Exploring the Role of Partnerships in Qualified Small Business Stock (QSBS) Planning

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One Big Beautiful Bill Act
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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 the QSBS library.

A key requirement of Section 1202 is that the issuer of qualified small business stock (QSBS) must be a domestic (US) C corporation.[2] So in large part, tax planning for QSBS involves understanding Sections 1202 and 1045 and basic C corporation tax planning, but "flow-thru" business entities such as LLCs and LPs ("**Partnerships**") do play a role in QSBS planning. This Article addresses the intersection of Partnerships and QSBS.

Conversion of Partnerships to C corporations

One topic that arises frequently is the conversion of Partnerships to domestic (US) C corporations. That topic is addressed in detail in *Guide to Converting Partnerships (LLCs/LPs) into C corporation Issuers of QSBS – Part 1* and *Guide to Converting Partnerships (LLCs/LPs) into C corporation Issuers of QSBS – Part 2*.

QSBS ownership through Upper-Tier Partnerships, including LPs/LLCs

Section 1202(g) enables certain "pass-thru entity" (including LPs/LLCs taxed as partnerships for federal income tax purposes and S corporations) to hold and sell QSBS. Section 1202's allowance

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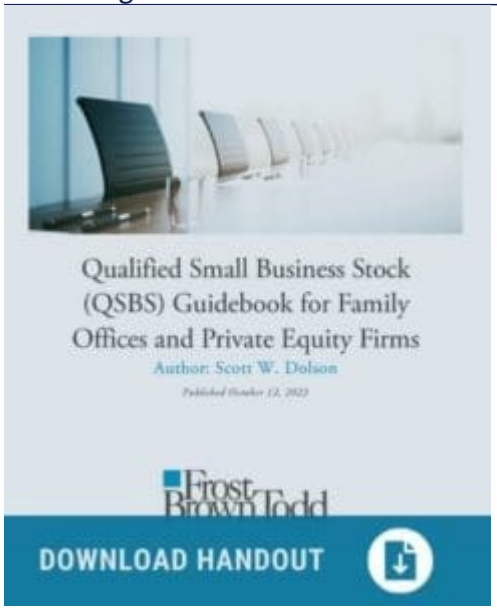
for ownership of QSBS by Partnerships opens the door for investment funds and business owners to use existing or newly-organized upper-tier partnerships ("**Upper-Tier Partnerships**") for the purposes of holding minority or majority ownership positions in QSBS and managing economic, governance, restrictions on transfer, drag-along, go-along, and other investment matters via LLC or LP agreements.[3] The use of Upper-Tier Partnership does add some level of complexity, particularly with respect to determining whether a partner/member who is allocated capital gain from the sale of QSBS is also entitled to claim Section 1202's gain exclusion based on the partner's applicable "interest" when the Partnership acquired its QSBS. As discussed below, Upper-Tier Partnerships facilitate participation in Section 1202's gain exclusion by holders of "profits interests." See also *Private Equity and Venture Capital Fund Investment in Qualified Small Business Stock (QSBS) – A Guide to Obtaining the Benefits of Sections 1202 and 1045*.



What gain exclusion does a partner have with respect to capital gain passed through on a Schedule K-1 from the Partnership's sale of QSBS? When capital gain from the sale of QSBS is passed through on a Partnership's Schedule K-1, equity owners are entitled to claim Section 1202's gain exclusion if all of Section 1202's eligibility requirements are met, but only with respect to an amount "*determined by reference to the interest the taxpayer held in the pass-thru entity on the date the qualified small business stock was*

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acquired." If the issue is whether either the Partnership or partner can elect to rollover proceeds under Section 1045, Treasury Regulation Section 1.1045-1 provides that each partner's share of the rollover will be based on that partner's smallest "interest in capital" in the Partnership while it held the QSBS. Partnerships can also distribute shares of QSBS to partners, and those partners can in turn hold or sell the QSBS and claim Section 1202's gain exclusion (to the extent of the partner's "**interest**") and elect to roll over proceeds under Section 1045. Section 1202(h)(2)(C) provides that QSBS will retain its status and holding period when distributed by a Partnership to partners based on their respective "**interests**" in the Partnership, or with respect to Section 1045 elections, the partners' respective smallest "**interest in capital**" while the Partnership held the applicable QSBS.

