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Corporations Are Eligible to Issue Qualified Small Business Stock (QSBS) Only if They Satisfy Section 1202's "Aggregate Gross Assets" Test

Section 1202 permits a taxpayer to claim a gain exclusion in connection with the sale or exchange (including redemption) of qualified small business stock (**QSBS**) issued by a domestic (US) C corporation.[1] For QSBS issued prior to July 5, 2025, the per-taxpayer, per-issuing corporation (the "**QSBS Issuer**") amount of excluded gain is generally capped at $10 million, which translates into $2.38 million of tax savings at the federal level.[2] The One Big Beautiful Bill Act (**OBBBA**) increased the amount of excluded gain to $15 million for QSBS issued after July 4, 2025.[3] Sections 1202 and 1045 were enacted by Congress to encourage investment in C corporations start-ups and small businesses, and towards that goal, end, Congress placed limits on the size of corporations eligible to issue QSBS.

There are a number of taxpayer-level and corporate-level eligibility requirements that must be satisfied before a taxpayer is eligible to claim Section 1202's gain exclusion. This article focuses on Section 1202's "aggregate gross assets" test, which limits the size of corporations eligible to issue QSBS.

An introduction to Section 1202's "aggregate gross assets" size test

Section 1202(d), as revised by OBBBA, provides that for QSBS issued after July 4, 2025, a corporation whose "aggregate gross assets" exceed $75 million at any time prior to the issuance date or immediately after the issuance is not eligible to issue QSBS. If the date of the stock issuance took place prior to July 5, 2025, $75 million is replaced by $50 million. The increase from $50 million to $75 million was intended to partially offset the effect of inflation from 1993 to 2025. A full offset would have required an increase to

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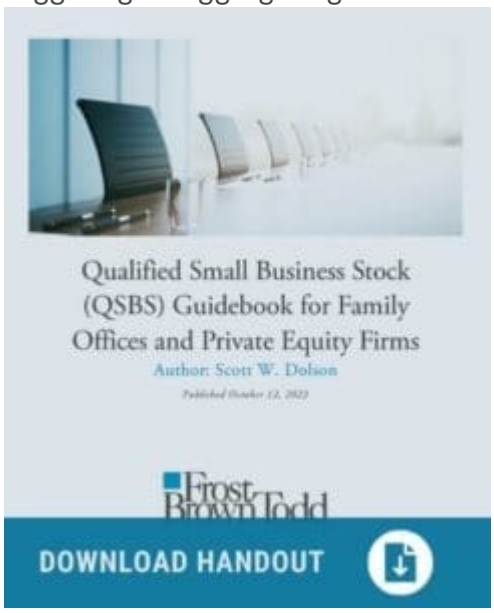
well over $100 million. Fortunately, with respect to a particular issuance of stock, the aggregate gross assets test only applies only at the time of issuance. If stock is issued on August 15, 2025, and the corporation's aggregate gross assets didn't exceed $75 million immediately after the issuance and at any time prior to the issuance, the fact that the corporation's aggregate gross assets later exceed $75 million will not generally affect the QSBS status of the stock. As discussed below, the general rule in the preceding sentence can be upended if there is a later recapitalization triggering an aggregate gross assets retesting.



One question that has arisen out of OBBBA's increase from $50 million to $75 million is whether a corporation whose aggregate gross assets exceeded $50 million prior to July 5, 2025, is now able to issue additional QSBS if its aggregate gross assets have not exceeded $75 million. Amended Section 1202(d) simply provides that a qualified small business is a domestic corporation which is a c corporation if *"(A) the aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of enactment of the Revenue Reconciliation Act of 1993 and before the issuance did not exceed $765,000,000, and (B) the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) do not exceed $75,000,000."* This language appears to answer the question – so long as the aggregate gross assets have

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not exceeded $75 million, the fact that aggregate gross assets previously exceeded $50 million isn't relevant.

