b)(1) to support sale (exchange) treatment should have the surrounding facts carefully reviewed by competent tax advisors. Perhaps the best advice is to rely, if possible, on Section 302(b)(2)'s mechanical test or Section 302(b)(3)'s complete redemption safe harbor rather than relying on the position that the redemption payment was not substantially equivalent to a dividend.

- ***Under Section 302(b)(2), the distribution is substantially disproportionate with respect to the stockholder***. A redemption will receive exchange treatment if three conditions are satisfied – (1) the stockholder's percentage ownership of the outstanding voting stock (including all classes that carry voting rights) is reduced immediately after the redemption to less than 80% of his percentage interest in such stock immediately before the redemption, (2) the stockholder's percentage ownership of the outstanding common stock (both voting and nonvoting) immediately after the redemption is reduced to less than 80% of such percentage ownership immediately before the redemption, and (3) the stockholder owns, immediately after the redemption, less than 50% of the total combined voting power of all classes of stock entitled to vote. The attribution rules of Section 318 apply and cannot be waived. This test is applied on a stockholder-by-stockholder basis, but if the participation of several stockholders in a redemption transaction reduces total outstanding stock after the exchange, it may be necessary to redeem more shares from a given stockholder than if he alone were redeemed. This "safe


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harbor" test provides a much greater degree of certainty than reliance on satisfying the "meaningful reduction" standard in Section 302(b)(1).

- ***Under Section 302(b)(3), the redemption is in complete redemption of all stock held by a stockholder, after applying the family attribution rules of Section 318 (subject to waiver of those family attribution rules under certain circumstances)***. A stockholder who has all of his shares redeemed is assured of exchange treatment if no related parties continue to hold shares. The attribution rules of Section 318 apply, subject to the specific rules in Section 302 regarding how Section 318's attribution rules are modified for purposes of Section 302.

## Redemptions through the use of related corporations can run afoul of Section 304 and result in dividend treatment (with no Section 1202 gain exclusion).

A question that occasionally comes up during the planning process is whether it possible to trigger Section 1202's gain exclusion by selling QSBS to family members or their affiliated entities. One concern being addressed by triggering a taxable sale or exchange is the issue of whether Congress or the IRS will take future steps to eliminate or reduce the benefits of claiming Section 1202's gain exclusion. A stumbling block associated with having family members purchase stock is that when QSBS is sold within the family, the stock will not be QSBS in the hands of the purchaser. A suggested workaround for this problem has been to form a corporation to purchase the related party's stock with the hope that the newco corporation could issue QSBS and rely on Section 1202's parent-subsidiary look-thru rules to meet Section 1202's eligibility requirements. The problem with this plan is that it runs afoul of Section 304, which provides that if two corporation's have related ownership, the purchase of stock of Corporation A by Corporation B will result in dividend treatment for the consideration paid to the stockholders of Corporation A. Related party


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transactions should be carefully vetted for the potential application of Section 304.

## Any portion of the redemption consideration representing payment for declared dividends won't qualify as "gain" for purposes of Section 1202.

If there is a redemption of QSBS preferred stock, any portion of the redemption proceeds representing payment for declared dividends would not be included in the redemption consideration eligible for claiming Section 1202's gain exclusion against.[22]

## Tax treatment of distributions made in connection with a partial liquidation.

A basic principle of Section 1202 planning is to avoid engaging in multiple activities within a single QSBS issuer if there is a foreseeable possibility that a purchaser might be interested in acquiring only one activity. If this occurs, the distribution of unwanted assets out of a corporation prior to a stock sale will trigger a deemed sale of those assets subject to the 21% corporate income tax. Also, corporate-level sale treatment along with the corporate income tax would apply to an actual sale of assets by the corporation. The subsequent distribution by the corporation of net sales proceeds generally results in a second level of tax at the stockholder level. But if the sale of assets by a corporation and distribution of proceeds qualifies as a "partial liquidation" under Section 302(b)(4), the distribution of sales proceeds can qualify as a redemption payment that can be offset by Section 1202's gain exclusion. Likewise, a distribution of unwanted assets in conjunction with a stock sale can potentially qualify as a partial liquidation under Section 302(b)(4). A partial liquidation generally occurs when a corporation engaged in multiple activities adopts a plan of partial liquidation, sells the assets of associated with one of the corporation's activities, and distributes the net proceeds within the taxable year in which the plan was adopted or the succeeding taxable year.[23]


