Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer

Jan 29, 2025

Categories:

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

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Section 1202 provides a gain exclusion when a stockholder sells qualified small business stock (QSBS), assuming all eligibility requirements are satisfied.[1] Legislative history states that Section 1202 was designed to provide "*targeted relief for investors who risk their funds in new ventures [and] small businesses*"[2] and the gain exclusion was intended to "*encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing.*"[3]

Section 1045 was enacted as a further incentive to encourage investment in the stock of start-ups and small businesses. Section 1045 provides for a deferral of gain arising out of a sale of QSBS, if proceeds are rolled over into replacement QSBS. Section 1045 is a useful tool for stockholders that either haven't met Section 1202's five+-year holding period requirement when their original QSBS is sold, or where their aggregate gain exceeds their Section 1202's gain exclusion cap.

Section 1045 is an attractive tax benefit, but finding suitable replacement QSBS has proven to be an ongoing challenge for selling stockholders. This article explores efforts made by stockholders, professional advisors and promoters to find or develop suitable replacement QSBS opportunities, and the tax and business issues associated with the results of those efforts.

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 favorable 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****.*

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Section 1202 basics

Previous articles have describe the generous tax benefits associated with Section 1202's gain exclusion and how the statute works. See the QSBS library.

Section 1045 basics

Section 1045 permits stockholders to roll over (defer) gain from the sale of an original QSBS investment if the stockholder acquires replacement QSBS within 60 days after closing on the sale of the original QSBS.[4] As mentioned above, Section 1045 is a useful provision for a stockholder who either haven't satisfied Section 1202's five+-year holding period requirement when the original QSBS is sold, or where the stockholder's aggregate gain on the sale of the original QSBS exceeds Section 1202's gain exclusion cap. In addition to deferring gain on the sale of the original QSBS, Section 1045 provides that the holding period for the original QSBS is tacked onto the holding period for the replacement QSBS, which often puts stockholders in a good position to satisfy Section 1202's holding period requirement when the replacement QSBS is sold or exchanged in a taxable transaction.[5]

The election to roll over proceeds under Section 1045 is available only if certain requirements are met: (i) the original stock being sold or exchanged must be QSBS; (ii) the replacement QSBS must be acquired during the 60-day period beginning on the date the original QSBS is sold,[6] (iii) the replacement stock must have been originally issued in exchange for money (there isn't a requirement that the funds used by the stockholder to purchase the replacement QSBS be used to the proceeds from the sale of the original QSBS); (iv) Section 1045 must be properly elected on the return reporting the sale of the original QSBS; (v) the holding period for the original QSBS must be greater than six months; (vi) the corporation issuing replacement QSBS must be a domestic (US) C corporation; and (vii) the corporation issuing replacement QSBS must meet Section 1202(c)(2)'s "active business requirement" for at least the first six months after issuance of the replacement QSBS.

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If a stockholder rolls over original QSBS proceeds into replacement QSBS and makes a Section 1045 election, the stockholder should be prepared to establish that: (i) the original stock investment was QSBS at the time of its taxable sale or exchange; and (ii) the requirements for a successful Section 1045 rollover were satisfied. If the stockholder not only rolls over original QSBS proceeds into replacement QSBS under Section 1045, but also later sells the replacement QSBS and claims Section 1202's gain exclusion, the stockholder should be prepared to establish that: (A) the original stock investment was QSBS at the time of its taxable sale or exchange; (B) the requirements for a successful Section 1045 rollover were satisfied; (C) the replacement stock was QSBS at the time of the taxable sale or exchange, and (D) the combined holding period for the original QSBS and replacement QSBS exceeded five years when the replacement QSBS was sold or exchanged

There are a number of interesting aspects to Section 1045. While most stockholders consider Section 1045 when they sell original QSBS before satisfying the five+-year holding period requirement, Section 1045 also permits a stockholder to claim a $10 million gain exclusion with respect to Corporation A's QSBS and then roll excess proceeds over into replacement QSBS. Section 1202's gain exclusion caps do not aggregate the gain claimed when original QSBS is sold with gain claimed when replacement QSBS is sold. Because of this, a taxpayer could sell original QSBS and reinvest proceeds in multiple replacement QSBS investments, each with a potential separate $10 million gain exclusion. Also, a stockholder might sell original QSBS with a four-year holding period, and then roll over $100 of the proceeds into founder common stock of a start-up, and that founder stock would start life with a four-year holding period. Also, Section 1045 only requires that the issuer of replacement QSBS meet Section 1202's "active business requirement" for a six-month period after issuance of replacement QSBS. After six months, the corporation issuing the replacement QSBS could elect S corporation status or begin to engage in significant non-qualified business or investment activities.

Three previous articles discussed in detail the workings of Section 1045 and the options available to stockholders selling their original

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QSBS: 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; and Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045.

The quest to find acceptable replacement QSBS

Most stockholders who are considering taking advantage of Section 1045 do so because they haven't satisfied the five+-year holding period requirement. A few stockholders take maximum advantage of Section 1202's gain exclusion and look to roll over excess proceeds above the applicable gain exclusion cap into replacement QSBS. Stockholders selling their original QSBS often don't have a ready solution to the problem of sourcing acceptable replacement QSBS. Stockholders are often understandably reluctant to recommit the gain from selling original QSBS proceeds into risky start-up investments. The challenge of finding acceptable replacement QSBS is also compounded by the short 60-day period for acquiring replacement QSBS. Because of these difficulties, some stockholders give up and surrender 23.8% of their gain to the federal government.[7] Other stockholders explore all of their options for rolling over proceeds into replacement QSBS. Several of these options and their associated tax and business risks and problems are discussed below:

Investing in replacement QSBS issued by unaffiliated early-stage companies

Investing in replacement QSBS issued by unaffiliated start-ups and early-stage companies should generally be a "safe" approach from a tax standpoint to solving the replacement QSBS problem, so long as the stockholder does the due diligence necessary to confirm that the corporation is eligible to issue QSBS. While this choice exposes the stockholder to the economic risks associated with investing in early-stage companies, the combination of the significant tax benefits associated with deferring gain under Section 1045 and potentially claiming Section 1202's gain exclusion should somewhat offset the investment risk. Most stockholders do not

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regularly take advantage of Section 1045, but there are serial venture investors who treat Section 1045 as a tool for rolling proceeds tax-free (or at least deferred) from a successful exit into multiple replacement QSBS investments.

One critical requirement of Section 1045 is that the rollover into replacement QSBS must be closed within 60 days after the sale of the original QSBS. This requirement is straightforward when 100% of the purchase consideration for the original QSBS is paid at closing, but many stock sale transactions involve deferred payments, including installments of purchase consideration, post-closing purchase price adjustments, earn-outs and indemnity escrows, all of which generally fall within the scope of a Section 453 installment sale. One reading of Section 1045 suggests that even if 100% of the purchase consideration is paid in one installment three years after closing, a stockholder must roll over proceeds into replacement QSBS within 60 days after the initial closing in order to make a Section 1045 election. However, there are tax authorities supporting the argument that a separate 60-day period should be deemed to commence with the payment of each installment (e.g., within 60 days of each earn-out payment).[8]

Because it is critical that replacement stock qualifies as QSBS, investors should, if possible, obtain representations prior to investment that the issuing corporation has satisfied each applicable Section 1202 eligibility requirement. Investors should also attempt to obtain covenants that management will use commercially reasonable efforts to maintain the "qualified small business" (within the meaning of Section 1202(d)) status of the issuing corporation. Also, a covenant should be obtained from the issuing corporation that it will cooperate in providing factual information and documentation supporting the investor's return positions that the rollover QSBS met the corporation-level eligibility requirements. Of course, some issuers of replacement QSBS will not be willing provide any representations or assurances, and investors should consider the corporation's position on these issues when selecting an issuer of replacement QSBS.

