Substantiating the Right to Claim QSBS Tax Benefits | Part 1

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Authors:

Scott W. Dolson

Section 1202 provides an exclusion from capital gains when a stockholder sells qualified small business stock (QSBS), assuming all eligibility requirements are satisfied.[1] The One Big Beautiful Bill Act (**OBBBA**) further enhances Section 1202's benefits for QSBS issued after the July 4, 2025, date of enactment. Section 1045 provides for the tax-free rollover of gain from the sale of QSBS, where proceeds are rolled over into replacement QSBS, again assuming all eligibility requirements are satisfied. For articles discussing the benefits, requirements and planning aspects for Sections 1202 and 1045, see our QSBS & Tax Planning Services library.

The federal income tax benefits associated with claiming Section 1202's gain exclusion or rolling over QSBS sales proceeds under Section 1045 are usually significant. Excluding $10 million of capital gain when QSBS is sold translates into $2.38 million (long-term capital gains rate of 20% plus net investment income tax rate of 3.8%) of tax savings at the federal level.[2] Rolling proceeds from the sale of QSBS into replacement QSBS not only defers gain but also positions a taxpayer to claim Section 1202's gain exclusion when the replacement QSBS is transferred in a taxable sale or exchange.

Section 1202's generous gain exclusion is undoubtedly attractive. But the statute's benefits are available only if a score of complicated eligibility requirements are satisfied. Given the obvious benefits associated with qualifying for the gain exclusion, there is a risk that taxpayers might place too much reliance on uninformed advice or unsupported and undocumented statements regarding eligibility, none of which will help if there is a hefty tax bill associated with a failed return position.

The purpose of this article is to alert taxpayers to the challenges associated with substantiating a QSBS return position, along with discussing the process and methods for accomplishing that task. Part 1 breaks down the evidence required to substantiate each QSBS-related eligibility requirement. Part 2 addresses the tools available to assist taxpayers in their substantiation efforts, including

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third-party attestations, issuing corporation ("QSBS Issuer") certificates, tax opinions and tax insurance. Part 2 also discusses IRS forms and tax returns, reporting by partnerships, partner Schedule K-1s, Circular 230, relevant aspects of IRS tax practice and procedure and tax penalties.

Under the tax laws, the taxpayer, not the Government, bears the burden of proving that he falls within the clear scope of a gain exclusion. The United States Supreme Court and the Tax Court have held that exclusion from gross income must be narrowly construed. The combination of these factors escalates the importance of being prepared to clearly substantiate that a taxpayer has satisfied each and every requirement when claiming a QSBS benefit.[3]

Part 1: Substantiating return positions claiming QSBS benefits

This Part 1 focuses on substantiation of return positions claiming QSBS benefits. A number of eligibility requirements must be satisfied before a taxpayer is eligible to claim Section 1202's gain exclusion or to qualify to rollover proceeds from an investment in QSBS proceeds into replacement QSBS under Section 1045. While it isn't possible to address every fact scenario and planning issue relating to QSBS, Part I addresses each Section 1202 and Section 1045 eligibility requirement. This article is not tax advice. The elements required to substantiate satisfaction of a particular eligibility requirement will differ among corporations and taxpayers.

Keep in mind that taxpayers generally have the burden of proof in disputes with the IRS over QSBS-related return positions, and that fully substantiating QSBS-related return positions can be a significant challenge, particularly for taxpayers lacking unfettered access to corporate financial information.

Taxpayers should commence their efforts to substantiate potential future QSBS return positions before they acquire their QSBS, and those efforts should continue through and after the sale or exchange of the QSBS (if the QSBS is exchanged under Sections 351 or 368, the effort must continue with respect to the replacement

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stock). Where the recommendation in this article is to obtain documentation for a taxpayer's QSBS substantiation file (referred to as the "**QSBS File**"), taxpayers should obtain a certificate, if possible, from the QSBS Issuer's management confirming each relevant corporate-level fact, along with confirmation that each of the documents, returns and financial statements provided were true, correct and complete copies. If a taxpayer holds QSBS through a partnership (fund), the taxpayer should obtain, if possible, a certificate from fund management. [4]

A recent case highlights how a taxpayer's failure to adequately substantiate the satisfaction of an element of a single eligibility requirement can result in a failed QSBS-related return position.[5] The taxpayer in *JU v. U.S.* acquired stock in 2003, but introduced into evidence only financial information for the 2009-2011 period. The IRS successfully argued that the financial records from 2009 to 2011 were not "credible evidence" of the corporation's aggregate gross assets six years earlier. The court noted that "*as a threshold matter [a] plaintiff has the burden of proving that a section of the Internal Revenue Code applies to him, before he is able to benefit from its provisions*."[6] In spite of the fact that the "aggregate gross assets" of the QSBS Issuer were only $2.15 million in 2009, the court concluded that the taxpayer had failed to provide sufficient evidence that the corporation's aggregate gross assets were less than $50 million in 2003. What can be inferred from the *JU* decision is that it only takes the failure to substantiate one element of a single eligibility requirement for a court to reject a taxpayer's QSBS return position.

A review of the Tax Court's earlier decision in *Holmes v. Commissioner*[7] further drives home the need to provide credible substantiation of every QSBS-related eligibility requirement. In *Holmes*, Ralph Holmes made a Section 1045 election on his return to roll over proceeds from the sale of an original QSBS investment into replacement QSBS issued by LeonardoMD, Inc. Holmes's substantiation for his position appears to have been based almost entirely on his testimony, which was found by the Tax Court to lack credibility.

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Petitioner has proffered no evidence beyond his own uncorroborated testimony to establish that he acquired LeonardoMD stock at its original issue. 'Original issue' is defined as the 'first issue of securities of a particular type or series.' Black's Law Dictionary 908 (9th ed. 2009). At trial, petitioner first testified that he purchased shares of LeonardoMD stock over time 'from the president and his—up till 2005. I purchased them from the president and his accountant at the company, at LeonardoMD.' That testimony appears to contradict his later testimony that he invested directly in the company and never bought stock from someone else. In any event, petitioner offered no documentary evidence, such as stock certificates or book entries from the corporation, indicating from whom he acquired the stock on each of the 36 stipulated purchase dates. He further failed to submit evidence showing that on each of those 36 purchase dates, he purchased any of the original issue of that stock type or series. We cannot (and do not) find that petitioner acquired LeonardoMD stock at its original issue; petitioner has failed to carry his burden of proof on that point.

We similarly cannot find that LeonardoMD was a qualified small business on the days on which he purchased its stock. As stated supra, in relevant part, a 'qualified small business' is any domestic C corporation if: (1) its aggregate gross assets did not exceed $50 million before the issuance, and (2) its aggregate gross assets immediately after the issuance (taking into account amounts received in the issuance) does not exceed $50 million. Sec. 1202(d)(1)(A) and (B). To prove that LeonardoMD's aggregate gross assets did not exceed that statutory ceiling, petitioner relies solely on his highly general testimony, the entirety of which is as follows:

Q: Have the gross assets of LeonardoMD ever exceeded $50 million?

A: No.

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Petitioner purchased shares of LeonardoMD stock on 36 separate dates between January 4, 2002, and July 27, 2004. Yet he made no attempt to introduce balance sheets or other financial statements showing the amount of cash and property held by the corporation before and immediately after each of those dates or at any time during the corporation's existence.

To lend credence to his purported knowledge of LeonardoMD's finances, petitioner testified that, since taking on executive responsibilities in 2005 (after the years in issue), he has looked at its corporate financial documents. Absent corroborating documentary evidence, we need not, and do not, conclude, solely on the basis of petitioner's self-serving testimony, that LeonardoMD's aggregate gross assets did not exceed $50 million on the days he received its stock. See Broz v. Commissioner, 137 T.C. 46, 59 (2011) ('We need not accept the taxpayer's self-serving testimony when the taxpayer fails to present corroborative evidence.'). Petitioner has failed to satisfy his burden of proving that LeonardoMD constituted a qualified small business on the purchase dates.

Finally, petitioner failed to prove that LeonardoMD met the active business requirements of section 1202(e) during substantially all of his holding period for its stock. In support of his position, petitioner again relies on his own testimony, the entirety of which is as follows:

Q: Does [LeonardoMD] have investment assets?

A: No investment assets. All of the revenue is used in its business.

The record is again devoid of documentary evidence showing the amount of corporate assets owned during the years in which he held the stock and the amount of those assets used in its business of providing on demand physician practice management software. In fact, the only evidence in the record concerning LeonardoMD's business is a stipulated paragraph describing its business as "providing on demand physician practice management software delivered over the Web", and

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petitioner's above-cited testimony. We cannot, on the basis of uncorroborated testimony and a stipulation that does not rule out inactive business assets and income, reasonably conclude that petitioner met his burden of proving that, during substantially all of his holding period for LeonardoMD stock, the corporation used at least 80% of its assets in the active conduct of one or more qualified trades or businesses.

Petitioner has failed to prove that the LeonardoMD stock that he purchased between January 4, 2002, and July 27, 2004, constituted qualified small business stock within the meaning of section 1202(c).