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Section 302(e)(1) provides that a distribution is to be treated as in partial liquidation if *"(i) the distribution is not essentially equivalent to a dividend (determined at the corporate level rather than the shareholder level), and (ii) the distribution is pursuant to a plan that occurs within the taxable year in with the plan is adopted or within the succeeding taxable year*." Section 302(e)(2) provides that a distribution will be treated as meeting the requirements of Section 302(e)(1) if (i) the distribution is attributable to a corporation ceasing to conduct, or consists of the assets, of a qualified trade or business, and (ii) immediately after the distribution, the corporation continues to be actively engaged in the conduct of a qualified trade or business. Section 302(e)(3) provides that the term "qualified trade or business" means a business which (A) was actively conducted throughout the 5-year period on the date of the redemption, and (B) was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

In order for a distribution to qualify as a partial liquidating distribution rather than a dividend, (i) the distribution must, as provided in Section 302(e)(1)(B), be attributable to a plan, (ii) must be attributable to a corporate contraction, or to fit within the Section 302(e)(2) safe harbor, must be attributable to the sale of an "activity," with the corporation continuing to operate another "activity" post-sale, and (iii) the proceeds attributable to the partial liquidation must be distributed by the corporation to its stockholders either in the year the plan of partial liquidation is adopted or in the subsequent year. A corporation should file an IRS Form 966 in connection with the adoption of a plan of partial liquidation.

Sections 302(b)(4) and 302(e)(1) provide that in order to qualify as a partial liquidation rather than a dividend, a distribution must be a redemption and must result from a contraction of the business. In spite of the "redemption" requirement, the Revenue Ruling 90-13 provides that the actual surrender of stock is unnecessary for a pro rata distribution in partial liquidation to qualify as a redemption under Sections 302(b)(4) and 302(e).[24] The Revenue Ruling 79-184 provides that a distribution arising out of sale of a subsidiary's stock is not eligible for partial liquidation treatment.[25] The


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workaround for this technical issue would be a deemed liquidation of the subsidiary (e.g., conversion to single-member LLC treated as a disregarded entity for federal tax purposes) governed by Sections 332(a) and 381(a), undertaken before the sale of the subsidiary's equity. Also, based on the language of Revenue Ruling 79-184, a sale of a subsidiary's assets followed by the liquidation of the subsidiary and distribution of the liquidation proceeds from the parent corporation in partial liquidation of the parent corporation should also work.

Section 346(b) was the predecessor to the partial liquidation provision now found at Section 302(b)(4). Treasury Regulation Section 1.346-1 and Proposed Regulation Section 1.346-1 provide that the determination of whether the assets sold constitute an "activity" for purposes of the partial liquidation activity safe harbor (i.e., that the sale of assets rises to the level of an "activity" and therefore is a sufficient corporate contraction to qualify for exchange treatment when the proceeds are distributed by the corporation) has the meaning provided in Treasury Regulation Section 1.355-3(b)(2). Section 355 and its regulations address the concept of "activity" in connection with corporate spin-offs. Section 355 provides generally that the determination of whether the assets involved constitute an "activity" is made from all of the facts and circumstances. The Section 355 regulations refer to the requirement that the activity includes active and substantial management and operational functions, the upshot being that the case would need to be made that the assets sold (i.e., the "activity") included management and operational functions. Section 355's regulations and proposed regulations, along with other tax authorities interpreting Section 355, include a significant body of materials providing guidance regarding what would be considered an activity that should translate into guidance regarding whether a sale of assets qualifies as a partial liquidation for purposes of Section 302(e)(1).[26]

## Treatment of distributions made in connection with a complete liquidation.


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Section 331(a) provides that *"amounts received by a stockholder in a distribution in complete liquidation of a corporation shall be treated as full payment in exchange for the stock."* Section 331(b) further provides that Section 301, which specifies possible dividend treatment for corporate distributions, does not apply to a distribution of property in complete liquidation of a corporation. So even where the distributing corporation has earnings and profits (E&P), the final distribution from the corporation will not be characterized as being sourced from E&P. A stockholder who receives distributions in exchange for his QSBS in connection with a complete liquidation is eligible to claim Section 1202's gain exclusion.[27]

Many sale transactions are structured as asset sales in spite of the fact that a stock sale is optimal when a corporation's stockholders are holding QSBS. An asset sale is often preferred by buyers because it allows for a step-up cost basis in the purchased assets, and can be structured to avoid stepping into shoes of the historic target company with respect to known or contingent liabilities. In other cases, the buyer might want to acquire only part of the target corporation's assets. Whatever the reason, the target corporation will have a corporate level tax on any gain triggered by the asset sale. After the asset sale (or sale of subsidiary stock), the target corporation may continue its business activities or undertake a complete liquidation "*when the corporation ceases to be a going concern and its activities are merely for the purposes of winding up its affair, paying its debts, and distributing any remaining balance to its stockholders.*"[28]

Distributions made without the adoption of a formal plan of dissolution can still be treated as payments in exchange for a stockholder's stock, allowing for the claiming of Section 1202's gain exclusion. But in particular where the dissolution will occur over time and includes multiple distributions, the corporation's board should adopt a plan of complete dissolution and file IRS Form 966 prior to making the first liquidating distribution.[29] One method often used to complete a corporation's dissolution is to convert the corporation into a partnership or disregarded entity for tax purposes, which can be accomplished several ways depending on the state law status of the corporation: by converting the


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corporation into a LLC under state law, via a check-the-box election on IRS Form 8832, or through merger of the corporation into the LLC, with the LLC as the surviving entity in the merger.