If proceeds from the disposition of one QSBS investment are rolled over into multiple QSBS investments, a stockholder has the

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potential for vastly increasing the aggregate gain exclusion due to the fact that Sections 1045 and 1202 do not aggregate the sales proceeds of original QSBS and replacement QSBS for purposes of Section 1202's gain exclusion cap – an investment in the replacement QSBS of five corporations with proceeds from one original QSBS investment could increase the potential aggregate gain exclusion to at least $60 million. This approach should work even if the investor claimed a $10 million gain exclusion with respect to the original QSBS, and then rolled over excess proceeds into the replacement QSBS. Also, by reinvesting original QSBS proceeds, the investor tacks the holding period for the original QSBS onto holding period of the replacement QSBS. Under Section 1045, an individual reinvesting even a small amount of original QSBS proceeds into replacement QSBS stock should commence ownership of the replacement QSBS with a tacked holding period.[9]

Self-created qualified business activities: engaging in start-up and research and development activities

Founders and early-stage employees seeking to roll over QSBS sales proceeds under Section 1045 often gravitate to organizing a new corporation that issues replacement QSBS and then commences start-up and/or research and development (R&D) activities that are a good fit with the organizer's background and skills. Sometimes stockholders reinvest proceeds the replacement QSBS of businesses operated or created by family members. Stockholders pursuing this path should have a clear understanding of how Sections 1045 and 1202 function, including the requirement that the rollover corporation must engage in the "active conduct of a trade or business" and that the reinvestment of proceeds in the issuer of replacement QSBS is both credible and bona-fide (see the discussion below).[10]

Readers may be familiar with the common understanding that approximately 90% of start-ups fail, and start-ups issuing replacement QSBS are no exception.[11] If a start-up fails after burning through all of its Section 1045 rollover proceeds, the contributing stockholders will walk away empty handed but perhaps

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unburdened by tax issues. But if the failed business retains significant assets, owners have several options – adopting a new business plan for the corporation, using the remaining cash to purchase investment assets, or adopting a plan of complete liquidation and distributing the remaining cash and business assets. [12] If the corporation's failure occurs after stockholders have achieved a five+-year holding period, the stockholders should be eligible to claim Section 1202's gain exclusion, assuming that all of Section 1202's eligibility requirements are met.[13] Stockholders bear the burden of proof if the IRS challenges either the Section 1045 rollover or the claiming of Section 1202's gain exclusion.

As discussed in past articles, one of Section 1202's key requirements is that the issuing corporation engage in the "active conduct" of qualified business activities. Section 1202(e)(2) provides that active conduct includes: *"(A) start-up activities described in section 195(c)(1)(A), (B) activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174, or (C) activities with respect to in-house research expenses described in section 41(b)(4)."* Start-up and R&D activities can qualify as "active conduct," but it is critical that management (whether that means the founding stockholder(s) or hired management) fully document the nature and extent of the corporation's start-up and/or R&D activities. Restrictive covenants and other commitments sometimes interfere with the founders engaging in actions that further the corporation's "active conduct," but the corporation's active conduct can be undertaken through hired employees – stockholders are not required to participate or contribute to the furtherance of those activities. Obviously, an exit through a subsequent sale of the replacement QSBS for more than the shareholder's rollover proceeds should substantially reduce the risk of an IRS challenge that the corporation issuing the replacement QSBS was not engaged in the active conduct of a trade or business. Documenting "active conduct" is particularly important if the corporation issuing replacement QSBS is unsuccessful and dissolves pursuant to a plan of complete liquidation after the stockholders reach the five+- year holding period for their QSBS, with the stockholders claiming Section 1202's gain exclusion. Two

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prior articles addressed the task of establishing active conduct through the undertaking of start-up and/or R&D activities.[14]

"Search fund" activities: finding and purchasing a qualified business

Some sellers of original QSBS use Section 1045 as a vehicle for acquiring the equity or assets of a business engaging in qualified activities. If the stars align, stockholders selling their original QSBS can organize an issuer of replacement QSBS and close on the acquisition of a target business within 60 days after the sale date for the original QSBS. But for many, closing on the acquisition of a target's business within the 60-day time frame ranges from challenging to impossible. Fortunately, Section 1202 appears to permit a stockholder to meet Section 1202's "active conduct" requirement by investing in the replacement QSBS of a corporation whose start-up activity includes searching for and acquiring a target business. Section 1202(e)(2)(A) provides that active conduct includes "*start-up activities described in section 195(c)(1)(A)*." Section 195(c)(1)(A) defines "*start-up expenditures*" to include amounts paid or incurred in connection with—"*(i) investigating the creation or acquisition of an active trade or business, (ii) creating an active trade or business, and (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*." A corporation engaging in the activities outlined in Section 195(c)(1)(A)(i) is in many respects engaging in activities similar to those of a "search fund," which is defined by the investment community as "*an investment vehicle, conceived in 1984, through which investors financially support an entrepreneur's efforts to locate, acquire, manage, and grow a privately held company*."[15] Outside of the language of Sections 1202(e)(2)(A) and 195(c)(1)(A), there are no tax authorities establishing any limits on a taxpayer's right to acquire a qualified business versus creating one from scratch.

Organizing a new corporation, funding it with QSBS rollover proceeds for which a Section 1045 election was made, and subsequently acquiring the assets of a business engaged in

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qualified activities should be relatively straightforward from a tax standpoint. But what about forming new corporation, funding it with QSBS rollover proceeds, and acquiring the stock of a "subsidiary" (i.e., acquiring at least majority ownership of a corporation)? Might the IRS take the position that acquiring the stock of a target business through a newco-holding company fails the original issuance requirement, and/or that there are no bona-fide business purposes for creating the parent-subsidiary arrangement rather than merely purchasing the target stock directly? A response to these possible arguments can be found in the express language of Section 1202. Section 1202(e)(5) provides for a "look-thru" when a parent corporation holds a majority interest in a corporate subsidiary: "*for purposes of this subsection, stock and debt in any subsidiary corporation shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets, and to conduct its ratable share of the subsidiary's activities*." Section 1202(e)(5) expressly contemplates a parent-subsidiary arrangement, and does not specify that the subsidiary must be created as a newco-start-up rather than acquired through a stock purchase. Taxpayers can counter the possible argument that there is no bona-fide business purpose for establishing the corporate holding company to acquire the stock of the target corporation by pointing out that buyers frequently form corporations to hold the stock of their target corporations, and further that the establishment of parent-subsidiary arrangements are adopted for a number of bona-fide business reasons, including asset protection planning, facilitating financing arrangements, allowing for the separate accounting for subsidiary operations, taking advantage of the flexibility gained through operating through subsidiaries, allowing for future diversification and expansion of operations, avoiding regulatory restrictions and the triggering of change-of-control provisions, and facilitating international and state and local tax planning.[16] Taxpayers might also ask why the purchase of the subsidiary's stock would merit different treatment than an issuer of QSBS that organizes a subsidiary to purchase assets. Section 1202 does not exclude a corporation that acquired its business assets from the scope of a qualified small business.

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Another issue to consider is whether there are any limits on the acquisition of foreign assets or equity (stock). Section 1202 provides that only a domestic (US) corporation can issue QSBS. This requirement raises the question of whether the ownership of foreign assets or the equity of foreign subsidiaries should affect the QSBS status of stock issued by the US corporation. Similar issues and arguments applicable to the acquisition of a domestic corporation by a newco-holding company discussed in the preceding paragraph could also be applied to an analysis of the consequences of the acquisition of foreign business entity treated as a corporation under Section 7701. The IRS might argue that since QSBS can only be issued by a domestic (US) C corporation, the forming of a domestic C corporation to acquire the stock of a foreign corporation should be viewed as an attempt to work around the domestic (US) corporation requirement. A response to these arguments would be to point out that while Section 1202 expressly requires the issuer of QSBS to be a domestic (US) corporation, Section 1202 is silent with respect to the domestic status of subsidiaries, and the statute does not exclude either foreign assets or foreign subsidiaries from the scope of what constitutes qualified business activities or "active conduct."

Neither Sections 195 nor 1202 establish any specific limit on the time period for identifying and acquiring the equity or assets of a qualified business. If the IRS challenged the length of time taken to identify and acquire a suitable qualified business, the courts would likely apply a facts and circumstances test and a reasonable person standard (i.e., what would a reasonable person do in similar circumstances not driven by tax considerations), examining the efforts undertaken during the search process and the results of those efforts. Also, stockholders should be aware of what might constitute a couple of practical limiting factors for conducting the search. First, Section 1202(e)(6) provides that after two years have passed (most likely two years after issuance of the replacement QSBS for newly organized corporations), no more than 50% of the corporation's money and investment assets count positively towards satisfying Section 1202's 80% Test. Effectively, the second anniversary might serve as a cut-off for undertaking an unsuccessful search. Second, a corporation whose assets consist

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solely of money and investment assets is potentially exposed to the reach of the personal holding company tax.

Although engaging in search fund activities as "active conduct" has support in the language of Sections 195 and 1202, stockholders should anticipate that the IRS might challenge the credibility of the taxpayers' efforts to identify and acquire a business. Stockholders should adopt a written business plan that credibly justifies the new corporation's need for capital to fund search expenses and the acquisition of a target business, and should further document each action taken and expense incurred during the search process. Stockholders should be well positioned to provide credible evidence to support "active conduct" in the event of an IRS audit, if a target business is identified and purchased within a reasonable period of time, and the stockholders thoroughly document their efforts. But what happens if the search for the right business fails, and the second anniversary of the issuance of the replacement QSBS passes? If stockholders do not believe that there is credible evidence of active conduct during at least the first six months after issuance of the replacement QSBS, a plan of complete liquidation can be adopted and the assets distributed in a taxable exchange. If stockholders believe that their corporation did actively conduct its search process during the six-month period, the stockholders may elect to make the Section 1045 election and then consider whether the corporation should continue the search, go in a different direction from a business or investment standpoint, or adopt a plan of complete liquidate. Finally, if stockholders believe that there is sufficient evidence that the corporation did indeed actively conduct its search activities beyond the point where the stockholders achieved the required five+-year holding period, but notwithstanding those efforts was not able to purchase a qualified business, the stockholder could adopt a plan of complete liquidation, distribute the corporation's assets, and claim Section 1202's gain exclusion, assuming all of Section 1202's and 1045's requirements were satisfied with respect to (i) the original QSBS, (ii) the rollover of original QSBS proceeds into the replacement QSBS, and (iii) the replacement QSBS.