After reading the Tax Court's discussion of Holmes efforts to substantiate his return position, the best that can be said is, don't be that guy! Obviously, the Tax Court expects taxpayers to provide more than uncorroborated and unconvincing testimony to substantiate satisfaction of QSBS eligibility requirements. The IRS argued for a 75% civil fraud penalty. The Tax Court ultimately did not impose the civil fraud penalty, but the IRS was successful in arguing for a 20% substantial understatement penalty. **A takeaway from the *Ju* and *Holmes* decisions is that when taxpayers takes QSBS-related positions, it is critical that they are fully prepared to provide both sufficient and credible substantiation of each element of every eligibility requirement.**

Statutory requirement that taxpayers retain relevant records

Section 6001 requires taxpayers to keep records, make statements and submit returns in compliance with the Treasury's rules and regulations. Treasury Regulation Section 1.6001-1(a) requires that taxpayers required to file a return, which would include any taxpayer claiming a QSBS benefit, "*shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.*" Treasury Regulation Section 1.6001-1(e) provides that "*the books and records required by this section shall*

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be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained for so long as the contents thereof may become material in the administration of any internal revenue law." The bottom line is that for taxpayers seeking to claim Section 1202's gain exclusion or make a Section 1045 election, it is necessary that those taxpayers compile and retain all of the records necessary to substantiate the claimed tax benefits. This could mean that a taxpayer who acquired QSBS in 1995 would need to include in the taxpayer's QSBS File the documents relating to the purchase of the QSBS but also records that would confirm substantiation of the corporate-level eligibility requirements for the period 1995 through the sale date, which could be 30 years later, including satisfaction of the 80% Test and the other requirements associated with meeting the "active business requirement" required by Section 1202(c)(2). As discussed elsewhere in this article, taxpayers have the general burden of proof when claiming a tax benefit, including Section 1202's gain exclusion. If a taxpayer is unable to produce during a tax audit sufficient records to substantiate satisfaction of each of Section 1202's or Section 1045's eligibility requirements, then the burden is likely to fall on the taxpayer to run down those records and produce them in the litigation process. If the taxpayer is unable to produce documents or other evidence necessary to substantiate a return position, then the *JU v U.S.* case discussed above is an example of where the court stripped the gain exclusion from the taxpayer.

There are some basic steps that taxpayers should take to position themselves to substantiate their right to claim QSBS-related tax benefits. The following list covers some of these steps but is by no means intended to be comprehensive as facts will differ among QSBS investments:

- The QSBS File should include QSBS Issuer organizational and governing documents, any other background information relevant to substantiating qualification for QSBS benefits, and if applicable, any attestations, tax opinions, QSBS Issuer certificates and other documentation mentioned in this article.

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- The QSBS File should include copies of QSBS Issuer's Form 1120 tax returns and financial statements, particularly for the year of QSBS issuance, but ideally also for each year during which the taxpayer held QSBS.
- The QSBS File should include copies of each relevant taxpayer tax return.
- The QSBS File should include documentation relating to the issuance of the QSBS for money, property or services, establishing when the QSBS was issued and for what consideration, including subscription, property contribution and/or incentive compensation plans and stock grant agreement. When the QSBS Issuer is using Carta, the stockholder (taxpayer) should confirm that Carta has complete and accurate information regarding the stockholder's stock issuance and holdings. Carta relies on the QSBS Issuer uploading information into Carta's database to provide complete and accurate information. Carta's information is only as good as what is provided by the QSBS Issuer.
- If QSBS was issued in connection with exercise of options or warrants, SAFE or convertible debt conversions or otherwise, copies of all relevant documentation should be included in the QSBS File.
- If QSBS was received as a gift, at death or as a distribution from a partnership to partner, the QSBS File should include all relevant transfer documentation.
- If QSBS was issued to a service provider and was restricted, the QSBS File should include documentation relating to the issuance of the QSBS, and if applicable, evidence that the Section 83(b) election was filed with and receipt acknowledged by the IRS.
- Note that if the QSBS Issuer uses Carta to manage its capitalization table, Carta's information will generally include the restrictions applicable to a stockholder's shares that functions as the virtual legend on a stock certificate, a statement as to whether the stockholder's shares have "vested," and a copy of the completed and signed Section

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83(b) election. But Carta's documentation generally does not include confirmation that the Section 83(b) election was timely filed by the stockholder with the IRS, or evidence of IRS receipt of the election or any IRS confirmation of receipt. The stockholder (i.e., not the QSBS Issuer) is responsible for making sure that the Section 83(b) election is properly completed and filed on a timely basis. The IRS has issued Form 15620 that can be used as the template for making the Section 83(b) election. The stockholder should also include all documentation relating to the Section 83(b) election filing in the taxpayer's QSBS File, along with documentation that any required money payment for the stock issuance was, in fact, paid by the stockholder to the QSBS Issuer and received by the QSBS Issuer. Note that Carta indicates what payment is required, e.g., an aggregate amount based on a $0.0001 per share subscription amount, but doesn't include confirmation of stockholder payment of the subscription amount or confirmation of the QSBS Issuer's receipt of such payment. The importance of these details is magnified when substantiation of QSBS eligibility is at stake. Stockholders and the QSBS Issuer's management, not Carta, are responsible for ensuring that accurate and complete information is loaded into the Carta database.

- If QSBS is owned indirectly through a partnership, the QSBS File should include whatever substantiation was obtained by the partnership from the QSBS Issuer regarding QSBS eligibility, and also should include, if possible, a certificate from the partnership addressing each eligibility requirement applicable at the partnership level (e.g., that the partnership did not establish an "offsetting short position" with respect to its QSBS holdings). If the partnership obtained any certificate or other relevant documentation of QSBS eligibility, the taxpayer should include, if possible, copies of those items in the QSBS File.
- The QSBS File should include documentation relating to any recapitalization or other event during the taxpayer's holding period that affected the QSBS, such as stock splits, tax-free reorganizations or any transaction involving the exchange of

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the QSBS for other stock.

- The QSBS File should include documentation relating to any sale or exchange of the taxpayer's QSBS.
- The QSBS File should include a certificate from the QSBS Issuer, if possible, addressing each QSBS Issuer-level eligibility requirements.
- Where the taxpayer is holding replacement QSBS issued in connection with a Section 1045 election and is claiming Section 1202's gain exclusion, the QSBS File should include substantiation of eligibility requirements associated with the original QSBS, the Section 1045 rollover into replacement QSBS and the replacement QSBS.

Each QSBS-related eligibility requirement is summarized below, along with suggested best practices for substantiating satisfaction of the requirement.

A. Is the taxpayer an eligible stockholder?

Individuals, trusts, S corporations and partnerships are all eligible to claim Section 1202's gain exclusion. C corporations are not eligible to claim Section 1202's gain exclusion. QSBS held by a grantor trust is treated for federal income tax purposes as if the trust assets remain owned by the grantor. A non-grantor trust files its own tax return and is generally eligible to claim Section 1202's gain exclusion as a separate taxpayer. "Flow-thru" entities such as partnerships and S corporations can own QSBS and Section 1202 and the Section 1045 regulations provide rules addressing the amount of QSBS-related tax benefits available under Sections 1202 and 1045 to equity owners. QSBS held by a disregarded entity (usually a single-member LLC) for federal income tax purposes is treated as being held by the entity's owner. LLCs and limited partnerships taxed as partnerships for federal income tax purposes are referred to as "**Partnerships.**"

Substantiation. Most holders of QSBS are individuals, grantor trusts (ignored for federal income tax purposes), non-grantor trusts, Partnerships or disregarded entities (usually single-member LLCs). Copies of taxpayer tax returns should provide sufficient

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substantiation of federal income tax status. If QSBS is held by a Partnership, equity owners will claim Section 1202's gain exclusion as an offset against capital gain passed through on a Schedule K-1. [8] Each equity owner must be ready to substantiate eligibility, which will require obtaining information regarding qualification from both the QSBS Issuer and the Partnership that owned and sold the QSBS. Investors should obtain assurances ***prior to*** investing that the Partnership will cooperate by providing necessary representations and documentation confirming that (i) the fund was a partnership for federal tax purposes throughout the investor's QSBS holding period, (ii) confirming the investor's economic interest in the Partnership was held when the QSBS was purchased and was held throughout the applicable QSBS holding period (including addressing any changes in the investor's economic rights), and (iii) confirming the Partnership's commitment to obtain all necessary documentation that the QSBS Issuer met all of the applicable Section 1202 eligibility requirements.

B. Is the purported QSBS "stock" for federal income tax purposes?

Only equity that is "stock" can qualify as QSBS. Voting and nonvoting common and preferred stock can qualify as "stock." Section 1202's holding period commences only when a stockholder holds equity that qualifies as "stock" for federal income tax purposes. Stock issued to service providers that is "restricted" stock under Section 83 is not treated as owned by the stockholder until the restrictions lapse, **unless a Section 83(b) election was timely made**.[9] Restricted stock units (RSUs), phantom stock, stock appreciation rights, convertible debt and non-qualified stock options stock rights are not "stock." SAFE instruments may qualify as equity for federal income tax purposes, but stockholders take that position at their own risk as the IRS may assert that the SAFE is a non-stock hybrid instrument for federal income tax purposes.