A stockholder who receives an installment obligation (which can include rights to future payments in the form of escrowed funds, deferred purchase consideration and earn-outs) that meets the requirements of Section 453(h) can defer the recognition of gain until receipt of the installment payments. A stockholder should consider electing out of installment sale treatment of a distributed installment obligation if the stockholder has sufficient Section 1202 gain exclusion available to offset the gain accelerated as a result of the election.[30] This strategy can lock in the gain exclusion and avoid the potential impact of future changes to Section 1202 or the impact of tax authorities affecting the section.

Any portion of distribution in a partial or complete liquidation attributable to declared dividends would not be treated as exchange proceeds eligible for claiming for Section 1202's gain exclusion.[31]

**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.


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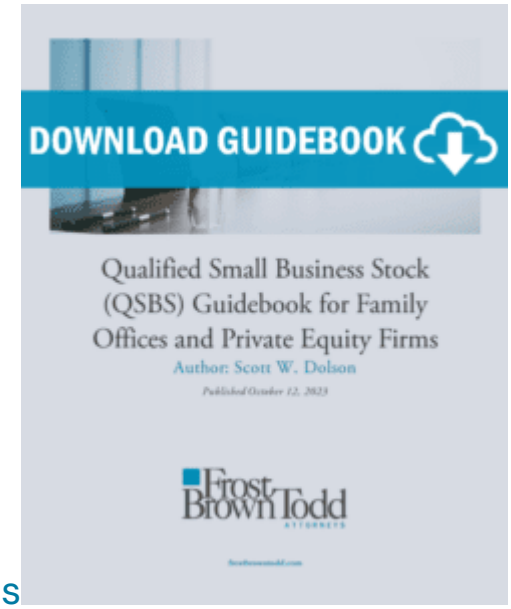


## More QSBS Resources

- 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
- 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
- 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


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- 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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[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. This article addresses federal income tax issues. The treatment of QSBS at the state and local level differs from jurisdiction to jurisdiction and is not addressed in this article but should certainly be taken into consideration in the planning process.

[2] Section 1202(a) provides "*in the case of a taxpayer other than a corporation, gross income shall not include 50 percent [increased to 100% by Section 1202(a)(4)] of any gain from the sale or exchange of qualified small business stock held for more than 5 years*." Section 1202(b)(2) provides that "*the term 'eligible gain' means any gain from the sale or exchange of qualified small business stock held for more than 5 years*."

[3] A commonly seen acquisition structure is to organize an acquiring C corporation to issue what is assumed to be QSBS, and thereafter purchase 100% of the stock of a target qualified small business.

[4] A direct sale of QSBS by a taxpayer will be reported on Form 8949 (Sales and Other Dispositions of Capital Assets) or pass-through to the taxpayer on a Schedule K-1 if the QSBS was sold by a partnership or S corporation.

[5] There are few useful tax authorities addressing this issue. See Technical Advice Memorandum (TAM) 83-37-012 (May 25, 1983); *Azar Nut Co. v. Commissioner*, 94 T.C. 455 (1990), *aff'd* 931 F.2d 314 (5th Cir. 1991); Revenue Ruling 58-614, 1958-2 CB 920.

[6] The price for the common stock is often the price set forth a contemporaneous issuance of preferred stock or some discount reflecting the different rights of the preferred and common stock.

[7] See TAM 83-37-012 and *Azar Nut Co.* In spite of the limitations associated with 409A valuations, corporations routinely use the


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409A value when determining what portion, if any, of the consideration paid to selling of preferred stock should be treated as compensation. Tax articles written by tax professionals who work regularly with Silicon Valley companies merely note this fact without challenge. See *Tax Issues Related to Startup Secondary Sales* authored by Marshall Mort, Hans Andersson, and Shawn Lampron, attorneys at Fenwick & West LLP and *Are the Proceeds from a Secondary Sale Taxed as Compensation or Capital Gains?* authored by Christopher M. DeMayo, partner at Withum.

[8] Revenue Ruling 59-60, 1959-1 CB 237.