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If stockholders elect to claim Section 1202's gain exclusion in connection with a complete liquidation, the stockholders will have the burden of proving that all applicable Section 1202 eligibility requirements were satisfied, that there was a bona-fide business reasons for engaging in the rollover and search activities, and that the stockholders' activities were not motivated by tax avoidance. [17] As previously mentioned, the Tax Court would likely undertake a facts and circumstances analysis, reviewing evidence revealing the nature and extent of the corporation's start-up activities, and in the process weighing the stockholders' credibility. The standard applied by the Tax Court would likely be one of whether a reasonable man, not motivated by tax consequences, would have acted in a similar fashion. Obviously, a successful search effort culminating in the acquisition of a qualified business would be preferable and less susceptible to second guessing on the part of the IRS and the courts.

Engaging in the activities of a "reseller"

For purposes of this article, a "reseller" is defined to be a corporation that engages in the activity of purchasing (i.e., not manufacturing or fabricating) and selling inventory. The inventory could be clothing, industrial parts, collectibles, bullion or collector coins, jewelry, watches, antiques, collectible cars, wine, whiskey (casks/barrels/bottles), toys or any other personal property, which in the past would often be sold in a brick and mortar store but today is more likely to be sold through Amazon, eBay, Facebook Marketplace or through internet-based specially selling platforms. Resellers range from companies that annually sell thousands of Pokémon cards to companies whose annual sales are limited to several aircraft or collector cars.

With the exception of excluding the buying and selling of real property, "*investing,*" "*performance of services in the field of brokerage services*, "and "*a trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees*" (each discussed below), acting as a reseller does not fit within any of Section 1202's categories of excluded activities, nor does the language of Section 1202 suggest that there are any

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limitations on the type of reseller inventory that would qualify under Section 1202 (other than real property).[18]

For several reasons that should be understood, the possibility of engaging in the activity of buying and selling inventory as a reseller has attracted the attention of the QSBS world. First, stockholders who want to roll over QSBS proceeds under Section 1045 are usually doing so because they want to claim Section 1202's gain exclusion when they sell their replacement QSBS. In many cases, the motivation to reinvest QSBS proceeds under Section 1045 is to satisfy the five+- year holding period requirement under Section 1202(a)(1). Such stockholders are not looking to lose their investment gain realized on the sale of the original QSBS when they acquire replacement QSBS by rolling into speculative ventures. Nor are such stockholders interested in an open-ended period of time before they trigger a liquidity event with respect to the replacement QSBS and take their money off the table. For these reasons, the reseller activity is attractive because stockholders believe that they can limit their economic losses by turning inventory (in particular when contrasted with investing in a true venture start-up) and have at least some control over how long the reseller activity is undertaken. For example, stockholders who sell original QSBS with a four-year holding period might reasonably believe that they can reinvest $5 million of original QSBS proceeds in a corporation that actively and perhaps successfully conducts reseller activities for more than a year, thereby achieving a five+- year holding period, followed by liquidating the corporation, triggering a taxable exchange and the right to claim Section 1202's gain exclusion.[19]

Not surprisingly, there are tax issues that should be considered when rolling funds over into a corporation engaged in reseller activities. These potential tax issues include: (i) whether the reseller is engaged in the activity of "*investing*"; (ii) whether the reseller is engaged in the "*performance of services in the field of 'brokerage services'*; (iii) whether the reseller is engaged in "*a trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its* employees;" (iv) the issue of whether there are insufficient sales activity to credibly support the position that reseller engaged in "active conduct" of its reseller

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activities (see, for example, the *John P. Owen* decision);[20] (v) the issue of whether the reseller is engaged in a "trade or business"; (vi) issues associated with relying on the assistance of non-employees to undertake the reseller's activities;[21] (vii) potential IRS arguments that a particular reseller's activities were not undertaken for bona-fide business reasons (i.e., for tax avoidance purposes); (viii) potential IRS arguments that a particular reseller's activities lack economic substance; (ix) potential issues associated with the possible accumulation within the reseller of cash and investment assets beyond the corporation's reasonable needs for working capital;[22] and (x) the potential application of the accumulated earning tax and the personal holding company tax.[23]

An in-depth discussion of all of the potential tax issues that would need to be addressed in connection with undertaking a reseller business is beyond the scope of this article. Some general thoughts about certain potential tax issues are discussed below, but whether and how these and other tax issues would apply in the case of a specific reseller activity would require a close look at the applicable facts and circumstances.

Does the activity of being a "reseller" fall within the scope of "investing"? Section 1202(e)(3)(B) excludes the activity of "investing" from the scope of qualified activities. There are no tax authorities interpreting Section 1202 that establish what is meant by "investing." Section 199A makes use of the term "investing" and Treasury Regulation Section 1.199A(b)(2)(xi) provides the following meaning of the provision of services in investing and investment management: "*For purposes of section 199A(d)(2) and paragraph (b)(1)(x) of this section only, the performance of services that consist of investing and investment management refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments.*"[24] In *Frank H. Taylor & Son, Inc. v. Commissioner*, 1973 T.C. Memo 82, the Tax Court focused on whether a taxpayer was a "dealer" or "investor" in certain real

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estate. The Tax Court noted that a taxpayer who holds property primarily for sale to customers in the ordinary course of the taxpayer's business would fall into the category of "dealer" rather than "investor." Relevant factors considered by the Tax Court included the purpose for which property was acquired and held, the extent and substantiality of the transactions, the nature and extent of the taxpayer's business, the extent of advertising to promote sales, or the lack of such advertising, and the listing of the property for sale directly or through brokers. Another factor that distinguishes the activities of a dealer from those of an investor is that a dealer's income is generally derived from taking advantages of the margin between inventory cost and sale price and inventory turnover, while an investor's income is generally derived from asset appreciation.

If the Tax Court follows the meaning of "investing" as it is used in Section 199A, the court would likely determine that no reseller engages in the activity of "investing." But if the Tax Court chooses to ignore Section 199A and instead focuses on whether the corporation is an "investor" or "dealer" as defined by tax authorities such as *Frank H. Tayor*, then the issue would be resolved through a facts and circumstances analysis of the reseller's activities. A corporation that purchases, holds and ultimately sells appreciated inventory may be at risk of being found to be engaged in "investing." If the Tax Court determined that a corporation was engaged in investing in assets rather than actively buying and selling inventory as a dealer, the court would likely also conclude that the corporation was not engaged in the active conduct of a trade or business.[25]

Does the activity of being a "reseller" fall within the scope of "*performance of services in the field of brokerage services*"? Section 1202(e)(3)(A) excludes "*performance of services in the field of brokerage services*" from the scope of qualified activities. Section 1202 does not address the scope of "brokerage services." The on-line version of the Merriam-Webster dictionary defines "broker" as "*one who acts as an intermediary; . . . such as an agent*

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who negotiates contracts of purchase and sale (as of real estate, commodities, or securities)." Investopedia.com defines a "broker" as "*an individual or firm that charges a fee or commission for executing buy and sell orders submitted by an investor.*" There is also a Private Letter Ruling (PLR) and a Chief Counsel Advice (CCA) tax memorandum addressing the scope of "brokerage services" for purposes of Section 1202(e)(3).[26] The CCA focused on the fact that the taxpayer in question was required to file broker information returns under Section 6045 when reaching the conclusion that the taxpayer was engaged in "brokerage services" for purposes of Section 1202. "Broker" is defined for purposes of backup withholding under Section 3406(h) and for purposes of Section 6045 dealing with returns of brokers as "*a dealer, barter exchange, or another person who (for a consideration) regularly acts as a middleman with respect to property or services.*" Treasury Regulation Section 1.6045-1(a)(1) defines "broker" as a person that in the ordinary course of a trade or business stands ready to effect sales to be made by others.