The aggregate gross assets test looks both back to the period prior to a stock issuance being tested and immediately after the issuance. Beyond the language of Section 1202, there are no tax authorities providing guidance as to how this requirement functions in the real world. Take for example a situation where QSBS is issued on May 1, 2026, followed by an additional stock issuance one month later. Absent some linkage between these two events, there appears to be no reason why the two issuances should be aggregated for purposes determining whether the May issuance passed the aggregate gross assets test. Following this logic, if an equity round is imminent, employees holding non-qualified options and investors holding convertible debt should consider getting the issuance of their stock in under the wire if holding QSBS is a goal. What if the May and June issuances are interim closing in the same offering? The IRS might argue that the two issuances should be integrated for the aggregate gross assets test, particularly if the company had accepted both subscriptions and was issuing stock on a rolling basis. The stockholders would argue that the literal wording "immediately after the issuance" should be read to mean exactly that and no more. Finally, what about the situation where calling all of the investors' committed capital would result in failure of the aggregate gross assets test? The taxpayer's position might be that since commitments to make future capital infusions are not assets on the QSBS Issuer's balance sheet, those commitments should not factor into the determination of the corporation's aggregate gross assets "immediately after the issuance." The Tax Court will likely to look closely at the applicable facts when applying the "immediately after the issuance" concept to a particular QSBS issuance, perhaps considering Section 351 tax authorities which also address what constitutes "immediately after" a stock issuance. The overall takeaway is that some corporations should be able to stage stock issuances for the purpose of allowing additional share issuances to be made before the corporation fails the aggregate gross asset test.

Section 1202(c)(1) provides that QSBS can be issued for money, other property (not including stock) or as compensation for

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services (other than services performed as an underwriter of such stock). When looking at a QSBS Issuer's "aggregate gross assets" immediately after the applicable stock issuance, the cash and the fair market value of property contributed to the QSBS Issuer would obviously be taken into consideration. But what about the value of services? Section 1202 does not address this issue, other than perhaps indirectly by defining "aggregate gross assets" to include money plus the adjusted tax basis of other assets, and as discussed below, the fair market value of certain assets contributed to the QSBS Issuer on a tax-free basis. The value of services is not included on a GAAP or a "Section 1202 balance sheet." Based on the preceding, it seems reasonable to conclude that the value of services (i.e., the amount of compensation associated with the services) would not be included in the calculation of a QSBS Issuer's "aggregate gross assets."

While it seems unrealistic that a Tax Court judge would require a taxpayer to establish a corporation's "aggregate gross assets" did not exceed the applicable amount on each day during a taxpayer's QSBS holding period that runs for years, there are no tax authorities establishing what constitutes a reasonable level of proof. Obviously, every effort should be made to fully document that a corporation's aggregate gross assets have not exceeded the applicable threshold. See the article *Substantiating the Right to Claim QSBS Tax Benefits – Part 1*. Section 1202(d) provides that corporations must agree to "*submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section*." But, no Treasury Regulations or other guidance has been issued by the IRS addressing the application of this reporting requirement.

How "aggregate gross assets" is calculated for purposes of Section 1202

Section 1202(d)(2) provides that "aggregate gross assets" means the amount of cash and the aggregate adjusted basis of other property held by the corporation. The phrase "adjusted basis of other property" should mean the corporation's adjusted tax basis of other property. A balance sheet prepared in accordance with GAAP

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could be misleading because assets are often not recorded at their adjusted tax basis and there are additional assets such as acquisition goodwill which would not belong on a tax basis balance sheet. The fair market value of the QSBS Issuer's assets, (e.g., enterprise value), including goodwill, is not relevant when preparing a Section 1202 balance sheet unless the goodwill was purchased or assets were contributed as part of a tax-free contribution governed by Section 118, 351 or 368. One result of how the "aggregate gross assets" calculation is made is that a corporation might have less than $75 million in aggregate gross assets and have an enterprise value or aggregate fair market value of all assets that far exceed $75 million. Of course, it is also that since liabilities are excluded from the calculation (see the discussion below), a corporation's "aggregate gross assets" could exceed the corporation's enterprise value/FMV.