Section 1202(g)(2)(B) makes it clear that in order for a partner to claim Section 1202's gain exclusion with respect to QSBS sold by the Partnership, the partner must have held an interest in the Partnership when the QSBS was acquired, and the partner's shares of gain exclusion cannot increase after that date through the acquisition of an additional interest in the Partnership.[4] If a taxpayer becomes a partner after the date of the Partnership's acquisition of QSBS, that partner will not share in the right to claim Section 1202's gain exclusion when capital gain from the sale of the QSBS passes through to the partner on a Schedule K-1.

Some tax practitioners believe that the definition of "interest" in Treasury Regulation Section 1.1045-1, which focuses on each partner's smallest interest in capital, also governs the determination of the partner's "interest" for purposes of Section 1202. But while the Section 1045 regulations refer to the smallest "interest in capital," Section 1202 merely refers to "interest" and doesn't mention "interest in capital." Nor does Section 1045 mention either "interest" or "interest in capital," as that discussion is limited to the Section 1045 regulations. Given the numerous tax authorities that define a partner's interest in terms other than a partner's mere share of capital, coupled with the recent Supreme Court case (*Loper Bright*) which overturned the *Chevon* doctrine giving deference to federal agency regulations (including Treasury Regulations), there may be doubt that the Tax Court would interpret

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Section 1202's reference to "interest" to mean solely a partner's interest in capital.[5]

A partner's "interest" in a Partnership is generally thought to include the partner's share of capital, income and loss allocations, and rights to operating and liquidating distributions. A partner can acquire additional economic rights through the issuance of an additional capital or profits interest by the Partnership or by purchasing another partner's interest. A partner's economic rights in a Partnership will also adjust if another partner's interest is redeemed by the Partnership or there is an amendment to the agreement changing the sharing of economic rights among partners. A reasonably safe conclusion is that increasing a partner's allocation of capital gain from the sale of QSBS after the date the QSBS is acquired by the Partnership through the issuance or acquisition of additional economic rights does not increase the partner's Section 1202 gain exclusion. But what if a partner's "interest" increases as a result of the redemption of another partner's interest? Is there at the least an argument that the remaining partners' interests did not change, and that the redemption of another partner's interest is no more a change in the remaining partners' interests than an increase in the value of the Partnership's assets? The bottom line is that precisely what constitutes a partner's interest for purposes of Section 1202 remains unanswered by existing tax authorities. The determination of what constitutes an increase in a partner's "interest" for purposes of Section 1202(g)(2)(B) would most likely entail a mixed analysis of law and facts focusing on a determination of what the partner's economic rights were on the date the Partnership's QSBS was acquired and what happened subsequently to adjust those rights. What constitutes a partner's "interest" is discussed in further detail below in the context of exploring the rights of holders of profits interests.

Dealing with restricted capital and profits interests in a Partnership. If the partner holds a capital interest, that interest must be unrestricted on the date a Partnership's QSBS is acquired, or the partner would not be considered to hold an "interest" on the acquisition date. If a restricted capital interest is issued to a partner, a Section 83(b) election should be filed if eligibility to claim

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Section 1202's gain exclusion with respect to the Partnership's QSBS is desired. If the partner is holding a restricted profits interest on the date the Partnership's QSBS is acquired, the partner might elect to rely on Revenue Procedure 2001-43, but consideration should also be given to filing a protective Section 83(b) election.[6]