With respect to LLCs taxed as corporations, Treasury Regulation Section 301.7701-3(g)(1)(i) provides that:

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[i]f an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

Based on Treasury Regulation Section 301.7701-3(g)(1)(i), membership interests issued by an LLC that "checks the box" to be taxed as a C corporation by filing IRS Form 8832 (Entity Classification Election) should be treated as "stock" for federal income tax purposes, including Section 1202.

Substantiation. Documentation evidencing the issuance of stock, the consideration paid for the stock and confirmation of the date of stock issuance should be included in the QSBS File. If the stock was "restricted" at the time of issuance, then a copy of the plan and award agreements, the Section 83(b) election (if made) and the stockholder's return for the year of issuance should be included in the QSBS File. If QSBS was issued upon the conversion of options, SAFE instruments, convertible debt or RSUs, documentation should be included in the QSBS File relating to the issuance of the QSBS, including confirming the date of issuance. If a taxpayer intends to take the position that a SAFE instrument was "stock" when issued, then compiling evidence supporting the equity status of the SAFE instrument and including relevant documentation and background information in the QSBS File is critical, as is obtaining tax advice about what information should be included in the QSBS File. Also, taxpayers should obtain tax advice before taking the return position that a SAFE instrument qualifies as "stock" for Section 1202 purposes. Finally, if a Partnership is converted to a C corporation, then documentation of the conversion should be included in the QSBS File.

If a Section 83(b) election is made, it is important that the election be made on a timely basis and that the QSBS File includes records evidencing the timing filing of the properly completed election. If the QSBS Issuer filed a "check-the-box" election, a copy of that election and corporate Form 1120 returns should be included in the

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QSBS File.

C. Was the QSBS issued for money, property (other than stock) or services?

In order for stock to qualify as QSBS, a taxpayer must have acquired the stock as an original issuance by the QSBS Issuer in exchange for money, property (not including stock) or services, with limited exceptions (e.g., pursuant to Section 1202(h)(2)), as a gift for income tax purposes, at death, as a distribution from a partnership to a partner, or an exchange governed by Sections 351 or 368 (see Section 1202(h)(4)).

Substantiation. If QSBS is issued for money, the QSBS File should include documentation confirming that the stock was issued for money, along with documentation that the subscription amount was actually paid, even if the payment is $0.0001 per share for founder common stock. Ideally, founders would report the issuance of founder common stock on their individual return, even if they indicate zero compensation (i.e., taking the position that founder stock has *de minimis* ($0.0001 per share) value when issued), but founder stock is reported as compensation on individual tax returns. If QSBS is issued for property, the QSBS File should include complete documentation of the contribution and stock issued, and a contemporaneous third-party valuation is recommended to confirm the fair market value of the contributed property if it had any significant value at the time of contribution. Any valuation report and background documentation and information should be included in the QSBS File.[10] The issuance of QSBS in exchange for services should be fully documented and reported on the taxpayer's individual return, even where the value of the service provider stock is *de minimis* at the time of issuance. Copies of the relevant documentation should be included in the QSBS File. If the QSBS is "restricted," a Section 83(b) election should be timely filed in order to start the holding period running, and a copy of the election and related confirmation of receipt by the IRS should be included in the QSBS File.

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If a taxpayer acquired QSBS as a gift (including transfers between spouses and from a grantor to non-grantor trust), the transfer should be properly documented, and if necessary, properly reported on a gift tax return. A full set of the relevant documentation of any gift should be included in the QSBS File. If a taxpayer exchanged QSBS for other stock (QSBS or non-QSBS) in a Section 351 non-recognition exchange or Section 368 tax-free reorganization, the taxpayer should include a full set of the transaction documents in the QSBS File, and if possible, obtain representations from the parties that the tax treatment of the exchanges fell within the scope of Sections 351 or 368.

D. Does the taxpayer's QSBS have a holding period exceeding five years?

For QSBS issued prior to July 5, 2025, a taxpayer is eligible to claim Section 1202's gain exclusion upon the sale or exchange of QSBS if the taxpayer's holding period exceeds five years. The required holding period for a taxpayer's QSBS is six months if the taxpayer intends to make a Section 1045. For QSBS issued after July 4, 2025, the following applies with respect to claiming Section 1202's gain exclusion:

Holding Period	Applicable Exclusion %	Estimated Federal Income Tax Savings[11]
3 years	50%	($119,000 tax savings per $1 million of gain)
4 years	75%	($178,500 tax saving per $1 million of gain)
5 years or more	100%	($238,000 tax saving per $1 million of gain)

Typically, it isn't difficult to track the holding period for QSBS and include documentation in the QSBS File establishing when the stock was originally issued. If QSBS is issued as a result of a conversion or exercise right, then the issuance date would generally be the date the stock was issued. Section 1202(i)(1)(A) provides that the holding period for QSBS issued when a taxpayer transfers property to the QSBS Issuer commences on the date the property was exchanged

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for QSBS. Section 1202(h)(1)(B) provides that if QSBS is exchanged for other QSBS (or non-QSBS) under Sections 351 or 368, the holding period for the original QSBS is tacked onto the holding period for the stock issued in the exchange. Section 1202(f) provides that the holding period of stock issued upon conversion of other stock (e.g., when convertible preferred converts into common stock) includes the holding period for the original stock. If stock is purchased as replacement QSBS under Section 1045, the holding period for the replacement QSBS is deemed to start when the original QSBS was issued. The period between the sale of the original QSBS and the purchase of the replacement QSBS would not be included in the stock's holding period.

Substantiation. Typically, including documentation of the stock's original issuance in the QSBS File should be sufficient. If QSBS was transferred as a gift, upon death or distributed from a partnership to a partner, documentation establishing when the QSBS was originally issued and detailing the transfer should be obtained for the QSBS File. Documentation relating to the issuance of the original QSBS should be included in the QSBS File if the stock was issued as a result of a conversion governed by Section 1202(f) or an exchange governed by Section 1202(h). If replacement QSBS was issued under Section 1045, documentation of when the original QSBS was issued and documentation of the issuance of the replacement QSBS should be obtained for the QSBS File. Likewise, if there is an exchange of stock for stock, documentation of the original issuance and the tax-free exchange should be obtained for the QSBS File.

There are closings of QSBS sales where taxpayers fall short of satisfying Section 1202's five-year+ holding period requirement by months or weeks. Although it is typical when corporations are organized to issue founder stock as of the date of the corporation's incorporation, there are situations where the drafting and dating of the corporation's organizational documents lag weeks or months behind the actual start-up date for the corporation. Normally, this doesn't have any consequences. ***But when QSBS is involved, careful attention should be paid to completing the corporation's organization and issuance of founder stock, including the dating of subscription and stock issuance***

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documentation, as of the date the corporation commenced activities. This approach would also apply to QSBS issued for property contributions or services – be aware of the importance of properly completing subscription and stock issuance documents and the dating of those documents and instruments. If the QSBS Issuer uses Carta, make sure the correct issuance dates and documentation is included in Carta's records.

E. Was the QSBS transferred in a taxable sale or exchange (which includes some redemptions, partial liquidations and distributions pursuant to a plan of complete liquidation)?

Many transactions are straightforward and clearly qualifying for taxable sale or exchange treatment. Transactions triggering sale treatment might include receipt of money and/or buyer equity, and payments might be made on the installment basis under Section 453. Exchanges of QSBS for a partnership interest governed by Section 721 are non-taxable exchanges but neither the partnership interest received in the exchange nor the contributed stock will thereafter qualify for Section 1202's gain exclusion. Recapitalizations and M&A transaction need to be carefully vetted for their effect on QSBS status and whether the structure maximizes Section 1202's benefits.

Substantiation. Taxpayers should include documentation in the QSBS File relating to the applicable sale or exchange transaction, and obtain, if possible, representations from the parties that the parties will treat and report the transaction as a taxable sale or exchange. If the transaction was a partial redemption of the taxpayer's QSBS, documentation should be included in the QSBS File relating to the partial redemption, including board actions and applicable corporate tax return. If the transaction is a redemption, the QSBS File should include documentation of the redemption transaction and the taxpayer should obtain, if possible, representations supporting the conclusion that the redemption should be treated as a taxable exchange under Section 302 rather than a dividend distribution.

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If QSBS is exchanged for non-QSBS in a Section 351 or 368 transaction falling within the scope of Section 1202(h)(4), evidence of the value of the QSBS transferred in the exchange should be included in the QSBS File. Participants in transactions governed by Section 351 and Section 368 are required to include statements with their tax returns providing information about the transactions, and copies of those statements should be included in the QSBS File. If QSBS is exchanged under Sections 351 or 368 for other QSBS, later claiming Section 1202's gain exclusion will require substantiation that (i) the original stock was QSBS, (ii) the exchange was governed by Sections 351 or 368, and (iii) proving the replacement stock was QSBS when sold or exchanged. Evidence establishing that each of these requirements was satisfied should be included in the QSBS File. Copies of transaction documents and relevant corporate tax returns should be included in the QSBS File.