Treasury Regulation Section 1.199A-5(b)(2)(x) provides that the performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in Section 475(c)(2)) for a commission or fee. This includes services provided by stockbrokers and other similar professionals. Treasury Regulation Section 1.199A-5(b)(3)(xiii), Example (13) provides the following: "*J is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. Customers place orders with J to trade securities or commodities based on the taxpayer's recommendations. J's compensation for its services typically is based on completion of the trade orders. J is engaged in an SSTB in the field of brokerage services within the meaning of section 199A(d)(2) or paragraphs (b)(1)(ix) and (b)(2)(x) of this section.*"

Every reseller/retailer in one sense acts as an intermediary between the manufacturer of inventory and purchaser of inventory. But resellers generally purchase and resell inventory and are compensated when they buy low and sell high. Resellers typically

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do not make money based on charging a fee for acting as an intermediary between sellers and buyers. Most resellers should fall comfortably outside of the scope of "brokerage services," but stockholders should carefully consider whether an economic arrangement falling outside of a typical reseller arrangement regarding the purchase and sale of inventory might give rise to an argument that a retailer was actually engaged in performing "brokerage services."

Does the activity fall within the scope of a "*trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees*"? Section 1202(e)(3)(A) provides that a "*trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees*" is engaged in an excluded activity. In *John P. Owen*, the IRS argued that the issuer of Mr. Owen's original QSBS was not engaged in qualified activities because one of the principal assets was the skill of Mr. Owen. The Tax Court disagreed with this position based on the fact that the principal asset of the Family First Companies was the training and organizational structure, along with the fact that independent contractors sold the policies that earned the corporations premiums, not the taxpayer in his "personal capacity."[27]

There are also several PLRs that reach the conclusion that a corporation whose business was conducted through skilled and trained employees was not engaging in this activity for purposes of Section 1202.[28]

Treasury Regulation Section 1.199A-5 provides the following guidance: "*Meaning of trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners. For purposes of section 199A(d)(2) and paragraph (b)(1)(xiii) of this section only, the term any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners means any trade or business that consists of any of the following (or any combination thereof): (A) A trade or business in which a person receives fees, compensation, or other income for endorsing products or services; (B) A trade or business in which a person*

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licenses or receives fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; or (C) Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format." It seems reasonable to conclude that the activities of most resellers would not include any of those referenced in this Section 199A regulation.

The Tax Court and the IRS have previously concluded that without additional circumstances, a corporation with highly trained and skilled employees does not fall within the scope of this excluded category.[29] It seems difficult to imagine a set of facts involving a corporation engaged solely in reseller activities that would bring it within the scope of this excluded activity. Perhaps a reseller whose success was based on marketing by a celebrity owner or social media influencer owner might bring a corporation within the scope of this excluded category.

Does the activity of the "reseller" qualify as "*engaging in the active conduct of a trade or business*" for purposes of Section 1202(e)? The 80% test set forth in Section 1202(e)(1)(A) establishes the requirement that a corporation issuing QSBS must be engaged in "*the active conduct of one or more qualified trades or businesses*."[30] If you unpack that requirement, the corporation must be engaged in a qualified "trade or business" (e.g., not an investor in collectibles or art) and must be actively conducting that qualified trade or business activity.

Section 1202 does not define "active conduct" or "trade or business." But Treasury Regulation Section 1.355-3(b)(ii) provides that:

A corporation shall be treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection

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of income and the payment of expenses" and that "*for purposes of section 355(b), the determination whether a trade or business is actively conducted will be made from all of the facts and circumstances. Generally, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others*.

The Tax Court addressed the "active conduct" issue in *John P. Owen* in connection with a taxpayer's rollover of $5 million of original QSBS sales under Section 1045.[31] John Owen acquired replacement stock in a newly-organized corporation that purported to undertake a jewelry business, although the evidence established that 92% of the corporation's assets remained in cash. During its first six months of operation, the retail jewelry business only bought 16 pieces of jewelry, using only 8% of the corporation's rolled over original QSBS proceeds. During its first twelve months of business, the jewelry corporation only sold six pieces of jewelry and three of those sales were to a group of corporations formerly owned by Owen and to Owen's business partner. As of two years after the purchase of the replacement stock, the jewelry corporation's inventory contained only 16 pieces of jewelry. Owen attempted to defend his position by arguing that it wasn't prudent to buy more jewelry inventory without first learning more about the business. After looking at all of the evidence, the Tax Court determined that Owen didn't follow his accountant's advice and appeared to be unaware of the 80% requirement. The Tax Court also found that two years after the sales proceeds were injected into the jewelry business, the business was not using its funds, and rejected Owen's explanation that it took time for a jewelry business to become established. The Tax Court also rejected Owen's argument that extensive cash on hand was an asset in active use in a trade or business. The bottom line is that Owen failed to credibly establish that the corporation was engaged in conduct sufficient to satisfy

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Section 1202's active conduct requirement.[32] The *John P. Owen* decision is useful for stockholders because it illustrates both how not to undertake a reseller activity and, more importantly, the issue addressed by the Tax Court was whether the reseller activity was actively conducted by Owen, not whether there was an inherent issue with undertaking a reseller activity. The issue addressed by the Tax Court was limited to whether there was a good Section 1045 rollover (there wasn't).

Practitioners have suggested that footnote 23 in *John P. Owen* ("*The balance of the assets were held in the form of wholesale jewelry consisting of precious metal and precious stones, a form of liquidity favored by some over currency*.") might be interpreted to support the conclusion that the Tax Court is predisposed to conclude that corporations engaged in retailer activities involving certain types of inventory are more likely to fail the "active conduct" test or the "bona-fide business purpose" test. Given the facts of *John P. Owen*, it does seem reasonable to conclude that Owen, like individuals living in societies where wealth is worn as jewelry, both select jewelry as a convenient way to hold and preserve wealth. Perhaps footnote 23 should be viewed as a cautionary note that the IRS and Tax Court are more likely to question the credibility of taxpayers (like Owen) whose retailer inventory consists of liquid collectibles, but we believe that footnote 23 should not be read to support the conclusion that the nature of the inventory dictates whether the requirements of Sections 1202 and 1045 are satisfied.[33] We can imagine a case where original QSBS proceeds are invested in replacement QSBS issued by what develops into a successful and highly active retail antique jewelry business, perhaps one where the replacement QSBS is eventually sold to a national jewelry chain. The main takeaway from footnote 23 might be that if stockholders are looking to avoid heightened scrutiny, the corporation should buy and sell washing machine parts rather than high-end collectibles or art.

In *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), the United States Supreme Court considered whether a gambler was engaged in a "trade or business" within the meaning of Sections 162(a) and 62(1). The Supreme Court noted that "*we accept the fact that to be engaged in a trade or business, the taxpayer must be involved in*

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the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify" and that the resolution of the issue of whether a taxpayer is engaged in a trade or business "*requires an examination of the facts in each case*."[34] In *Rafferty v. Commissioner*, 452 F.2d 767 (1st Cir. 1971), the Federal Appeals Court stated that "*it is our view that in order to be an active trade or business under § 355 a corporation must engage in entrepreneurial endeavors of such a nature and to such an extent as to qualitatively distinguish its operations from mere investments. Moreover, there should be objective indicia of such corporate operations*." In *Rafferty*, leasing a subsidiary's sole asset to its parent corporation was determined to be more akin to a passive investment in securities than the active conduct of a business. As these tax authorities suggest, the determination of whether a corporation is actively conducting a trade or business is a factual determination. The guidelines established by these cases serve as a warning that courts are likely to interpret the "active conduct" requirement to mean that there must be a substantial level of activity undertaken by the corporation issuing the replacement QSBS.

One issue often associated with reseller arrangements structured by third-party professionals is how the issuing corporation undertakes satisfying the "active conduct" requirement. Section 1202 doesn't define what is meant by "active conduct," or who must actively conduct the business on behalf of the corporation. There is no requirement that the stockholder who is issued the replacement QSBS must contribute towards the corporation satisfying the "active conduct" requirement. The "active conduct" requirement is a corporation-level requirement.