Section 1202 gain exclusion cap issues. Under Section 1202, each taxpayer, including each partner/member, is generally subject to a $10 million gain exclusion cap with respect to gain associated with the sale of a particular issuing corporation's QSBS (the "Standard Cap") (the per-taxpayer, per-QSBS Issuer Standard Cap increased to $15 million for QSBS issued after July 4, 2025), including the respect to any capital gain passing through on a Partnership's Schedule K-1 from the sale of an issuing corporation's QSBS. For example, if a Partnership passes through on Schedule K-1s $12 million of gain from the sale of Corporation A's QSBS to each of 10 partners, each partner that is a separate taxpayer would have a separate Standard Cap with respect to excluding capital gains arising out of the sale of Corporation A's QSBS, assuming that all of Section 1202's eligibility requirements were met and the stock was issued after the 100% gain exclusion took effect. Each partner's Standard Cap would be calculated taking into account both capital gain from the sale of Corporation A's QSBS passed through on Schedule K-1s, plus any capital gain from the direct sale by the partner of Corporation A QSBS. If a taxpayer had sufficient tax basis in Corporation A's QSBS, the 10X gain exclusion cap might allow for the per-QSBS Issuer's aggregate capital gain exclusion to exceed the applicable Standard Cap.

Distributions of QSBS from an Upper-Tier Partnership to partners. Under Section 731(a), a distribution of QSBS from a Partnership to a partner is generally accomplished on a tax-free basis. Under Section 732(a)(1), QSBS distributed in a current distribution generally takes a carryover basis in the hands of the partner equal to the Partnership's pre-distribution tax basis. If a partner receives shares of QSBS in the complete liquidation of a Partnership, the partner generally recognizes neither gain or loss on the distribution, but under Section 732(b), the partner's tax basis in the QSBS would be determined using a substituted basis equal to the basis of the exchanged equity interest in the Partnership.

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Special tax rules under Section 731(c) apply if distributed QSBS is treated as a "marketable security." Section 731(c) doesn't apply to the extent of a partner's share of the Partnership's net appreciation inherent in its QSBS. So, Section 731(c) triggers taxable gain with respect to a partner only when a partner's share of distributed QSBS causes the partner to receive a share of the net gain attributable to the QSBS that exceeds what the partner would have been allocated if the Partnership had sold all of the QSBS in a taxable transaction.

Under Section 1202(h)(2)(C), QSBS retains its tax status and holding period in connection with a transfer of QSBS from a Partnership to a partner, so long as the amount of QSBS distributed to the partner is equal to the partner's "interest" in the Partnership as contemplated in Section 1202(g).

Treasury Regulation Section 1.1045-1 has detailed rules addressing various tax aspects associated with the ownership of QSBS by a Partnership. Under Treasury Regulation Section 1.1045-1(e), a similar result applies for purposes of Section 1045 with respect to QSBS distributed by a Partnership to a partner. Treasury Regulation Section 1.1045-1(e)(3) provides that, with respect to QSBS distributed by a Partnership to a partner in an operating or liquidating distribution, the amount of gain that is not recognized when proceeds from the partner's subsequent sale of the original QSBS when reinvested in replacement QSBS under Section 1045 is limited to the partner's smallest interest in the Partnership's capital. The upshot of Treasury Regulation Section 1.1045-1(e)(3)'s rules is that a partner's right to rollover proceeds under Section 1045 is essentially unchanged whether the Partnership or the partner sells the original QSBS. If the partner held a pure "profits interest" on the date the Partnership acquired the QSBS, the partner would not be able to rollover any proceeds under Section 1045 whether the sale of the original QSBS occurred at the Partnership or partner level.

Certain interests in Partnerships will not result in a pass-through of capital gain or qualify for a corresponding Section 1202 gain exclusion. The analysis of whether a partner has a right to claim Section 1202's gain exclusion presumably would focus on determining whether a partner had an economic "interest" in the

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Partnership on the date the Partnership acquired its QSBS that would result in the allocation of capital gain on a Schedule K-1. For example, guaranteed payments to partners are treated as ordinary income and therefore would not trigger the right to claim Section 1202's gain exclusion. Likewise, the exclusion of various Partnership equity rights, options and bonus arrangements from the benefits of Sections 1202 and 1045 would be consistent with the exclusion of Section 1202's benefits for holders of corporate equity rights and bonus arrangements. In contrast, holders of profits interest can be allocated capital gains on their Schedule K-1s.