[9]See Sections 301(c), 316(c) and 356(a). If the target corporation doesn't have E&P, then the boot would be return of capital to the extent of tax basis and then "gain" against which Section 1202's gain exclusion could be claimed.

[10] Under Section 1202(h)(4), if QSBS is exchanged for stock in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization, Section 1202's gain exclusion can be claimed in connection with the sale of the replacement stock. If the corporation issuing the replacement QSBS failed to meet Section 1202's "$50 million test" at the time of issuance, the amount of Section 1202 gain exclusion will be limited by Section 1202(h)(4)(B).

[11] See Section 1202(h)(4). The eventual results differ if the stock received in the exchange is QSBS or "quasi-QSBS." Section 1202(h)(4)(B) provides for a limited Section 1202 gain exclusion when the replacement QSBS is eventually sold if the issuing corporation did not qualify as an issuer of QSBS at the time of the exchange of original QSBS for replacement QSBS.

[12] A stockholder might want to trigger a taxable transfer for the purpose of claiming Section 1202's gain exclusion because of a fear that Section 1202 might be amended or revoked.

[13] Section 317(b) provides that "*stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock*."


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[14] Treasury Regulation Section 1.316-1(c) provides as follows: "*the term 'dividend' includes any distribution of property to shareholders to the extent made out of accumulated or current earnings and profits. See, however, section 331 (relating to distributions in complete or partial liquidation), section 301(e) (relating to distributions by personal service corporations), section 302(b) (relating to redemptions treated as amounts received from the sale or exchange of stock), and section 303 (relating to distributions in redemption of stock to pay death taxes).*"

[15] *United States v. Davis*, 397 US 301 (1970).

[16] *Himmel v. Commissioner*, 338 F.2d 815 (2d Cir. 1964).

[17] See Revenue Ruling 85-106, 1985-2 CB 116. In CCA 200409001, the Chief Counsel's Office advised that the right of control is a key right in determining if a redemption substantially reduces a stockholder's interest in a corporation.

[18] *Patterson Trust v. United States*, 729 F.2d 1089 (6th Cir. 1984) and *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973).

[19] Revenue Ruling 77-218, 1977-1 CB 81 (dividend treatment where reduction was from 60% to 55%).

[20] Revenue Ruling 75-502, 1975-2 CB 111 (exchange treatment where reduction was from 57% to 50%).

[21] In Revenue Ruling 84-111, 1984-2 CB 90 and Revenue Ruling 76-364, 1976-2 CB 91, the IRS ruled for sale treatment in voting reductions from 29% to 23% and 27% to 22% that were accompanied by loss of concerted control. Where there is no possibility of control by a minority stockholder, even a small vote reduction generally results in sale treatment. See Revenue Ruling 75-512, 1975-2 CB 112 (drop from 27% to 22% was not a dividend where stockholder took no part in management); Revenue Ruling 56-183, 1956-1 161 (reduction in group's ownership of common stock from 11% to 9% not equivalent to a dividend).

[22] See Private Letter Ruling 91110760 (holding 8) (12/21/90); Revenue Ruling 69-130, 1969-1 CB 93; and Revenue Ruling 69-131, 1969-1 CB 94.


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[23] See Treasury Regulation Section 1.346-1(a)(2).

[24] Revenue Ruling 1990-1 CB 65.

[25] Revenue Ruling 79-184, 1979-143. An actual redemption of stock may make sense if a stockholder intends to take advantage of Section 1202's 10X gain exclusion cap. There are no tax authorities providing actionable guidance on this issue.

[26] A corporation should be engaged in two activities if it operates a software development and licensing business and manufactures widgets. If a corporation has multiple store locations, it is possible that each store could qualify as separate activities. Finally, the marketing and manufacturing divisions of the sale business could potentially qualify as separate activities.

[27] Subject, of course, to satisfying all of Section 1202's eligibility requirements.

[28] Treasury Regulation Section 1.332-2(c).

[29] An example of a situation where there might be multiple distributions would be where the corporation sells its assets and the purchase agreement includes an up-front payment, escrows of purchase consideration and an earn-out. One strategy would be to keep the corporation "alive" while the payments play out rather than triggering a distribution of both of the up-front cash and the value of the contract rights to the deferred payments by completing the liquidation of the corporation (including by converting the corporation to an LLC taxed as a partnership or disregarded entity).

[30] This decision will depend on a stockholder's personal facts and circumstances, including the amount of available Section 1202 gain exclusion, taking into account the applicable gain exclusion caps, and the stockholder's state of residence (i.e., whether the state follow the federal treatment of QSBS or like California, doesn't recognize Section 1202).

[31] See footnote 21.

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