F. Did the taxpayer or a related person establish any offsetting short positions?

Section 1202(j) provides that no "offsetting short position" can be established for QSBS during the first five years of a stockholder's holding period for QSBS by the stockholder or any person who is related (within the meaning of Sections 267(b) or 707(b)) to the stockholder.

An "offsetting short position" is defined to mean any of the following: (i) where the stockholder has made a short sale of substantially identical property; (ii) where the taxpayer has acquired an option to sell substantially identical property at a fixed price; or (iii) the taxpayer has entered into any other transaction which substantially reduces the risk of loss from holding the QSBS. In the absence of the enactment of Treasury Regulations interpreting Section 1202, it isn't clear that item (iii) would be deemed applicable by the Tax Court, and if it is deemed applicable, how to define the scope of that further extension of the short sale limitation. Establishment of an "offsetting short position" results in terminating the QSBS status of the affected stock. If an offsetting short position is established by a stockholder with a five-year holding period, Section 1202's gain exclusion would no longer apply

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unless the stockholder elects to recognize gain as if the QSBS were sold for its fair market value on the date the offsetting short position was established.

Substantiation. The main challenge is understanding what might be considered to qualify as an "offsetting short position," and avoiding falling into that trap. Evidence supporting the position that no offsetting short positions were established most likely would involve taxpayer testimony and a certificate from a fund (LLC/LP) indicating that the fund did not establish any "offsetting short position" if the applicable QSBS was owned through the fund.

G. Did any redemptions occur that would trigger the application of Section 1202's "anti-churning" rule?

Redemptions from the stockholder or related persons. Stock issued to a particular stockholder, or a person who is related that stockholder, may not qualify as QSBS if the QSBS Issuer redeems, directly or indirectly, any of such stockholder's or related person's stock during the four-year period beginning on the date two years before the issuance of the applicable shares.

Significant redemptions. Stock may not qualify as QSBS if the QSBS Issuer redeems, during the two-year period beginning on the date one year before the issuance of the applicable stock, stock with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of the QSBS Issuer's stock as of the beginning of such two-year period.

Treasury Regulation exceptions to the "anti-churning" rule. Treasury Regulation Section 1.1202-2 provides that the redemption of shares issued in connection with the performance of services as an employee or director does not constitute a "significant redemption" for Section 1202 purposes if the redemption of such shares was incident to a bona fide termination of the redeemed stockholder's services as an employee or director. There is also an exception for redemptions involving the payment of *de minimis* redemption consideration.

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Substantiation. This eligibility requirement is another circumstance where it is difficult to prove a negative other than by testimonial evidence and a certificate from the QSBS Issuer confirming that either no redemptions were made during the two year period commencing one year prior to the issuance of the taxpayer's QSBS, or if redemption(s) occurred, then sufficient details and documentary evidence should be included in the QSBS File that confirms the redemption(s) fits within one of the exceptions referenced in Treasury Regulation Section 1.1202-2 (e.g., a redemption triggered by the termination of employment). Footnotes to financial statements often reference redemptions and copies of the QSBS Issuer's financials statements should be included in the QSBS File

H. Was the QSBS Issuer a domestic (US) C corporation: (1) when the QSBS was issued, (2) when the QSBS was sold or exchanged, and (3) for substantially all of the taxpayer's QSBS holding period?

The QSBS Issuer must be a domestic (US) C corporation when the QSBS is issued, when the QSBS is sold or exchanged, and for substantially all of the taxpayer's holding period for the applicable QSBS. While Section 1202 is clear that the QSBS Issuer must itself be a domestic (US) C corporation, the statute does not require a corporate subsidiary to be a domestic (US) corporation or include any requirement that assets be located within the United States. Unless or until there is clear guidance in tax authorities addressing the location of subsidiaries and/or assets, a reasonable assumption is that there are no requirements beyond the requirement that the QSBS Issuer itself be a domestic (US) corporation. Finally, the provisions in Section 1202 that allow for an exchange of QSBS for non-QSBS in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization opens the door for the potential exchange of the QSBS of a domestic (US) QSBS Issuer for stock of a non-domestic corporation.

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Substantiation. A taxpayer should obtain, if possible, copies of the QSBS Issuer's Form 1120 tax returns spanning the applicable QSBS holding period and include the documentation in the QSBS File, along with a representation confirming that the QSBS Issuer was a domestic (US) C corporation throughout a taxpayer's QSBS holding period. Additional documentation to include in the QSBS File might include sale documentation or financial statements referencing the domestic (US) C corporation status of the QSBS Issuer. Also, information on the state Secretary of State website provides additional support that the QSBS Issuer was a domestic (US) corporation during the applicable period. If the QSBS Issuer is an LLC that "checked the box" to be taxed as a corporation, copies of the Form 8832 election and corporate Form 1120 tax returns should be included in the QSBS File.

I. Was the QSBS Issuer ever a domestic international sales corporation (DISC) or former DISC, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit (REMIC) or a cooperative?

The QSBS Issuer must not have been a domestic international sales corporation (DISC) or former DISC, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit (REMIC) or a cooperative. Section 1202 is silent regarding whether this rule would also apply to a corporate subsidiary of the QSBS Issuer.

Substantiation. Copies of the QSBS Issuer's Form 1120 tax returns spanning the applicable QSBS holding period should, if possible, be included for the QSBS File, and representations should be obtained confirming that the QSBS Issuer's tax status and that of its corporate subsidiaries, did not fall within the scope of the excluded classifications during the taxpayer's QSBS holding period.

J. Did the QSBS Issuer's consolidated group have more than $50 million in "aggregate gross assets"

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at any time prior to the issuance of the applicable QSBS or immediately after the issuance of the applicable QSBS, taking into account the cash or property paid for the QSBS?

The "$50 Million Test" focuses on whether the QSBS Issuer, and any parent corporation or subsidiaries that must be consolidated with the QSBS Issuer under Section 1202's rules, had "aggregate gross assets" exceeding $50 million at any time prior to the issuance of the stock being tested for QSBS status, or immediately after the issuance of the stock, taking into account any consideration in cash or property paid for the stock (which generally would include any consideration paid to the QSBS Issuer for other stock included in the same issuance). Once the $50 Million Test is satisfied with respect to a particular issuance of QSBS, the fact that the QSBS Issuer aggregate gross assets subsequently exceed $50 million does not affect the status of previously issued QSBS. But once a QSBS Issuer fails the $50 Million Test, no additional QSBS can be issued by that QSBS Issuer.

Section 1202(d)(2) defines "aggregate gross assets" as the amount of cash and the aggregate adjusted basis of other property held by the QSBS Issuer; provided, however, that if property has been contributed to the QSBS Issuer in a Section 351 nonrecognition exchange, a Section 368 tax-free reorganization, or a capital contribution governed by Sections 118 and 362, the property goes onto the QSBS Issuer's tax books for purposes of the $50 Million Test as if the aggregate tax basis of the contributed property was its fair market value.

Section 1202(d) includes the value of the assets of any majority owned corporate subsidiary and/or parent corporation (C or S corporation stockholder) that must be consolidated with those of the issuing stockholder in the aggregate gross assets calculation.

Substantiation. Taxpayers must be prepared to prove that not only did the QSBS Issuer's "aggregate gross assets" not exceed $50 million, taking into account the consideration paid for the issuance of stock at issue, but also that the QSBS Issuer's "aggregate gross

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assets" did not exceed $50 million at any time prior to the issuance. Therefore, taxpayers must have financial information associated with the issuance of the stock in question, showing what the "aggregate gross assets" were immediately after the issuance, which can be straightforward or complicated if there is a question about what stock should be included in the immediately after the issuance determination. Also, the taxpayer must have financial information for all of the years prior to the issuance back to 1993, showing that at no point did the "aggregate gross assets" exceed $50 million. And the taxpayer must be able to provide sufficient evidence that no appreciated assets were contributed to the QSBS Issuer in the past in a nonrecognition contribution under Sections 118, 351 or 368 that would have pushed the "aggregate gross assets" over $50 million with those assets valued at fair market value. How contributed property is valued in subsequent $50 million test calculations remains an unresolved issue.