Can you gift a Partnership interest and preserve the recipient's right to the indirect benefits of the Partnership's QSBS? Under Section 1202(h)(2)(A), a stockholder can transfer QSBS as a gift to separate taxpayer, with the gift recipient stepping into the shoes of the transferring stockholder with respect to the status of the stock as QSBS and the transferor's holding period. In contrast, Section 1202 does not expressly provide favorable treatment for the gifting of interests in Partnerships holding QSBS, although Treasury Regulation Section 1.1045-1(g)(ii) does provide that an "eligible partner" includes the recipient of a gifted Partnership interest. As an "eligible partner," the gift recipient is treated as having held the acquired interest in the Partnership during the period the partner held the interest in the Partnership. In the absence of direct tax authorities, a partner/member who wants to preserve QSBS status in connection with the indirect gifting of QSBS must either rely on Treasury Regulation Section 1.1045-1(g)(ii) as authority for purposes of Section 1202, or cause the Partnership to first distribute the QSBS (as permitted by Section 1202(h)(2)(C)) to the partner prior to the direct gifting of the QSBS by the partner.

Partner due diligence and substantiation of QSBS benefits. Prior to investing in QSBS through a Partnership, taxpayers should determine what due diligence the Partnership has undertaken to ensure that the Partnership is actually investing in QSBS. Also, investors should find out whether the Partnership has obtained covenants from the QSBS Issuer that it will maintain qualified small business status through the Partnership's QSBS holding period and provide the Partnership with the documentation and background information necessary for partners to substantiate the right to claim

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Section 1202's gain exclusion or make a Section 1045 election.

Reporting QSBS tax benefits on Partnership returns and Schedule K-1s. Schedules 8949 and Schedule D and their instructions address the reporting of transfers of QSBS in taxable sales or exchanges by Partnerships, and the reporting of Section 1045 elections. These reporting requirements are discussed in *Substantiating the Right to Claim QSBS Tax Benefits (Part 2)*.

Section 1045 elections associated with QSBS held by a Partnership. When a Partnership sells QSBS, either the Partnership or a partner can elect to rollover the proceeds under Section 1045 into replacement QSBS. Treasury Regulation Section 1.1045-1 provides detailed instructions for all aspects of Section 1045 rollovers by Partnerships and partners.

Operating through a multi-upper tiered partnership structure. Some partnerships have two or more tiers of upper-tier partnerships. Section 1202 is silent about whether the holder of an equity interest in a upper-upper tier partnership has an "interest" for purposes of Section 1202. However, Treasury Regulation Section 1.1045-1 has multiple references to holding an interest in a tiered (upper-tier) partnership structure. Treasury Regulation Section 1.1045-1(b)(3)(B) provides the following "Tiered-partnership rule" that makes sense only if one starts from the premise that QSBS can be held through multi-upper tiered partnership structure:

If a partnership (upper-tier partnership) holds an interest in another partnership (lower-tier partnership) that makes an election under section 1045, the portion of the lower-tier partnership's basis adjustment as provided in paragraph (b)(3)(ii)(A) of this section in the replacement QSB stock must be segregated and allocated to the upper-tier partnership and any eligible partner as defined in paragraph (g)(3)(iii) of this section. Similarly, that portion of the basis of the upper-tier partnership's interest in the lower-tier partnership attributable to the basis adjustment as provided in paragraph (b)(3)(ii)(A) of this section in the lower-tier partnership's replacement QSB stock must be segregated and allocated solely to any eligible partner as defined in

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paragraph (g)(2)(iii) of this section.

The challenge in some circumstances will be calculating a taxpayer's "interest" if the partner holds membership interests in several tiers of partnerships and perhaps just determining the interest of holders of membership interests in the upper-tier partnerships.

Operation of Lower-Tier Partnerships (Joint Ventures, LPs, LLCs) by QSBS Issuers

Background. Some corporations that have issued QSBS ("**QSBS Issuers**") engage in some or all of their business activities through lower-tier Partnerships (referred to as "**Lower-Tier Partnerships**"). Typically, the C corporation holds a controlling equity interest in the Lower-Tier Partnership, which will generally be a state-law LLC or LP taxed as a partnership for federal income tax purposes. In addition to the parent C corporation, the Lower-Tier Partnership will have employees, existing QSBS Issuer stockholders, domestic or foreign investors, or business associates as outside partners.