Various private letter rulings addressing the issue of whether a particular corporation is engaged in qualified or excluded activities generally refer to the activities of the corporation's employees.[35] If a sole stockholder is responsible for satisfying a corporation's "active conduct" requirement, it would make sense for the stockholder to be formally employed by the corporation, although there are tax authorities supporting the conclusion that a corporation should be credited with the conduct of its stockholders

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in connection with satisfying the active conduct requirement. Section 355's regulations include the following discussion of "active conduct": *Generally, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A corporation may satisfy the requirements of this subdivision (iii) through the activities that it performs itself, even though some of its activities are performed by others*"[36] and "*activities performed by a corporation include activities performed by employees of an affiliate (as defined in paragraph (c)(1) of this section), and in certain cases by shareholders of a closely held corporation, if such activities are performed for the corporation. For example, activities performed by a corporation include activities performed for the corporation by its sole shareholder. However, the activities of employees of affiliates (or, in certain cases, shareholders) are only taken into account during the period such corporations are affiliates (or persons are shareholders) of the corporation. A corporation will not be treated as engaged in the active conduct of a trade or business unless it (or its SAG, or a partnership from which the trade or business assets and activities are attributed) is the principal owner of the goodwill and significant assets of the trade or business for Federal income tax purposes. Activities performed by a corporation generally do not include activities performed by persons outside the corporation, including independent contractors, unless those activities are performed by employees of an affiliate (or, in certain cases, by shareholders). However, a corporation may satisfy the requirements of this paragraph (b)(2)(iii) through the activities that it performs itself, even though some of its activities are performed by persons that are not its employees, or employees of an affiliate (or, in certain cases, shareholders).*[37]

Section 355's regulations suggest that there would likely be a problem with trying to satisfy Section 1202's "active conduct" requirement through the use of independent contractors. The Section 355 proposed regulations along with other tax authorities such as Revenue Rulings 79-394 and 80-181 suggest that "active

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conduct" can be, at least under some circumstances, imputed from the activities of employees of affiliated corporate entities, whether or not such employees are compensated by corporation whose "active conduct" is under review.[38] The takeaway from these tax authorities is that the IRS might scrutinize arrangements where the activities of the reseller are undertaken through the efforts of individuals other than employees of the replacement QSBS issuer itself and perhaps employees of affiliated corporations (i.e., through parent-subsidiary structures and perhaps common ownership).

What role can judicial doctrines (otherwise known as IRS weapons of destruction) such as sham transaction; absence of bona-fide business purpose a/k/a tax avoidance and economic substance play if the IRS challenges reseller activities? In circumstances where the IRS or courts might believe that claimed tax benefits appear to be beyond what Congress intended, the IRS has an inconsistent history of asserting judicial doctrines such as sham transaction, absence of bona-fide business purpose a/k/a tax avoidance and/or economic substance, and courts have an equally inconsistent history of interpreting and applying those judicial doctrines. Why might the IRS and/or the courts believe that judicial doctrines should apply to Section 1045 rollover arrangements? The IRS might believe that the scope of Section 1045 should be limited to rollover of original QSBS proceeds into third-party early-stage venture/small business stock investments. The IRS might consider organizing and operating a reseller activity that results in tax benefits under Sections 1045 and 1202 to be a sham that lacks a bona-fide business purpose, i.e., constituting a series of actions undertaken solely for tax avoidance purposes. The IRS might consider as relevant the fact that the corporation issuing the replacement QSBS was ultimately liquidated rather than sold. The IRS might believe and argue that stockholders would never have utilized a C corporation absent the purpose of claiming Section 1202's tax benefits. Finally, the IRS might believe that Section 1045 reseller arrangements lack "economic substance," arguing that the contribution of funds into the C corporation for the purpose of operating a reseller business would not generally make economic sense absent the tax benefits of Sections 1045 and 1202.

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An in-depth analysis of how the judicial doctrines identified above might be applied when taxpayers and their advisors structure reseller arrangements to take advantage of Sections 1045 and 1202 is beyond the scope of this article. And since the devil will always be in the factual details of a particular arrangement, any actionable guidance will always depend on looking carefully at those facts. Nevertheless, a basic understanding of these judicial doctrines, and the arguments for and against their potential application to Sections 1202 and 1045, should be helpful when considering different Section 1045 arrangements, perhaps particularly those promoted by third party advisors.

An example of an arrangement that might induce the IRS to assert tax avoidance and lack of economic substance might be one that commenced with a Section 1045 rollover followed later by the liquidation of the corporation and the claiming of Section 1202's gain exclusion shortly after a stockholder satisfies the five+-year holding period requirement. We can assume that the corporation actively conducted its business and was marginally profitable. If the stockholder claimed Section 1202's gain exclusion and was audited, the IRS might argue that corporation's formation and its reseller activities, coupled with the timing of the corporation's liquidation and claiming of Section 1202's gain exclusion, evidence an arrangement (i) motivated by tax avoidance, and (ii) the lack economic, perhaps based on an argument that no reasonable person would undertake reseller activities a C corporation without a principal purpose being one of obtaining the tax benefits of Sections 1045 and 1202. In response to this hypothetical IRS position, we believe stockholders would be able to respond with several good arguments against the assertion of judicial doctrines.

With respect to the IRS's economic substance argument, *Historic Boardwalk Hall, LLC v. Commissioner*, 136 T.C. 1 (2011) supports the position that the tax benefits associated with both Section 1045 and 1202 should be taken into consideration in determining whether the reseller activity had economic substance and the stockholder a bona-fide business purpose for rolling proceeds over into replacement QSBS. In *Historic Boardwalk*, the IRS argued that a transaction was a sham, served no subjective business purpose and lacked economic substance because a partnership was structured

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in part to give Pitney Bowes the benefit of rehabilitation tax credits. The IRS argued that absent the tax credit benefits, the arrangement would never have been undertaken by Pitney Bowes and lacked economic substance because the arrangement was unprofitable unless the benefits of the tax credits were taken into account. In response to the IRS's position, the Tax Court referred to *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995) where the court stated an investment (i) *"did not become a sham just because its profitability was based on after-tax instead of pre-tax projections*," and (ii) "*absence of pre-tax profitability does not show whether the transaction had economic substance beyond the creation of tax benefits where Congress has purposely used tax incentive to change investors' conduct*," and that "*if the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative*." The Tax Court went on to note that "*ultimately, the Court of Appeals recognized that if the types of transactions that Congress intended to encourage had to be profitable on a pretax basis, then Congress would not have needed to provide incentives to get taxpayers to invest in them; in effect, the Commissioner was attempting to use the reason Congress created the tax benefits as a ground for denying them*.

Historic Boardwalk, and tax authorities addressed by the Tax Court in that decision, support the conclusion that so long the issuer of replacement QSBS actively conducts its reseller business, stockholders should be able to structure an arrangement to obtain the benefits of the incentives established by Congress through Sections 1045 and 1202. However, as discussed above, stockholders first argument should be that the rollover of proceeds into replacement QSBS and subsequent events should not be viewed on a stand-alone basis, but as an extension of the original QSBS investment. There is no evidence in the legislative history of Sections 1045 and 1202 that Congress intended the benefits of those statutes to apply only if a stockholder was successful hitting the ball out of the park twice. As long as the corporation issuing the replacement QSBS actively conducts its trade or business, the appropriate question to ask if the IRS asserts the application of judicial doctrines should be whether the outcome of the

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stockholder's original QSBS investment, when coupled with the stockholder's reinvestment of proceeds in replacement QSBS, sufficiently evidences a bona-fide business purpose and satisfies the economic substance doctrine, taking into account both tax and economic benefits.

With respect to the IRS's tax avoidance argument, taxpayers should first note that it was Congress that established the rules of Section 1202 and 1045, and taxpayers, in the absence of additional IRS guidance such as Treasury Regulations that are consistent with and properly interpret the statutes, are merely following the established rules. Sections 1202 establishes a five+year holding period requirement. Sections 1202, 1045 and 1223(13) provide for the tacking of holding periods. Neither the decision of a holder of Apple stock to sell once he qualifies for long-term capital gain treatment nor the decision of the holder of QSBS to exchange his QSBS once he has satisfied Section 1202's holding period requirement should be considered tax avoidance. Congress did not restrict the benefits of Section 1202 to situations where the stockholder sells QSBS to a third party, but instead Section 1202 explicitly refers to a taxable "exchange" (i.e., an exchange of stock in a complete liquidation) as triggering the right to claim Section 1202's gain exclusion.

Following the rules for the purpose of qualifying tax benefits established by Congress should not be considered tax avoidance. There should be a presumption that Congress intended taxpayers to access benefits of Sections 1202 and 1045 if they successfully followed the rules established by those statutes. The focus of the IRS and the courts should be on whether stockholders met the express requirements (rules) of Sections 1202 and 1045, and in particular whether the corporation issuing the replacement QSBS engaged in the active conduct of a trade or business.

Finally, we believe that Section 1045 should not be viewed on a stand-alone basis, but instead should be considered as an additional tax benefit established by Congress to further incentivize investors and founders to make their initial investment in original QSBS and pursue Section 1202's gain exclusion. By the time stockholders are acquiring replacement QSBS, they have

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accomplished the goal of Congress when enacting Section 1202, which was to incentivize investment in the original QSBS. Where the stockholders' investment in original QSBS was bona-fide and in many cases where Section 1045 is elected, highly successful, there should be no separate requirement that the rollover of proceeds into replacement QSBS separately satisfy each judicial doctrine.

The taxpayer arguments outlined above are just a sampling of the defenses taxpayers would have against an assertion by the IRS of judicial doctrines. Nevertheless, stockholders considering arrangements structured to facilitate a Section 1045 rollover into a reseller should be students of these judicial doctrines and be fully prepared to defend against their potential assertion. Stockholders should further consider the additional risk of heightened IRS scrutiny if they rollover into a QSBS "product" developed and marketed by promoters.[39] Of course, the potential for increased IRS scrutiny doesn't necessarily mean that the arrangement won't survive an IRS challenge, but any possible tax vulnerabilities should certainly be considered when making an investment decision.