As noted above, *JU v. Commissioner* highlights how a taxpayer's failure to adequately substantiate satisfaction of an eligibility test will result in failure. The taxpayer in *JU* acquired stock in 2003 but only had financial information for the 2009-2011 period. In spite of the fact that the "aggregate gross assets" of the QSBS Issuer were only $2.15 million in 2009, the court concluded that the taxpayer had failed to provide sufficient evidence that the corporation's aggregate gross assets were less than $50 million because the taxpayer failed to introduce into evidence financial information for 2003. The IRS successfully argued that the financial records from 2009 to 2011 were not "credible evidence" of the corporations aggregate gross assets six years earlier. The court noted that "*as a threshold matter [a] plaintiff has the burden of proving that a section of the Internal Revenue Code applies to him, before he is able to benefit from its provisions.*"[12]

A taxpayer's QSBS File should include evidence confirming whether any parent corporation or subsidiaries would need to be consolidated with the QSBS issuer and whether any assets were contributed into the QSBS Issuer on a tax-free basis that would need to be valued at fair market value. The taxpayer should include, if possible, copies of financial statements and tax returns in the

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QSBS File, and obtain representations from knowledgeable members of the management team addressing the various factual elements that go into determining whether the $50 Million Test was passed, all of which should be included in the taxpayer's QSBS File. If there is a parent corporation or subsidiary, a certificate and associated financial information that helps to consolidate the "aggregate gross assets" of the group will need to be included in the QSBS File. The fair market value of assets contributed in a tax-free transaction would need to be determined, with the evidence included in the QSBS File. An independent third-party appraisal of the fair market value of the contributed assets would be the best evidence of fair market value for purposes of both the 10X gain exclusion cap and to substantiate that the QSBS Issuer's "aggregate gross assets" were less than $50 million immediately after the property contribution.

K. Were at least 80% (by value) of the QSBS Issuer's assets used in the operation of qualified trade or business activities during the taxpayer's QSBS holding period?

Section 1202(e)(3) provides that a taxpayer's stock is QSBS only if the QSBS Issuer satisfies the "active business requirement" during substantially of the taxpayer's holding period for the applicable QSBS. The most critical requirement of Section 1202(e)(3) is that the QSBS Issuer must use at least 80% (by value) of the QSBS Issuer's assets in one or more qualified business activities (the "**80% Test**"). Section 1202(e)(3) provides that the term "qualified trade or business" means any trade or business other than –

> (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,

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(B) any banking, insurance, financing, leasing, investing, or similar business,

(C) any farming business (including the business of raising or harvesting trees),

(D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and

(E) any business of operating a hotel, motel, restaurant, or similar business.

Also, Section 1202(e)(7) provides that 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)(5) provides a look-thru to the activities of a greater than 50% owned corporate subsidiary. Section 1202 is silent regarding whether there is a look-thru to the activities of joint ventures (LLC/LPs) or if so, the percentage ownership required.

Section 1202(e)(6) provides that assets which:

(A) are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or (B) are held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business, shall be treated as used in the active conduct of a qualified trade or business.

Section 1202(e)(6) provides that after the first two years of a company's existence, no more than 50% of a company's assets (by value) can consist of cash and investment assets held for the future working capital needs of the company and still qualify towards satisfying the 80% Test.

Section 1202(e)(2) provides that the QSBS Issuer's assets used in the following activities count towards satisfying the 80% Test if they are anticipated to lead to engaging in qualified business activities: (i) engaging in start-up activities described in Section 195(c)(1)(A), (ii) activities resulting in the payment or incurring of

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expenditures which may be treated as research and experimental expenditures under Section 174, or (iii) activities with respect to in-house research expenses described in Section 41(b)(4).[13] Section 195(c)(1)(A) includes within its scope activities associated with investigating the creation or acquisition of an active trade or business, creating an active trade or business, or 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. In connection determining whether a corporation has actively conducted start-up or R&D activities, Section 1202(e)(32) provides that "*[a]ny determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination*."

Finally, Section 1202(e)(8) provides that "*rights to computer software which produces active business computer software royalties (with the meaning of section 543(d)(1)) shall be treated as an asset used in the active conduct of a trade or business*."

Substantiation. A taxpayer must be able to establish that the QSBS Issuer engaged during the taxpayer's QSBS holding period in one or more activities that were either (i) qualified business activities, or (ii) activities falling within the scope of Section 1202(e)(2) that were undertaken with the intent to develop into qualified business activities. Whether the activities of the QSBS Issuer are among the excluded activities listed above depends on a reasoned analysis of the facts within the framework of tax authorities that help to define the scope of what constitutes engaging, for example, in the "*performance of services in the field of health*" or what constitutes the business of operating a restaurant. If the QSBS Issuer has a majority owned subsidiary or interests in joint ventures, the activities of those affiliates would need to be included in the analysis.

The 80% Test analysis can be relatively straightforward if all of the QSBS Issuer's assets are directed towards undertaking one activity and that activity is clearly qualified (e.g., a single-activity life sciences company, software startup, or manufacturer or distributor). Where it can become more complicated is where the

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QSBS Issuer has engaged in both qualified and non-qualified activities, and/or engages in qualified activities, and owns real property not used in the business, minority interests in corporations, has money or has investment assets that don't qualify as acceptable working capital under Section 1202(e)(6). What further complicates the gathering of evidence that the 80% Test has been satisfied is that it is an ongoing test that applies throughout a taxpayer's QSBS holding period.

How the activities of the QSBS Issuer should be documented depends on the nature of those activities. First, a taxpayer should endeavor to obtain sufficient evidence of the nature and evolution of the QSBS Issuer's activities over the applicable QSBS holding period. In many cases, it is possible to paint a picture of a company's activities through on-line resources, supplemented by information obtained from the business (e.g., investor decks, business plans), corporate tax returns, financial statements, and representations from key management personnel might help establish that the company satisfied the 80% Test on an ongoing basis through the taxpayer's QSBS holding period. The additional evidence and documentation of the QSBS Issuer's assets, asset values, working capital needs and the allocation of assets among qualified and excluded activities that might be required to establish that the 80% Test will differ dramatically among companies. In some instances, it may be necessary to value both the assets used in the qualified business activities and those that fall into the "excluded" category (e.g., non-working capital cash, investment assets that don't qualify as invested working capital, assets used in excluded activities, real estate assets not used in the qualified business), and in some cases, substantiation may require obtaining professional appraisals. All relevant documentation should be obtained for the QSBS File.

Where the QSBS Issuer engaged in start-up and/or research and development activities, the taxpayer will need to provide support for the conclusion that if the start-up and/or R&D activities were successful, and the business activities reached the commercial stage, that the products and services of the corporation would fall into the category of a qualified trade or business.

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Taxpayers should be prepared to substantiate with contemporaneous records that the active conduct requirement was met by virtue of the corporation engaging "*regularly, continually, extensively, actively and substantially*" in whatever activities are involves, whether those activities are start-up, research and development or the commercialization and marketing of products and services, or a combination of those activities. Taxpayers should expect that the bar will be higher from a credibility and substantiation standpoint if the QSBS Issuer's board of directors made the determination to cease operations and adopt a plan of complete liquidation, with its stockholder claiming Section 1202's gain exclusion in connection with the taxable exchange of stock for liquidation proceeds.

L. Did the QSBS Issuer hold corporate stock or securities with an aggregate value exceeding 10% of the value of all of the QSBS Issuer's assets (in excess of liabilities)?

Section 1202(e)(5)(B) provides a corporation will not meet the active business requirement for any period during which more than 10% of the value of the corporation's assets (in excess of liabilities) consists of stock or securities in other corporation, with the exceptions addressed in this next sentence. Section 1202(e)(5) excludes from the scope of "corporate stock or securities" (i) stock or securities of a subsidiary which is defined as being a more than 50% owned corporation, and (ii) stock being held for investment and which is reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increase in working capital needs of the company's qualified business activities (i.e., falling within the scope of Section 1202(e)(6)). Section 1202(e)(5) doesn't address the ownership of equity interests in LLCs or partnerships.

Substantiation. Taxpayers should obtain copies of financial statements and QSBS Issuer's Form 1120 tax returns, along with representations from management regarding the QSBS Issuer's stock investments, and include the documentation in the QSBS File.

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It probably also makes sense to obtain a certificate from the QSBS Issuer addressing the facts regarding stock and security investments.

M. Did the QSBS Issuer hold real property exceeding 10% of the total value of the QSBS Issuer's assets?

Section 1202(e)(7) provides that a corporation will not meet the active business requirement for any period during which more than 10% of the total value of the corporation's assets consists of real property which is not used in the active conduct of a qualified trade or business. Section 1202(e)(7) further provides that the "*ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business*." The QSBS Issuer will fail the "active business requirement" for any period that its holding of corporate stock or securities exceeds Section 1202(e)(7)'s limitation.

Substantiation. Taxpayers should obtain copies of financial statements and corporate tax returns, along with representations from management regarding the company's real estate ownership and activities, and maintain the documentation in the QSBS File. It probably also makes sense to obtain a certificate from the QSBS Issuer addressing the facts regarding involvement with real property.

N. The status of QSBS can be potentially impacted by the occurrence of forward or reverse stock splits, recapitalizations, Section 351 nonrecognition exchanges, Section 368 tax-free reorganizations, etc. involving the applicable QSBS.

The status of stock as QSBS can be affected by various company-level actions taken during a taxpayer's QSBS holding period.

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Substantiation. Taxpayers should obtain copies of financial statements and issuing Form 1120 tax returns, along with representations from management confirming whether any activities occurred that might potentially affect QSBS status, all of which should be obtained for the QSBS File. If any events have occurred that might potentially affect the QSBS status of outstanding stock, additional background information and documentation should be obtained for the QSBS File.