A sampling of tax and business reasons for operating through Lower-Tier Partnerships. Many corporations use corporate joint ventures (generally organized for legal purposes as LPs or LLCs in the United States or similar pass-through entities organized in foreign jurisdictions) for a variety of domestic and foreign activities, including property ownership vehicles and operating companies. There are a number of tax and non-tax reasons why business owners might use a two-tier structure with a corporate parent and subsidiary Partnership. From the tax standpoint, Lower-Tier Partnerships taxed as partnerships for federal income tax purposes can be used to allow for the issuance of "profits interests" to the non-corporate owners. If the Lower-Tier Partnerships is acting as a platform company, it might be used as a vehicle to structure tax-free rollovers by target company owners under Section 721. Another possible use for the Lower-Tier Partnership structure is the potential for using a Partnership to flush money out of the business to the non-corporate owner, particularly where there is overlap between the stockholders of the corporation and non-corporate

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owners of the Lower-Tier Partnership.

The ability to distribute funds out of the operating company through the non-corporate owners of the Lower-Tier Partnership provides a vehicle for distributing money to tputting money in the hands of owners while avoiding the problem of double taxation associated with the payment of dividends by a C corporation. Having a tax-efficient means to flushing money out of the business could also assist in managing a potential accumulated earnings tax problem.

Finally, the use of a Lower-Tier Partnership structure allows for the possibility of issuing incentive compensation not only at the parent C corporation level but also at the subsidiary Partnership level, thereby introducing the possibility of issuing profits interests (see the discussion below) through the Lower-Tier Partnership. There are a number of additional potential state and local tax and foreign tax planning issues associated with operating or owning assets through Lower-Tier Partnerships.

Can the activities of a Lower-Tier Partnership's contribute towards satisfying Section 1202's "active conduct" requirement? One potential issue associated with mixing a Lower-Tier Partnership and QSBS Issuer is the uncertainty surrounding whether the QSBS Issuer would be considered as actively conducting the business undertaken through the Lower-Tier Partnership. Section 1202(c)(2)(A) states that a corporation's stock is not QSBS unless "*during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of [Section 1202(e)] and such corporation is a C corporation*." Section 1202(e) provides that at least 80% (by value) of the issuing corporation's assets must be used in the **active conduct** of one or more qualified trades or businesses. The bottom line is that there are solid arguments based on tax authorities interpreting Section 355 that a parent corporation should be able to satisfy Section 1202's active conduct requirement if it holds a significant equity interest in a Lower-Tier Partnership that actively conducts qualified business activities. See *Exploring Section 1202's Active Business Requirement*. If the IRS were successful in asserting that the activities of a Lower-Tier Partnership do not contribute

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towards satisfying Section 1202 80% Test, then the value of the QSBS Issuer's interest in the Lower-Tier Partnership would be treated as passive investment assets counting against satisfying the 80% Test.

Planning with profits interests (carried interests or promotes) for Upper-Tier and Lower-Tier Partnerships

Many business owners find the features of profits interests (carried interests or promotes) attractive as an incentive compensation tool. Equity that qualifies as a profits interest under Revenue Procedure 93-27 (and Revenue Procedure 2001-43 for an unvested Partnership interest) does not trigger taxable compensation when issued, and subject to holding period requirements, including Section 1061's three year holding period requirement for carried interests, permits at least partial capital gains treatment when the Partnership interest or assets are sold. Unfortunately, C corporations cannot issue profits interests, but in some cases, it is possible to issue common stock with a low valuation that approximates the issuance of profits interests. For example, common stock is likely to have a modest value if a corporation has an enterprise value of $1 million and preferred stock with a $1.2 million aggregate liquidation preference.

For those business owners who are seeking to combine the benefits of profits interests with Section 1202's gain exclusion, QSBS can be owned through an Upper-Tier Partnership that issues both capital and profits interests or the C corporation can engage in business activities through a Lower-Tier Partnership that issues both capital and profits interests.