Potential excess working capital issue. Section 1202 requires that at least 80% of an issuing corporation's assets (by value) are used in qualified business activities (referred to as the "80% Test"). Sectio 1202(e)(6) provides that money and investment assets (i.e., cash management assets) can qualify as working capital included as "good" assets for purposes of calculating the 80% Test. The flip side, however, is that money and investment assets that don't qualify as good working capital under Section 1202(e)(6) would be in the "bad" asset column and count against satisfying the 80% Test.

The principal question that must be asked is whether the taxpayer can substantiate that all of the money and cash management assets are needed for the corporation's qualified business activities. During any point where the taxpayer is unable to substantiate that the money and associated cash management assets are "good" working capital, the assets would during that period count against satisfying the 80% Test. The substantiation of various elements of Section 1202's eligibility requirements is addressed in detail in a two-part article: "*Substantiating the Right to*

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Claim QSBS Tax Benefits – Part 1" and "*Substantiating the Right to Claim QSBS Tax Benefits – Part 2*."

Another critical issue with respect to the treatment of working capital in connection with running the 80% Test is the application of Section 1202(e)(6), which provides that *"[f]or periods after the corporation has been in existence for at least 2 years, in no event may more than 50 percent of the assets of the corporation qualify as used in the active conduct of a qualified trade or business by reason of this paragraph*." For corporations that have been funded up front with Section 1045 rollover money, and where the overall value of the corporation's assets have not outstripped by at least 100% the amount of working capital, this provision can cause a corporation to failed the 80% Test and in turn Section 1202(d)" "qualified small business" requirement. If a corporation is not a "qualified small business" during "substantially all" of a taxpayer's holding period for his QSBS (probably at least 80% of the holding period), the stock subject to the Section 1045 election will cease to qualify as QSBS. This won't affect the Section 1045 election, as the test period is only the first six months after issuance of the replacement QSBS, but it may affect the availability of Section 1202's election when the replacement QSBS is ultimately sold or exchanged in a taxable transaction. For example, if $10 million is rolled over into the replacement QSBS of a newly-organized corporation engaged in searching for and acquiring business assets falling within the scope of a qualified activity, but two years into the search, only $200,000 has been expended in the search and the FMV of the money and investment assets are now $11,500,000, only $5,750,000 of that amount can qualify as "good" working capital, and the amount in excess of $5,750,000 would cause the corporation to commence failing the 80% Test and the "qualified small business" test. At that point, the corporation would need to consider distributing out excess money/investment assets or accept that the replacement stock may not meet Section 1202's eligibility requirements. Another possible route would be to liquidate the corporation for bona-fide business reasons if it is a reasonable position that the search efforts have failed.

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We have heard from some tax practitioners that a possible solution for the two-year cliff on working capital is to liquidate the QSBS issuer and reinvest the distributed money into new QSBS investments under Section 1045. The plan would be for the taxpayer to start a new two-year clock for purposes of Section 1202(e)(6). Whether this strategy should be expected to work will be fact specific. Treasury Regulation Section 1.331-1(c) provides the following:

Recharacterization. A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of 'other property.'

If the distribution was recharacterized as a "dividend," then the distribution would not qualify for the necessary "sale or exchange" treatment that would support a Section 1045 election with respect to the gain. Further, taxpayers should also consider the potential assertion by the IRS of the liquidation-reincorporation doctrine and/or no bona-fide business purpose argument. A question that would be asked by the IRS and Tax Court would be whether there is a bona-fide business purpose for the timing of the liquidation and subsequent reinvestment of the proceeds. This strategy may have a better chance of passing muster if there is a bona-fide business reason for the complete liquidation and some or all of the funds distributed in liquidation are reinvested into third-party QSBS rollover investments.

If the liquidation is a partial liquidation governed by Sections 302(b)(4) and 302(e), the key question is under what circumstances would the IRS assert the application of Treasury Regulation Section 1.331-1(c) or the liquidation-reincorporation doctrine where the property or money distributed in the partial liquidation is rolled over pursuant to a Section 1045 election into replacement QSBS. An article addressing corporate liquidations suggests based on several tax authorities that if the assets distributed in partial liquidation represent less than 30% of the value of all of the distributing corporation's assets, the IRS won't

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assert the application of Treasury Regulation Section 1.331-1(c) or the general liquidation-reincorporation doctrine.[40] In order for a distribution to qualify as a partial liquidation, however, the distribution needs to either involve the termination of an activity or represents "a genuine contraction of the corporate business."[41] Whether any mere distribution of excess money not resulting from the sale of a business activity would ever qualify for partial liquidation treatment remains an unanswered question based on existing tax authorities.

Accumulated earnings tax and personal holding company tax. Business owners and tax professionals need to also consider the potential application of the accumulated earnings surtax and personal holding company surtax in connection with the operating and investment income of issuers of replacement QSBS. See the article "*Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide*."

Real property related activities

Stockholders seeking "safer" investments in replacement QSBS often gravitate toward activities involving real property. If real property is involved, however, there is a significant challenge attempting to navigate through Section 1202's excluded activities. Section 1202(e)(7) provides that:

A corporation shall not be treated as meeting the requirements of paragraph (1) [the 80% Test] for any period during which more than 10 percent of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business. For purposes of the preceding sentence, the ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business."

Section 1202(e)(3)(C) provides that a "*farming business (including the business of raising or harvesting trees)*" is an excluded activity. Section 1202(e)(3)(D) provides that oil and gas production and extraction that qualify for percentage depletion are excluded activities. Section 1202(e)(3)(E) provides that "*any business of*

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operating a hotel, motel, restaurant, or similar business" is excluded. On a more positive note, a negative inference from Section 1202(e)(7)'s wording is that the value of real property used in a corporation's active trade or business does count towards satisfying Section 1202's requirement that at least 80% by value of the corporation's assets must be used in undertaking qualified business activities.

While attempting to structure qualified activities involving real property have proven to be challenging, Section 1202(e)(7) does appear to open the door for engaging in activities that require significant ownership of real property but don't involve engaging in investing, dealing or renting real property. Examples of activities that might qualify include the ownership of commercial office space by a software company, or retail space by a retailer, or factory or warehouse properties by a manufacturing, fabricating or retailing company. Activities that involve a high percentage of real property assets such as hunting preserves, golf courses, senior living properties or storage facilities might trigger an IRS challenge based on the argument that those activities are "similar businesses" to operating a hotel or motel (i.e., an argument that the use involves a short-term rental or license or real property), or involve the ownership or leasing of "real property." In each case, stockholders would likely have a better chance of success if the ownership of the real property is coupled with the providing of significant additional services and/or products. For example, purchasing and renovating real property for the purpose of operating a boutique store (grocery, clothing, art gallery, etc.) might prove to be an effective way to make a substantial investment in real property that is used in a qualified business activity. Some activities are difficult to characterize for Section 1202 purposes. For example, does operating a golf course or hunting preserve involve engaging in activities similar to operating a hotel/motel/restaurant or renting real property (i.e., licensing the right to use the property to golf or ski) or should those activities fall outside of Section 1202's excluded activities? Perhaps ownership of the real property is better kept outside of the operating C corporation if the operating business has significant value and positioning stockholders for claiming Section 1202's gain exclusion is a top priority? The bottom line is that any

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activity involving real property assets should be carefully reviewed with an eye towards best positioning stockholders to qualify under Sections 1045 and 1202.

Waiving the white flag – electing not to pursue a Section 1045 rollover and paying the 23.8% federal tax triggered by the sale or exchange of QSBS

For some stockholders, making the necessary election under Section 1045 and acquiring replacement QSBS either isn't worth the effort or presents seemingly insurmountable or unacceptable investment and tax risks. As this article highlights, sourcing replacement QSBS takes effort, and there usually are significant investment risks associated with recommitting money into a replacement QSBS investment. Compliance with Section 1202 is complicated, and there are tax risks associated with both electing to rollover proceeds under Section 1045 and claiming Section 1202's gain exclusion. Any taxpayer considering electing to roll proceeds over under Section 1045 or claiming Section 1202's gain exclusion should consider not only the potential tax benefits but also the potential consequences associated with taking the return position.

The evolution of QSBS funds and special purpose vehicles (SPVs) as potential solutions for investors seeking to source replacement QSBS

During the past several years, investment professionals have identified stockholders focused on obtaining the benefits of owning QSBS as a potential source of investment capital. These professionals are generally focusing on creating funds or special purpose vehicles ("SPVs") to invest directly or indirectly in minority QSBS investments, but there are also funds and SPVs that acquire majority positions in companies engaged in qualified business activities. Also, some of these funds and SPVs focus on stockholders needing to purchase replacement QSBS.