O. Additional Section 1045 requirements.

There are several statutory requirements that must be satisfied in order to qualify for a rollover of original QSBS proceeds into replacement QSBS under Section 1045. These requirements include the following: (i) the original stock must be QSBS when sold or exchanged; (ii) the rollover of proceeds into replacement QSBS must occur during a 60 day period after the sale of the original QSBS; (iii) the taxpayer's holding period for the original QSBS must exceed six months; (iv) the QSBS Issuer must meet Section 1202's "active business requirements" for at least the first six months after issuance of the replacement QSBS; and (v) an election to rollover proceeds under Section 1045 must be properly made on the taxpayer's return for the year the original QSBS was sold or exchanged. If the taxpayer intends to claim Section 1202's gain exclusion with respect to the replacement QSBS, all of Section 1202's eligibility requirements would need to be satisfied with respect to both the original QSBS and the replacement QSBS.

Substantiation. Taxpayers should obtain documentation establishing that the rollover of original QSBS sales proceeds was completed within the applicable 60-day period, including confirmation that funds were deposited in the QSBS Issuer's bank account, and include such documentation in the QSBS File.[14] This may seem straightforward but could be more complicated if the taxpayer invested in QSBS through a pass-thru entity. Treasury Regulation Section 1.1045-1 addresses how Section 1045's election functions when investments in QSBS are made indirectly through a pass-thru entity. The Section 1045 election should be properly made on the return for the year that the original QSBS was sold or

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exchanged. The IRS recently added the following additional reporting requirements to the 2024 Partner's Instructions for Schedule K-1 (Form 1065) for Section 1045 elections made with respect to the sale of original QSBS by a partnership and the rollover into replacement QSBS, which might suggest that the IRS has a plan in the works to step up enforcement and might include similar instructions to Form 8949 and/or Schedule D with respect to QSBS sold directly by a taxpayer and rolled over into replacement QSBS:

Attach to your Schedule D (Form 1040) a statement that includes the following information for each amount of gain that you don't recognize under section 1045.

- *The name of the corporation that issued the QSB stock.*
- *The name and EIN of the selling partnership.*
- *The dates the QSB stock was purchased and sold.*
- *The amount of gain that isn't recognized under section 1045.*
- *If a partner purchases QSB stock, the name of the corporation that issued the replacement QSB stock, the date the stock was purchased, and the cost of the stock.*
- *If a partner treats the partner's interest in QSB stock that's purchased by a purchasing partnership as the partner's replacement QSB stock, the name and EIN of the purchasing partnership, the name of the corporation that issued the replacement QSB stock, the partner's share of the cost of the QSB stock that was purchased by the partnership, the computation of the partner's adjustment to basis with respect to that QSB stock, and the date the stock was purchased by the partnership.*

The discussion of the "active conduct" requirement (Section P) and the pervasive judicial doctrines (Section Q) below should be of particular interest and concern if the QSBS Issuer was eventually liquidated and Section 1202's gain exclusion claimed in connection

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with the distribution of funds that were not spent undertaking the QSBS Issuer's activities.

P. Addressing Section 1202's "active conduct" requirement.

Section 1202(c)(2)(A) provides that stock will not be treated as QSBS unless the QSBS Issuer meets the active business requirements of Section 1202(e). Section 1202(e)(1)(A) provides that satisfying the active business requirement includes the requirement that at least 80% (by value) of the assets of the QSBS Issuer were used in the active conduct of one or more qualified business activities. So, the QSBS Issuer must not only be engaging in qualified activities, but also be engaging in the "active conduct" of those qualified activities. Section 1045 provides that in order to qualify for making a Section 1045 election, the QSBS Issuer is required to meet the active business requirement (including the active conduct requirement) for only the first six months after the issuance of the replacement QSBS. If the stockholder ultimately sells or exchanges replacement QSBS, then in connection with claiming Section 1202's gain exclusion, the active conduct requirement would apply for the entire holding period for the original QSBS and presumably separately for the entire holding period for the replacement QSBS.

Neither Sections 1202 nor 1045 define what is meant by "*actively conducting*" the QSBS Issuer's business activities. For purposes of Section 355, the determination of whether an activity is "actively conducted" is an "*all the facts and circumstances*" test.[15] The Tax Court would likely consider evidence of the QSBS Issuer's activities and test those activities against what the court determines would qualify as reasonable activities under similar circumstances undertaken by a taxpayer and the taxpayer's corporation where the parties are not motivated by QSBS tax benefits. The Tax Court would also likely consider all of the available evidence in connection with a determination whether the taxpayer's plans and actions evidenced a bona-fide business purpose to start-up, acquire and/or operate a successful and profitable business engaged in qualified business activities, or instead evidenced actions driven by "tax avoidance" motives. The review of applicable tax authorities

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suggests that a corporation must "*participate regularly, continually, extensively, and actively in the management and operation*" of the corporation's business activities to be considered as "actively conducting" those activities.[16]

The "active conduct" of start-ups. Section 1202 contemplates that not only profitable commercial-stage companies are considered to be engaging in qualified business activities, but also pre-revenue and unprofitable corporations that are engaging in start-up, research and development (**R&D**) and associated development activities, so long as those activities are reasonably anticipated to develop into qualified activities.[17] Section 1202(e)(2)(A) provides that for purposes of Section 1202(e)(1) (i.e., the "active business requirement" generally), the scope of active conduct of a trade or business, includes,

in connection with any future qualified trade or business, a corporation is engaged in—(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), assets used in such activities shall be treated as used in the active conduct of a qualified trade or business. Any determination under this paragraph shall be made without regard to whether a corporation has any gross income from such activities at the time of the determination.

Section 195(c)(1)(A) focuses on activities associated with investigating the creation or acquisition of an active trade or business, creating an active trade or business, or any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business. Treasury Regulation Section 1.174-2 includes within the scope of Section 174 experimental or laboratory research and development activities.[18] Treasury Regulation Section 1.174-2(a)(1) provides that:

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expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.[19]

In connection with the determination of whether the QSBS Issuer engaged in the "active conduct" of its activities, it is possible that a different and less stringent standard would apply to a QSBS Issuer that is engaged in start-up or R&D activities, as Section 1202(e)(2) provides that the assets of a QSBS Issuer engaged in start-up activities or R&D activities are "*treated as used in the active conduct of a qualified trade or business*." Presumably, the QSBS Issuer would be held to some reasonable standard of "actively conducting" start-up and/or research and development activities, but it is unclear what level of activities might be required. As discussed elsewhere in this article, a court would likely undertake a review of facts and circumstances and consider what a reasonable person not motivated by "tax avoidance" would do in like circumstances.

As a practical matter, the question of whether a QSBS Issuer engaged in "active conduct" should be more or less a non-issue where the QSBS Issuer's QSBS is sold for a substantial gain. Where the "active conduct" requirement and the pervasive judicial doctrines discussed below are more likely to be a central

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consideration is where (i) a Section 1045 election is made and the QSBS Issuer ceases to satisfy the "active business requirement" sometime after six months or (ii) the QSBS Issuer ceases to operate and liquidates after the taxpayer meets the five year holding period requirement, and the taxpayer claims Section 1202's gain exclusion.

Q. Preparing for the possible assertion of judicial doctrines – absence of bona-fide business purpose a/k/a tax avoidance, economic substance and sham transaction.

In addition to documenting that each of Section 1202's or Section 1045's expressly stated eligibility requirements are satisfied, taxpayers must be prepared for the possible assertion by the IRS of what are referred to a pervasive judicial doctrines. These judicial doctrines include the requirement that taxpayers have a bona-fide business purpose for undertaking a transaction, the requirement that transactions have economic substance apart from tax benefits (more recently codified at Section 7701(o)), and the sham transaction doctrine. The role and nature of these judicial doctrines is discussed in additional detail in the article, "*Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer*," which outlines arguments why these judicial doctrines should not apply to the reinvestment of proceeds under Section 1045 and the subsequent claiming of Section 1202's gain exclusion in connection with the sale or exchange of replacement QSBS. But unless tax authorities clarify whether or not these judicial doctrines apply, taxpayers would be prudent to operate under the assumption that that they could be asserted by the IRS, and as a result, taxpayers should fully document the business reasons for rolling funds into replacement QSBS, how the QSBS Issuer's operations were undertaken and why, if applicable, was the decision made to cease operations and dissolve.

Section 7701(o) codified the judicially created economic substance doctrine (generally first attributed to *Gregory v. Helvering)*,[20] that a transaction:

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to which the economic substance doctrine is relevant . . . shall be treated as having economic substance only if – (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apparent from Federal income tax effects) for entering into such transaction.

A taxpayer should be considered to be engaging in activities for bona-fide business reasons rather than tax avoidance where the taxpayer can credibly show that the decision to roll over proceeds into replacement QSBS, and the subsequent activities of the QSBS Issuer, including the complete dissolution of the QSBS Issuer, if applicable, were undertaken with the ultimate goal of changing in a meaningful way the taxpayer's economic position (or perhaps in connection dissolution, a reasonable decision arising out of the failure to achieve the results anticipated by the business plan), and that the taxpayer had substantial non-tax purposes for the material decisions made in connection with the Section 1045 rollover and the replacement QSBS Issuer. The standard likely to be considered by the Tax Court would be whether a reasonable man acting in place of the taxpayer and not motivated for tax reasons would have acted in a similar fashion t – i.e., would that person have made similar decisions regarding the initial investment, the operation of the business, and, if applicable, the decision to adopt and implement a plan of complete dissolution. As discussed further below, taxpayers should focus on fully and credibly substantiating, and including documentation in the QSBS File, how and why the investment of the rollover funds initially made sense from a business standpoint, why each investment dollar was required assuming actual events mirrored those anticipated by the business plan, how the QSBS Issuer was operated and how decisions were made with a constant eye for pursuing economic success, and how the decision to adopt and implement a plan of complete dissolution was driven by commercial business considerations.