Issuance of profits interests by Upper-Tier Partnerships. One Section 1202 rule is particularly relevant to the ownership of equity in a "pass-thru" entity that holds QSBS. Section 1202(g)(2)(B) provides that the amount of gain included in the gross income of an equity owner of a pass-thru entity which is eligible for Section 1202's gain exclusion is determined by "*the holding of an interest in such entity which was held by the taxpayer on the date on which*

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such pass-thru entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-thru entity." The result is that an employee must hold equity in a pass-thru entity on the day that the pass-thru entity acquires the applicable QSBS. If a Partnership is converted to a C corporation on January 1, 2025, resulting in the issuance of QSBS, and an employee was issued a profits or capital interest in the Upper-Tier Partnership on January 2, 2025, the employee will not be eligible to claim Section 1202's gain exclusion when the QSBS is sold or the stock is distributed to stockholders, even though the employee shares in proceeds from the sale of the QSBS. How this rule functions seems clear when the employee owns unrestricted S corporation stock or an unrestricted Partnership capital interest on the day the flow-thru entity acquires QSBS – the employee would be eligible to participate in Section 1202's gain exclusion. But what if the employee holds an unrestricted or restricted profits interest in the Partnership?

Is the holder of a profits interest in an Upper-Tier Partnership entitled to a Section 1202 gain exclusion with respect to the Partnership's sale of QSBS? Some tax practitioners believe that the definition of "interest" in Treasury Regulation Section 1.1045-1, which focuses on a partner's **capital** interest, should also govern the determination of a partner's "interest" for purposes of Section 1202. The alternative position is that an employee who is issued a profits interest on the day that the Partnership acquires QSBS has an "interest" in the Partnership on that day – that interest consists of what the holder would be entitled to economically if the QSBS appreciates beyond its value on the date of issuance. While the Section 1045 regulations specifically refer to "interest in capital," Section 1202 itself merely refers to "interest." Section 1045 is silent. There are no tax authorities beyond the language of Section 1202 and Treasury Regulation Section 1.1045-1(g), that can be cited as direct tax authorities addressing this critical issue.[7] Given the numerous tax authorities that define a partner's interest in terms other than merely a partner's share of capital, coupled with the recent Supreme Court case (*Loper Bright*) which overturned the *Chevon* doctrine giving deference to federal agency regulations (including Treasury Regulations), there is at the least significant

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doubt that the Tax Court would interpret Section 1202's reference to "interest" to mean solely a partner's relative capital interest.[8]

If the profits interest is restricted, a holder can rely on Revenue Procedure 2001-43 for the position that the interest should be treated as owned regardless of the restrictions, but given the possible pitfalls associated with relying on Revenue Procedures 93-27 and 2001-43, the filing of a protective Section 83(b) election makes sense.

Issuance of profits interests by Lower-Tier Partnerships. A planning option is to drop the operating assets of a business into a Lower-Tier Partnership owned in part by the Issuer and issue at the Lower-Tier Partnership level profits interests to employees and other equity interests to investors. One drawback of the Lower-Tier Partnership profits interest structure, however, is that in contrast to stockholders of C corporations, partners who hold Lower-Tier Partnership interests will not participate in Section 1202's gain exclusion. Another drawback is that sharing the equity of the Lower-Tier Partnership with partners who do not own their interest through the C corporation reduces the percentage of the business eligible for gain exclusion under Section 1202. Finally, Section 1202 does not expressly address whether a business can qualify as engaging in "active conduct" through ownership of a partnership interest. Section 1202 refers to majority-owned corporate subsidiaries but is silent about Partnerships. Treasury Regulations issued under Section 355 provide that "active conduct" can be achieved by a corporation through ownership of a Partnership, so long as the size of the equity interest and participation in management is sufficient.[9] See *Exploring Section 1202's Active Business Requirement*. It seems reasonable that the courts would look to these regulations if asked to address active conduct through a Partnership in the context of Section 1202, but there is some risk that the IRS might argue that that the value of the Partnership interest does not apply towards meeting Section 1202's requirement that at least 80% of the corporation's assets are used in the active conduct of a qualified business.