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The fund structures we have seen developing in the investment marketplace in response to the demand for QSBS investment opportunities include: (i) investment funds focused generally on acquiring minority stock positions in QSBS issuers; (ii) SPVs and funds that hold SPVs engaged in reseller activities; and (iii) funds that organize SPVs (corporations) that acquire either assets or majority stock positions in businesses engaged in qualified activities. SPVs are sometimes created and managed with the assistance of investment professionals, with the stockholders investing directly or through a fund structure in SPVs engaged in reseller or other qualifies activities, and with the investment professionals paid management, administration and other fees.

Treasury Regulation Section 1.1045-1 addresses the interplay between Section 1045 and entities taxed as partnerships (limited partnerships and limited liability companies). Investment in QSBS through a "pass-thru" (partnership/fund) is permissible under Section 1202 but can be more complicated than investing directly in QSBS.[42] Treasury Regulation Section 1.1045-1 addresses the mechanics for a fund or its partners to reinvest original QSBS proceeds in replacement QSBS, and the various tax consequences of doing so, including when tiered partnership structures are involved. The regulations also introduce the concept of a "purchasing partnership" which is defined as a partnership through which a seller of original QSBS reinvests proceeds in replacement QSBS. The "purchasing partnership" concept is critical because it supports the creation of funds that can aggregate rollover proceeds from sellers of original QSBS for purposes of taking advantage of Section 1045.

While Treasury Regulation Section 1.1045-1 only expressly addresses the use of "purchasing partnership" by partners of selling partnerships, there doesn't appear to be any reason why a "purchasing partnership" wouldn't be available to any seller of original QSBS as a vehicle through which to acquire replacement QSBS. Section 1045(b)(5) provides that rules similar to those of Section 1202(g) apply in connection with Section 1045. Section 1202(g) provides that gain arising out of the sale of QSBS held by "pass-thru" entities can be treated as gain from the sale of QSBS by a partner of the "flow-thru" entity if the requirements of that

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subsection are met. These provisions support the conclusion that a "purchasing partnership" can be used by any stockholder who sells original QSBS and elects to roll over proceeds into replacement QSBS.

Although somewhat beyond the scope of this article, Treasury Regulation Section 1.1045-1(f) reveals one planning pothole to avoid when working with QSBS: "*stock that is contributed to a partnership is not QSB stock in the hands of the partnership*." While it works to acquire QSBS through a partnership, or to contribute money (original QSBS proceeds) to a purchasing partnership to acquire replacement QSBS, the direct purchase of QSBS and the subsequent contribution of the QSBS to a partnership should be nontaxable under Section 721, but neither the partnership nor its partners will be able to claim Section 1202's gain exclusion if the partnership sells the contributed stock.

Investment professionals must consider several issues when structuring and operating funds and SPVs focused on QSBS investments: (i) developing a sufficient understanding of Section 1202's and Section 1045's requirements; (ii) formulating what disclosure (e.g., risk factors) should be made to investors regarding QSBS related tax issues and the fund's efforts to assist investors' efforts to obtain the benefits of Sections 1045 and 1202; (iii) sourcing acceptable QSBS investments, and with respect to investors seeking to reinvestment original QSBS proceeds under Section 1045, insuring that the reinvestment is made within the required 60 day period; (iv) obtaining sufficient representations from QSBS issuers that stock investments qualify as QSBS; (v) obtaining sufficient covenants from QSBS issuers that at least commercially reasonable efforts will be made to continue satisfying Section 1202's eligibility requirements; (vi) addressing the issue of ongoing communication with investors regarding QSBS-related issues; and (vii) understanding and addressing Section 1202's provisions dealing with investing through "flow-thru" entities (e.g., limited partnerships and limited liability companies).[43]

Fund professionals should also consider a number of tax issues associated with owning QSBS through a "flow-thru" entity (e.g., limited partnership or limited liability company), including: (i) the

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fact that the allocation of Section 1202 gain exclusion among partners is limited by their "interest" in the partnership (LP/LLC) on the date the partnership acquires the QSBS investment; (ii) the fact that the allocation of Section 1045 rollover amount when the partnership or partner sells QSBS is limited to the "capital interest" of the partner on the date the partnership acquired the QSBS; (iii) the fact that partners who acquire a partnership interest do not share in Section 1202 gain exclusion or Section 1045 rollover with respect to any QSBS previously acquired by the partnership; (iv) the fact that partnerships can distribute stock (QSBS) to partners without disrupting the QSBS status or holding period; (v) how to structure liquidity (if any) for fund investors, given the "anti-churning" rules in Section 1202; and (vi) the issues associated with holders of profits interests (carried interests) sharing in Section 1202's gain exclusion.[44] The bottom line is that while ownership of QSBS through a fund does work under Section 1202, the tax issues are complicated and require careful attention if the parties involved want to successfully roll over proceeds under Section 1045 and maximize the potential Section 1202 gain exclusion.

An ongoing challenge for fund professionals has been to create arrangements that meet the unique needs of stockholders seeking to acquire replacement QSBS. As noted above, these investors are generally looking for investments that are not highly speculative. Also, these investors must reinvest original QSBS proceeds within a short 60-day window, which can be complicated where there is payment of deferred consideration, and investors will have different holding periods for their original QSBS.

Stockholders should consider a number of issues when considering whether to acquire replacement QSBS through a fund offering direct or indirect investments in QSBS: (i) if applicable, making sure that the fund intends to acquire QSBS within the 60 day window permitted under Section 1045; (ii) understanding whether the fund will permit post-investment changes in ownership that might affect the pass-through of Section 1202 gain exclusion; (iii) understanding what steps the fund intends to take to confirm that investments qualify as QSBS and will remain qualified during the fund's entire holding period; (iv) understanding the fund's timeline for holding its QSBS and what rights the investor has, if any to exit; (v)

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understanding what representations and covenants the fund is obtaining from the issuers of QSBS, and what future rights the fund has to obtain information supporting efforts to make Section 1045 elections and/or claiming Section 1202's gain exclusion (e.g., what documents, financial statements, certificates confirming factual matters relating to satisfaction of eligibility requirements will be provided); (vi) understanding generally what support the fund will provide investors with respect to claiming Section 1202's gain exclusion; and (vii) understanding the implications for wealth planning associated with the absence of tax authorities addressing whether recipients of gifts of partnership interests steps into the shoes of the transferor with respect to the QSBS held by the partnership. Many of these issues also apply if the investment is made through an SPV.

Stockholders rolling over original QSBS proceeds into replacement QSBS under Section 1045 and potentially ultimately claiming Section 1202's gain exclusion need to be familiar with the potential tax penalties that can be asserted by the IRS if the arrangement is determined to be undertaken for tax avoidance purposes or lack economic substance. Guidance issued to IRS agents suggests that promoted arrangements or plans are more likely to attract economic substance review. Likewise, investment professionals involved in creating and promoting arrangements or plans to attract Section 1045 rollover proceeds need to be familiar with the promoter penalties that can be asserted by the IRS if the plan or arrangement is deemed to be undertaken for tax avoidance purposes or labelled a tax shelter.

Contact Scott Dolson if you want to discuss any Section 1202 or Section 1045 issues by video or telephone conference.

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[1] There are a number of articles on the Frost Brown Todd website addressing the benefits of Section 1202's gain exclusion and the various eligibility requirements and planning issues associated with seeking and obtaining Section 1202's benefits. The website also includes several articles focused on the workings of Section 1045. See *Frost Brown Todd's QSBS library.*

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Section 1202 has a gain exclusion cap that generally functions to limit a stockholder gain exclusion from a single issuer of QSBS to the greater of $10 million or 10 times the stockholder's aggregate basis in QSBS sold during the taxable year.

This article focuses on federal income taxes. Some states follow the federal treatment of QSBS, and other states, like California, do not follow the federal treatment.

[2] Committee Reports ¶ 12,021 (1993 Revenue Reconciliation Act, PL 103-66, 8/10/93).

[3] Committee Report ¶ 1721.0072 (1993 Revenue Reconciliation Act, PL 103-66, 8/10/93).

[4] There are arguments supporting the position that with respect to installment sale payments, a 60-day period should run off of each installment rather than just off of the initial sale closing date.

[5] Section 1223(13) provides that "*except for purposes of subsections (a)(2) and (c)(3)(A) of section 1202, in determining the period for which the taxpayer has held property the acquisition of which resulted under section 1045…in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period for which such other property has been held as of the date of such sale*." Section 1202(c)(3)(A) deals with redemptions of stock, which means that the period applicable to the "anti-churning" rules of that section run off of the issuance date of the replacement QSBS, not the issuance date of the original QSBS.

[6] See footnotes 4 and 5 above.

[7] Typically, a 20% capital gains tax given the income bracket usually applicable to sellers of QSBS, plus 3.8% investment income tax, plus state tax where applicable.