Before investing in replacement QSBS, a taxpayer should focus on whether the activities of the QSBS Issuer might be reasonably expected to be sufficiently profitable to attract investors not

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motivated by Section 1202's potential tax benefits, taking into account the potential that the products and/or services that would be the end result of the start-up and R&D efforts would reach the commercialization stage. While it should not be necessary for a business to be economically successful, efforts should certainly be made to adopt and then follow a business plan and budget that an independent industry expert should consider to result in an economically viable business if successful. With respect to whether start-up and R&D activities are treated as "active conduct" of business activities, taxpayers should take some comfort in the last sentence of Section 1202(e)(3) which provides that *"[a]ny determination under this paragraph shall be made without regard to whether a corporation has gross income from such activities at the time of determination*."

A fact scenario that might be particularly vulnerable to an IRS challenge is one where a taxpayer sells original QSBS, purchases replacement QSBS, and subsequently liquidates the QSBS Issuer and claims Section 1202's gain exclusion. Assuming the QSBS Issuer actively conducted its business, the IRS might argue nevertheless argue that there was no bona-fide business purpose for rolling proceeds over into the QSBS Issuer or for liquidating the QSBS Issuer, and therefore the taxpayer must have been motivated primarily for tax avoidance purposes. A taxpayer with facts like those described in this paragraph should consider the arguments suggested in "*Finding Suitable Replacement Qualified Small Business Stock – Advanced Section 1045 Issues*," and developing similar arguments that judicial doctrines should not apply to an investment in replacement QSBS. The taxpayer should also refer to Section R below for a discussion regarding how to substantiate that the rollover of proceeds into replacement QSBS and subsequent claiming of Section 1202's gain exclusion was not undertaken for tax avoidance purposes.

R. Substantiating bona-fide business purpose, active conduct, and economic substance.

A taxpayer who makes successful minority investments in replacement QSBS under Section 1045 either directly or through a

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purchasing partnership (i.e., a fund) should focus on obtaining from the QSBS Issuer certified representations that back up satisfaction of each corporate-level eligibility requirements and providing a covenant of cooperation and access to financial statements, tax returns and other documents to populate the taxpayer's QSBS File.

Where the taxpayer creates a newly-organized corporation to serve as the QSBS Issuer, it seems reasonable that the IRS would not focus attention on the possible application of judicial doctrines or the active conduct requirement where on the rollover under Section 1045 culminated in outsized gains when the replacement QSBS was sold. However, taxpayers should focus significant attention on substantiating active conduct, bona-fide business purpose and economic substance where the QSBS Issuer is organized for the purpose of creating or acquiring a business, but after the taxpayer has satisfied Section 1202's five-year holding period requirement, the taxpayer claims Section 1202's gain exclusion in connection with the termination of the QSBS Issuer's operations and subsequent complete liquidation.

Taxpayers should think twice about rolling original QSBS proceeds into replacement QSBS under Section 1045 if they are unable or unwilling to commit the time and financial resources necessary to develop a credible business plan and budget, and then cause the QSBS Issuer to actively conduct qualified business activities. The taxpayer should made an effort to substantiation associated with the following: (i) there were bona-fide business reasons to roll the original QSBS proceeds into replacement QSBS; (ii) the QSBS Issuer's business plan and budget evidences a plan to develop or acquire a profitable business (whether or not that goal is ultimately achieved); (iii) the business plan and budget prepared contemporaneously with the formation of the QSBS Issuer anticipated the future use of all of the funds contributed into the QSBS Issuer in exchange for the replacement QSBS; (iv) there were bona-fide business reasons for why and how the QSBS Issuer's business activities were undertaken; (v) the QSBS Issuer through its employees and/or the taxpayer's efforts actively conducted its business activities throughout the applicable period; (vi) if applicable, how and why the activities of the QSBS Issuer deviated from those originally outlined in the initial business plan and budget;

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(vii) how and why the business activities (start-up, research and development or otherwise) failed and decision-making process underlying the decision to cease operations and liquidate; (viii) if applicable, an credible explanation why the QSBS Issuer failed to use its funds as anticipated in the original budget and business plan; (ix) in circumstances where the QSBS Issuer did not fail, but the taxpayer nevertheless made the decision to cease operations and liquidate, a full and credible explanation of the decision-making process undertaken by QSBS Issuer's board that led to such decision; and (x) how and why material business decisions were made for bona-fide business reasons throughout the period QSBS Issuer operated.

The following discussion further fleshes out the points introduced above:

Taxpayers should maintain a QSBS File that gathers together and includes relevant documents associated with the applicable return positions. Any documentation that helps supports a taxpayer's return position or provides background information and documentation for a tax opinion should be included in the taxpayer's QSBS File, and the QSBS File should be maintained in a format that is accessible for future use. This physical or electronic file should include all of the entity documents, subscription documents, sale documents, financial statements, tax returns, and any other information/documents provided to or relied upon by the taxpayer and the tax advisor, plus any other documents that could possibly assist in connection with a future tax audit and/or controversy.

Initial business plan with budget and financial forecast (expected use of invested capital). Taxpayers electing to reinvest proceeds under Section 1045 election should focus time and attention on gathering relevant documents and background information that will assist the taxpayer in establishing why the QSBS Issuer needed 100% of the capital contributed into the corporation in connection with issuance of the replacement QSBS, with such documentation including contemporaneous written business plan and budget (with a financial forecast). The same degree of effort should be put into preparing this business plan and

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budget that would go into preparing offering materials where the corporation's success depended upon attracting investors. The business plan should identify in reasonable detail how the business is expected to become profitable if the start-up, research and development (R&D) activities developed into commercialized products and services as planned. The QSBS Issuer is not be required to immediately spend all of the contributed funds, but there should to be a reasonable and well-conceived plan, backed up by a detailed anticipated use of proceeds and other pro forma financials, showing both how the business would, in fact, use all of the funds within a reasonable timeframe if successful, and how the business would be profitable if the development process was successful. The degree of anticipated profitability reflected in the forecast should ideally fully support the decision to rollover the funds invested in replacement QSBS.

The QSBS Issuer's spending activities. In most circumstances, the QSBS Issuer should not be expected or required to immediately spend all of the contributed funds, but there should to be a reasonable multi-year plan, backed up by a detailed pro forma use of proceeds and pro forma financials, showing both how and why it is anticipated that the business would use 100% of the rolled over funds within a timeframe that would be reasonable for the applicable business. Then, contemporaneous records, and a running written narrative, should be prepared and maintained showing how the actual use of funds differed from the pro forma project use of funds, and most importantly, what caused the differences.

Maintain a contemporaneous written record documenting business activities and explaining deviations from the initial business plan, budget, and forecast. Once the business is funded and start-up and R&D activities commence, we believe that it is critical that detailed records of the activities of the company's employees and other personnel are maintained, along with information regarding the expenditure of funds and the efforts of those working for the QSBS Issuer, again including a record and analysis of how and why the actual activities may have deviated from the original business plan and budget. Documenting "active conduct" means a detailed description of what start-up, R&D and development activities were undertaken by the QSBS Issuer's

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personnel (ideally by the taxpayer or employees of the QSBS Issuer). If the start-up activity is seeking opportunities to acquire certain types of businesses, then documenting "active conduct" should include a thorough record of all of the efforts made to acquire the equity or assets of target companies, including documentation of why such efforts might not have succeeded and who was enlisted to assist with the efforts.

Taxpayers should compile comprehensive documentation of those activities, including documentation of associated expenditures (discussed above), business records and diaries or calendars of activities, email records and evidence of other relevant communications, along with statements from employees, contractors, customers and others that help flesh out the nature and extent of the QSBS Issuer's activities. Taxpayers should substantiate their spending on qualified activities (whether start-up, R&D or other activities) with documentation that evidences the amount and nature of the QSBS Issuer's expenditures (receipts; invoices; canceled check), along with other corroborating evidence such as business records. All of this documentation should be obtained for the taxpayer's QSBS File.

Maintain a written explanation of the decision to cease operations and liquidate. A contemporaneous narrative should be maintained explaining in detail the decision-making process of the board of directors that culminated in the decision to cease business operations and liquidating, with particular focus on why the QSBS Issuer would cease operations while still holding substantial funds. In connection with the decision to dissolve and liquidate, the company's minutes should explain in reasonable detail why the company did not simply modify its business plan to take into account events and continue operating. A reasonable approach might be to prepare these narratives and documentation as one would if management was required to make detailed presentations to outside directors.