No Section 1045 rollover by holders of profits interests. Treasury Regulation 1.1045-1(g) provides that the limit on a partner's

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nonrecognition of gain in connection with the partner's reinvestment in replacement QSBS under Section 1045 is that partner's "*smallest percentage interest in partnership capital*." Based on this provision, an employee must hold a capital interest in a Partnership on the day that the Partnership acquires the applicable QSBS before that employee can elect to reinvest sales proceeds under Section 1045. Revenue Procedure 93-27 provides that "*a capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest*" and that *"a profits interest is a partnership interest other than a capital interest."* Since a "profits interest" by definition doesn't initially have any associated capital interest, the employee holding a mere profits interest on the day the QSBS is purchased by the Partnership won't be eligible to reinvest the sales proceeds under Section 1045.

Rolling over original QSBS proceeds through a "purchasing partnership" under Section 1045

Treasury Regulation Section 1.1045-1 incorporates the concept of reinvesting proceeds from a taxpayer's sale of QSBS through a "purchasing partnership." Although the statute addresses for Section 1045 purposes reinvestment through a "purchasing partnership" by taxpayers who were partners in a Partnership selling the original QSBS, there doesn't seem to be any reason why the same principles wouldn't apply to a taxpayer's purchase of replacement QSBS through an investment Partnership where the taxpayer pools funds with other investors to acquire replacement QSBS (or with respect to other partners, perhaps their original QSBS investment). A taxpayer must be able to show that the Partnership reinvested that taxpayer's original QSBS within Section 1045's 60-day window. From the standpoint of substantiating a return position, a taxpayer who contributes cash to a Partnership for purposes of accomplishing a Section 1045 rollover should obtain assurances that the 60 day requirement was met and that the stock purchased by the Partnership was, in fact, QSBS.

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Neither Partnerships nor their partners are eligible to claim Section 1202 gain exclusion if previously issued QSBS is contributed to the Partnership and the Partnership sells the QSBS

Section 1202 includes several methods for transferring QSBS that preserves the QSBS status of the transferred stock, including gifts, transfers at death, and from a Partnership to partners. But Section 1202 doesn't include a transfer of QSBS by a taxpayer to a Partnership, other than perhaps by gift or at death. Further, Treasury Regulation Section 1.1045-1(f) provides the following unfriendly advice:

Section 721 applies to a contribution of QSB stock to a partnership. Except as provided in section 721(b), any gain that was not recognized by the taxpayer under section 1045 is not recognized when the taxpayer contributes QSB stock to a partnership in exchange for a partnership interest. Stock that is contributed to a partnership is not QSB stock in the hands of the partnership.

Without a doubt, QSBS should not be contributed to a Partnership where the contributor receives back any economic rights in the Partnership or already holds any interest in the Partnership. A gift to a Partnership where the contributor holds no interest in the Partnership either before or after the transfer or "at death" should be possible, as it doesn't fall within the scope of a property transfer under Section 721. But any transfer of QSBS to a Partnership could invite IRS scrutiny, and the absence of tax authorities confirming that taxpayers can transfer QSBS as a gift or "at death" (in each case for federal income tax purposes) to a Partnership makes it at least somewhat problematic from the standpoint of certainty of tax treatment. It may be possible to unwind the contribution if action is taken prior to a sale or exchange of the QSBS by the Partnership.

Ownership of QSBS by an S corporation

The limitations of Section 1202(g)(2)(B) apply equally to equity and equity rights held by employees of S corporations. The distinction

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between a capital interest and a profits interest applicable to Partnerships pursuant to Treasury Regulation Section 1.1045-1(g) does not apply to S corporations, since S corporations are limited to a single class of stock. In order for employees to share in Section 1202's gain exclusion through an S corporation, the employees must hold unrestricted S corporation stock on the date the S corporation acquires shares of QSBS. Neither Section 1202's gain exclusion nor the right to reinvest gain under Section 1045 applies to holders of an S corporation's nonqualified stock option, other stock rights or bonus arrangements. No QSub election would be made for the corporate subsidiary because of the requirement that a QSBS Issuer be a domestic (US) C corporation.