[8] See, for example, Treasury Regulation Section 1.1045-1(h)(1).

[9] Section 1223(13) provides that "*except for purposes of subsections (a)(2) and (c)(3)(A) of section 1202, in determining the period for which the taxpayer has held property the acquisition of which resulted under section 1045…in the nonrecognition of any*

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part of the gain realized on the sale of other property, there shall be included the period for which such other property has been held as of the date of such sale." The better reading of Sections 1045 and 1223(13) is that the period between the sale of the original QSBS and purchase of the replacement QSBS does not count towards the tacked holding period of the replacement QSBS. Section 1202(c)(3)(A) deals with redemptions of stock, which means that the period applicable to the "anti-churning" rules of that section run off of the issuance date of the replacement QSBS, not the issuance date of the original QSBS.

[10] See the Scott Dolson articles found on the Frost Brown Todd website: "*Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045*" and "*Part2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045*." Section 1202 provides that certain business activities are excluded from the list of qualified business activities, and engaging in those excluded activities can result in the corporation failing the 80% test and loss of QSBS status.

[11] Investopedia and Forbes both report that as many as 90% of startups fails.

[12] If the corporation acquires investment assets, attention will need to be paid to whether the income will be subject to the additional 20% personal holding company. When a corporation adopts a plan of complete liquidation and distributes assets in liquidation to stockholders, there is a deemed sale of assets at the corporate level subject to the 21% federal income tax, and the liquidating distribution is treated as an exchange of the stockholders' stock for the distributed assets under Section 331, which qualifies the distribution for taxable exchange (sale) treatment. Taxable exchange treatment permits the claiming of Section 1202's gain exclusion, if all eligibility requirements are met.

[13] Under Section 1223(13), the holding period for the original QSBS is tacked onto the holding period for the replacement QSBS.

[14] See the Scott Dolson articles found on the Frost Brown Todd website: "*Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045*" and "*Part2 – Reinvesting QSBS Sales*

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Proceeds on a Pre-tax Basis Under Section 1045." Section 1202 provides that certain business activities are excluded from the list of qualified business activities, and engaging in those excluded activities can result in the corporation failing the 80% test and loss of QSBS status.

[15] See definition on the Stanford Business School website at https://www.gsb.stanford.edu/experience/about/centers-institutes/ces/research/search-funds.

[16] See BNA Portfolio 759 – Section 351 Special Topics at IV.C – *Section 351 and the Reorganization Provisions, Acquisitive §351 Transactions* for further discussion of acquiring businesses through an acquisition holding company.

[17] See the discussion below addressing potentially applicable judicial doctrines (sham transaction, business purpose and economic substance). As discussed, taxpayers might assert that neither the Section 1045 rollover or the operation of the issuer of the replacement QSBS should be considered in isolation, but rather as an extension of the taxpayer's investment in the original QSBS and the operation (and presumably, the economic success) of the issuer of the original QSBS.

[18] There is a long tradition of "vest pocket dealers" in the numismatic business – dealers who don't take tables at shows or have a fixed location, but instead walk the floors buying and selling inventory. Also, see *Guide to reselling in Amazon stores* at https://sell.amazon.com/blog/reselling.

[19] The sale of inventory would be subject to a 21% corporate level tax and the complete liquidation of the corporation under Section 331 would be treated as a taxable exchange, paving the way for claiming Section 1202's gain exclusion if all of that section's eligibility requirements are met.

[20] *John P. Owen v. Commissioner*, TC Memo 2012-21.

[21] What constitutes "active conduct" under Section 1202 has not been addressed to any useful degree in direct tax authorities. The Section 355 regulations interpret "active conduct" in the context of splitting activities and generally places limitations on the ability to

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use outside contractors when determining whether a corporation is engaged in the "active conduct" of a business activity. The safe approach for supporting an active conduct argument under Section 1202 would be to engage in business activities through employees and stockholders acting on the corporation's behalf. The use of outside contractors providing management, operating or administrative services should be closely scrutinized to see if the arrangement impacts arguments supports the position that the corporation is actively conducting business.

[22] One of the requirements of Section 1202 is the "80% Test" which requires at least 80% by value of the corporation's assets to be used continuously in the qualified business activities. Section 1202(e)(6) confirms that cash and investment assets reasonable required for the qualified business can be included to satisfy the 80% Test, but after two years puts a cap on the aggregate assets that can fall into these two categories to 50% of the corporation's overall assets (by value) – excess cash and investment assets would count against meeting the 80% Test. An unresolved issue is how to fit within these rules a corporation that uses funds to acquire and sell inventory and has periods where something close to 100% of the corporation's assets consist of money and investment assets.

[23] See the Scott Dolson article on the Frost Brown Todd website: "*Dealing with Excess Accumulated Earnings in a Qualified Small business – A Section 1202 Planning Guide*."

[24] The Treasury Regulations interpreting Section 199A expressly provide that they are not a tax authority that can be relied upon for purposes of interpreting Section 199A. Many practitioners believe that Section 199A's regulations are useful, however, because in many cases Section 199A relies on the same terminology as Section 1202 and in the absence of better authority, the discussion of the meaning and scope of terms such as "investing" in Section 199A's regulations at least provides some level of guidance as to how the term would be defined by a court for purposes of Section 1202.

[25] See *Higgins v. Commissioner*, 312 U.S. 212 (1941).

[26] PLR 202114002 and Chief Counsel Advice 202204007.

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[27] *John P. Owen v. Commissioner*, TC Memo 2012-21 at p. 210.

[28] See, for example, PLR 20248001.

[29] See for example, Private Letter Ruling (PLR) 202319013 and *John P. Owen v. Commissioner*, TC Memo 2012-21.

[30] The 80% Test is the requirement that issuing corporation must use at least 80% of its assets (by value) in the active conduct of qualified business activities.

[31] *John P. Owen v. Commissioner*, TC Memo 2012-21.

[32] See footnote 10.

[33] We acknowledge that the bar might be very high to establish that some retailer businesses pass the smell test. For example, a taxpayer who reinvests $5 million under Section 1045 in gold bullion and then turns over the inventory for a modest profit or loss is much more likely to be considered engaged in investing in the bullion than engaged in an active trade or business. But, of course, there are some highly credible brick and mortar jewelry and coin stores where a high percentage of the sales consist of bullion gold, platinum and silver coins. The takeaway should be that the nature of inventory may impact the analysis.

[34] See also, *Higgins v. Commissioner*, 312 U.S. 212 (1941).

[35] See for example, PLRs 20248001, 20352009, and 202242014.

[36] Treasury Regulation Section 1.355-3.

[37] Proposed Regulation Section 1.355-3(b)(2)(iii).

[38] Revenue Rulings 79-394, 1979-2 CB 141 and 80-191, 1980-2 CB 121.

[39] Guidance issued to IRS agents suggests that promoted arrangements or plans are more likely to attract economic substance review.

[40] Jasper L. Cummings, Jr. "*Corporate Liquidations*" in Tax Notes, July 31, 2017.

[41] See Treasury Regulation Section 1.346-1.

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[42] For a more in-depth discussion of investment in QSBS through "funds," see the Scott Dolson article found on the Frost Brown Todd website: "*Private Equity and Venture Capital Fund Investment in Qualified Small Business Stock (QSBS) – A Guide to Obtaining the Benefits of Sections 1202 and 1045*."

[43] See Section 1202 and Treasury Regulation Section 1.1045-1.

[44] We believe that a partner holding a profits interest should be able to share in Section 1202's gain exclusion, but there are no tax authorities other than the language of Section 1202 that expressly deal with the issue, and our position is based on a reasoned analysis, looking at a number of analogous and related tax authorities. With respect to the right of sharing in Section 1045 rollover, the reference in Section 1045 to "capital interest" most likely means that the holder of a pure profits interest on the date the partnership acquired the QSBS would not be able to elect to roll over proceeds received in the early sale of the original QSBS as that partner would not have had a "capital interest" on the acquisition date of the original QSBS.

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- Rolling QSBS Gains Under Section 1045? Don't Ignore Working Capital
- Planning for the Sale of Qualified Small Business Stock (QSBS)
- Revisiting the Choice of Entity Decision After OBBBA's 2025 Tax Law Changes | Part 1
- Exploring Section 1202's Active Business Requirement
- Substantiating the Right to Claim QSBS Tax Benefits | Part 2
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- To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)

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- Advanced Section 1202 (QSBS) Planning for S Corporations
- Finding Suitable Replacement 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 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 Staffing Companies Claim Section 1202's Gain Exclusion?
- QSBS Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, and Stock Splits Involving QSBS
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The QSBS Gain Exclusion
- A SPAC Merger Primer for Holders of Qualified Small Business Stock
- Determining the Applicable Section 1202 Exclusion Percentage When Selling QSBS
- 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
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