Additional substantiation pointers. Taxpayers considering rolling over original QSBS proceeds into replacement QSBS should take reasonable steps to confirm that their original stock was QSBS and that the transfer was a taxable sale or exchange for federal income

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tax purposes. This step includes addressing each of Section 1202's eligibility requirements with respect to both the original QSBS and the replacement QSBS, and compiling and maintaining in the QSBS File all the necessary documentation, including subscription and sale documents, and if available, tax returns, financial statements and attestations/certificates from management of the QSBS Issuer. Further, taxpayers should maintain a complete set of executed organizational documents in the QSBS File, including subscription documents and evidence of payment of money, property or services in exchange for the issuance of the replacement QSBS. Copies of the tax returns and financial statements, along with board actions of the QSBS Issuer should be obtained for the QSBS File. Finally, all relevant corporate records associated with the termination of business operations and liquidation should be obtained for the QSBS File.

In the course of undertaking to compile documentation to substantiate that actions were undertaken for bona-fide business reasons, taxpayers should keep in mind that the standard that taxpayers are likely to be held to in Tax Court is whether the taxpayers' and the QSBS Issuers' actions evidence those of a reasonable persons engaging in like activities and not motivated by tax avoidance. The IRS might rely on experts inclined to argue that no rational and reasonable business person would undertake investing in the QSBS Issuer unless tax avoidance was a key motivating factor. With that backdrop, taxpayers should focus on including documentation in the QSBS File supporting the conclusion that the taxpayers' actions and decisions mirrored those of business persons actively engaged through their applicable QSBS Issuers in developing qualified activities that were reasonably expected to be commercially successful.

Please contact Scott Dolson if you want to discuss any Section 1202 or Section 1045 issues by video or telephone conference. You can also visit our QSBS & Tax Planning Services page for more QSBS-related analysis curated by topic, from the choice of entity decision and Section 1202's gain exclusion to Section 1045 rollover transactions.

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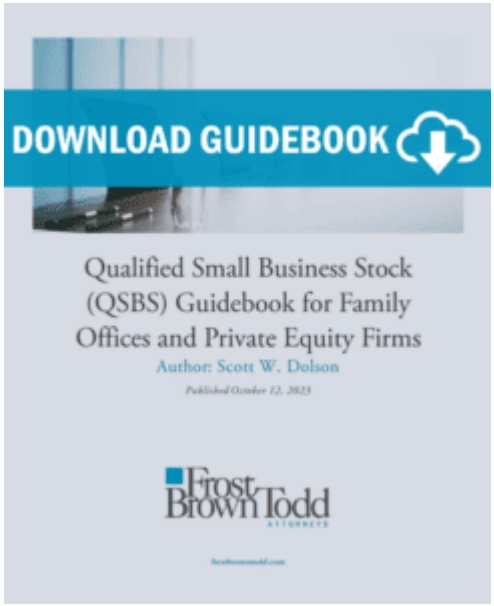
More QSBS Resources



- To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)
- Advanced Section 1202 (QSBS) Planning for S Corporations
- Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 2
- Structuring the Ownership of Qualified Small Business Stock (QSBS) – Is There a Role for Roth IRAs?
- Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide
- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations
- Can Stockholders of Employee Leasing or Staffing Companies Claim Section 1202's Gain Exclusion?
- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms

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- Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion
- A SPAC Merger Primer for Holders of Qualified Small Business Stock
- Determining the Applicable Section 1202 Exclusion Percentage When Selling Qualified Small Business Stock
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Dissecting 1202's Active Business and Qualified Trade or Business Qualification Requirements
- Recapitalizations Involving Qualified Small Business Stock
- The 21% Corporate Rate Breathes New Life into IRC § 1202

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[1] 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 Section 1045's tax-free rollover or original QSBS sales proceeds into replacement QSBS. See *Frost Brown Todd's QSBS library.* This article has been updated to reflect changes to Section 1202 made by the One Big Beautiful Bill Act (OBBBA). For additional discussion of OBBBA, see the article authored by Scott Dolson and Brian Masterson, "*One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors*."

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Section 1202 has gain exclusion caps 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 for stock issued prior to July 5, 2025, and $15 million or 10 times the stockholder's aggregate basis in QSBS sold during the taxable year for stock issued after July 4, 2025.

This article focuses on federal income taxes. Many states follow the federal treatment of QSBS. California, Pennsylvania, Alabama, Mississippi, and New Jersey (until January 1, 2026) do not follow federal treatment.

[2] See endnote 1.

[3] The Tax Court in *Gates v. Commissioner*, 135 T.C. 1 (2010), stated that "*exclusions from income must be construed narrowly, and taxpayers must bring themselves within the clear scope of the exclusion*." The Supreme Court in *Commissioner v. Schleier*, 515 U.S. 323 (1995) stated that "*the default rule of statutory interpretation [is] that exclusions from income must be narrowly construed*." The Chief Counsel's office cited the courts position on interpreting gain exclusions in Chief Counsel Advisory Memorandum (CCA) 202204007, which addressed whether a business that facilitates the leasing of property between lessors and lessees constitutes a business involving the performance of brokerage services within the meaning of Section 1202(e)(3(A).

[4] Sections 6501(a) and (b) provide that, generally, the IRS has three years from the date a tax return is filed or the date the return is due to assess any additional tax owed.

[5] *JU v. U.S.*, 170 Fed. Cl. 266 (Ct. Fed Cl. 3/18/2024)

[6] *Free-Pacheco. v. United States*, 114 AFTR 2d 2014-5272 (2014).

[7] T.C. Memo 2012-251.

[8] Most pass-thru entities holding QSBS will be partnerships for tax purposes rather than S corporations. If an S corporation is holding QSBS, much of the discussion of Partnerships is applicable but there will be differences that should be considered that are not discussed in detail in this article.

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[9] See the article "*To Be Clear. . . LLCs Can Issue Qualified Small Business Stock (QSBS)*."

[10] Knowing the fair market value of the contributed assets is important for purposes of confirming the amount of gain excluded by Section 1202(i)(B) from the benefit of Section 1202 if the property is contributed in a Section 351 nonrecognition exchange, and for purposes of establishing Section 1202's "tax basis" for the taxpayer's QSBS for purposes of Section 1202(b)(1)(B)'s 10X gain exclusion cap.

[11] Assumes a combined effective federal tax rate of 20% (long-term capital gains) plus 3.8% (net investment income tax rate).

[12] *Free-Pacheco. v. United States*, 114 AFTR 2d 2014-5272 (2014).

[13] As of June 1, 2025, there is a proposed amendment to Section 1202 included in H.R. 1, the One Big Beautiful Bill Act, reading as follows:

Small business stock: Section 1202(e)(2)(B) is amended by striking 'research and experimental expenditures under section 174' and inserting "specified research or experimental expenditures under section 174 or domestic research or experimental expenditures under section 174A.

[14] Taxpayers may argue that there is an argument supporting a return position that the 60 day period can run off of the receipt of an installment payment under Section 453 which is actually more than 60 days after the closing date of the sale.

[15] 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 of income and the payment of expenses and that for purposes of section 355(b), the determination whether a

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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.

[16] See *Medchem (P.R.) Inc. v. Commissioner*, 116 T.C. 308 (2001).

[17] Basically, Section 1202(e)(2) allows companies in the start-up/R&D phase to qualify as engaging in the active conduct of the anticipated future qualified business activities for purposes of Section 1202's 80% Test.

[18] See endnote 10.

[19] The WG&L Tax Dictionary defines "qualified research" as follows:

a research and experiment activity, as defined in § 174, that is conducted within the United States, fundamentally of a technological nature, and intended to be useful in the development of a new or improved trade or business already being carried on by the taxpayer. § 41(d)(1). The trade or business requirement can also be met if in-house research expenses, when incurred, have the principal purpose of making use of the research in the active conduct of a future business of the taxpayer or certain related taxpayers. § 41(b)(4). Research activities must also constitute elements of a process of experimentation for a fundamental purpose, which requires more than one alternative designed to achieve an unproven result. Only research involving a new or improved function, performance, reliability, or quality is considered to have fulfilled a functional purpose, whereas research relating to style, taste, cosmetic, or seasonal design factors is not. § 41(d)(3). Each business component must satisfy these requirements independently. § 41(d)(2). In cases of entire marketable products, the requirements apply to the

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most significant subset of elements, until they have been met, or the most basic components have been reached. A plant process, machinery, or a technique for commercial production of a business component is considered a separate component that will not be available for the credit unless the definition of qualified research is met separately, without taking into account research relating to development of the product. See HR Conf. Rep. No. 841, 99th Cong., 2d Sess. II-73 (1986). Computer software developed primarily for internal use qualifies if it is used in qualified research undertaken by the taxpayer or in a production process. § 41(d)(4)(E). Regulations may also require all software to be innovative, to involve significant economic risk, and not to be commercially available for use by the taxpayer. No credit is allowed to the taxpayer when research is funded by another entity, including the government. § 41(d)(4)(H). See § 41(a)(1)(A).

[20] 293 U.S. 465 (1935).

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