Section 1202 does not allow for the distribution of QSBS by an S corporation to its stockholders. Also, Treasury Regulation Section 1.1045-1 is silent regarding whether a transferee of S corporation stock steps into the shoes of the original stockholder with respect to the indirect investment in QSBS. Therefore, any transfer planning with S corporation stock should be done before the S corporation acquires QSBS to avoid falling within this grey area of tax law. There is also no guidance regarding what happens to a transferee stockholder's right to claim Section 1202's gain exclusion when there is an involuntary transfer of S corporation stock arising out of death, divorce or bankruptcy.

Planning with single-member LLCs

Since a single-member LLC is treated as a disregarded entity unless an election has been made to treat the LLC as a corporation for federal income tax purposes, the ownership of QSBS indirectly through a single-member LLC should be treated as direct ownership for federal income tax purposes.[10]

Many corporations use disregarded entities (generally single-member LLCs) to hold operating assets or property for a variety of business and reasons, including parent-subsidiary asset protection, isolation of pre-acquisition liabilities and obligations, state and local tax (SALT) planning, general asset management. Although there are no tax authorities directly on point addressing the use of disregarded entities in connection with QSBS, the treatment of a

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wholly-owned LLC that has not "checked-the-box" to be a corporation as disregarded for federal income tax purposes should allow them to be owned by corporations issuing QSBS without concern for any adverse consequences regarding the QSBS status of stock issued by the parent corporation – the assets and activities of the LLC should be treated as those of the parent corporation for Section 1202's various eligibility requirements.

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.

More QSBS Resources

- Substantiating the Right to Claim QSBS Tax Benefits | Part 1
- Substantiating the Right to Claim QSBS Tax Benefits | Part 2
- One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors
- To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)
- Advanced Section 1202 (QSBS) Planning for S Corporations
- Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 2
- Structuring the Ownership of Qualified Small Business Stock (QSBS) – Is There a Role for Roth IRAs?
- Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide
- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations

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- Can Stockholders of Employee Leasing or Staffing Companies Claim Section 1202's Gain Exclusion?
- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving 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*

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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*.

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, but not all, states follow the federal treatment of QSBS. Notably, California and New Jersey (until 2026) do not have a corresponding gain exclusion.

[2] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended.

[3] LLCs and LPs can make a "check-the-box" election on Form 8832 to be taxed as a corporation for federal income tax purposes. In some cases, business owners decide to check-the-box rather than convert to state law corporations to either keep the economic and governance arrangements set out in an LLC operating agreement or LP agreement in place or simply because they prefer the state-law features of LLCs or LPs over state-law corporations. For a more detailed discussion, see *To Be Clear. . . LLCs Can Issue Qualified Small Business Stock (QSBS)*.

[4] Section 1202(g)(2)(B) provides that an amount meets the requirements for the passing through of Section 1202's gain exclusion if "*such amount is includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-thru entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-thru entity*."

[5] *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024).

[6] Revenue Procedure 2001-43, 2001-2 CB 191.

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[7] Legislative history includes an express indication by Senator Lieberman that Section 1202(g)'s definition of "interest" is intended to apply to a profits interest. 139 Cong. Rec. S10680-01, S10732-33 (Aug. 6, 1993). Materials prepared for the 2024 May Tax Meeting of the American Bar Association Tax Section on Section 1202 and Partnerships noted that "*while Senator Lieberman was not a manager of the bill, and therefore his statement cannot be considered directly in the determination of whether substantial authority exists for the tax position pursuant to Treas. Reg. § 1.6662-4(d)(3)(iii), it still provides a helpful contextual background.*"

[8] *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024). *Chevron U.S.A, Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

[9] See Treasury Regulation Section 1.355-3; Proposed Regulation Section 1.355-3.

[10] See Treasury Regulations issued under Section 7701.

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