Contributed property is valued at fair market value (**FMV**), not at its historic tax basis. Section 1202(d)(2)(B) requires that for purposes of the aggregate gross assets test, the adjusted basis of property contributed to a corporation in a tax-free exchange (e.g., Section 351 nonrecognition exchange, a Section 368 reorganization or a capital contribution governed by Sections 118 and 362) ("Contributed Property") is treated as if the basis of such Contributed Property (immediately after the contribution) is equal to its FMV at the time of contribution. Although not explicitly addressed in Section 1202, it seems reasonable that when Contributed Property is added to the "Section 1202 balance sheet," the property would remain on that special Section 1202 balance sheet thereafter at the FMV number, perhaps adjusted going forward to account for amortization and depreciation based on the initial FMV.[4] Section 1202(d)(2)(B)'s rule must be taken into consideration in connection with acquisitive Section 351 nonrecognition exchanges or tax-free reorganizations, and rollovers generally associated with QSBS Issuer's business and asset acquisitions.

A corporation's liabilities are excluded from the calculation of aggregate gross assets, but cash proceeds from loans and tangible personal property purchased using borrowed funds are included in the calculation. The 1993 House bill subtracted short term liabilities,

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but the 1993 Conference Agreement eliminated that subtraction from the aggregate gross assets computation. Because debt is not offset against assets on the Section 1202 balance sheet, situations can arise where the QSBS Issuer will have a line of credit, floor plan or other debt facility that ties directly into increasing the assets on the corporation's balance sheet (e.g., inventory or equipment). For example, a car dealership floor plan ensures that dealers have the capital needed to purchase inventory. When an automobile is purchased and added to the "inventory" number on the balance sheet, the outstanding balance of the dealer's floor plan increases. For Section 1202 purposes, what this means is that the job of monitoring whether a corporation has exceeded or will exceed the aggregate gross asset ceiling must include not only monitoring cash arising out of equity or debt investments but also at whether money drawn down on commercial bank loan facilities contributes to increases in cash, equipment, inventory, supplies, purchased goodwill or capitalized expenses.

OBBBA restored through new Section 174A the deductibility of domestic research and experimentation (R&E) expenditures, which reversed a recent tax law change requiring all R&E expenditures to be capitalized starting in 2022. Previously capitalized R&E can be deducted either on a going forward basis or for certain small businesses, via amending their corporate returns back to 2022. The right to immediately expense R&E will be a significant factor in reducing many start-ups' aggregate gross assets for purposes of the Section 1202 calculation. Further, the right to amend corporate Form 1120 tax returns back to 2022 could result in some stock issuances now falling below the $50 million aggregate gross assets ceiling during the period 2022 through 2024. There is no reason to assume that either this retroactive right to write-off R&E beginning with the 2022 return or any other amendment to a corporate tax return during that period affecting the corporation's tax basis in assets wouldn't have a corresponding effect on whether or not the corporation passed through the $50 million aggregate gross assets ceiling. The same analysis should apply if there was an error on 2022 through 2024 tax returns that when corrected would result in the corporation passing through the $50 million aggregate gross assets ceiling, resulting in a stock issued during that period not

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qualifying as QSBS.

The calculation of "aggregate gross assets" must take into account whether a QSBS Issuer is a member of a "parent-subsidiary controlled group."

The "aggregate gross assets" of all corporations included in the "**parent-subsidiary controlled group**" must be included in the calculation of a QSBS Issuer's "aggregate gross assets." Section 1202(d)(3) provides that the assets of corporations that are part of the same "parent-subsidiary controlled group" as defined in Section 1563(a)(1) (substituting "more than 50 percent" for "at least 80 percent") are included when making the $50 Million Test calculation. Because of Section 1202(d)(3), the aggregate gross assets of the QSBS issuer might need to be aggregated with one or more tiers of that corporation's subsidiaries. Note that the "aggregate gross assets" of the QSBS issuer might need to be aggregated with either a C corporation or S corporation stockholder. Finally, if there is a C or S corporation stockholder whose aggregate gross assets must be aggregated with those of the QSBS Issuer, that parent corporation might have one or more tiers of subsidiaries whose aggregate gross assets would also need to be included calculating aggregate gross assets. This requirement is possible because of the potential scope of Section 1563's "parent-subsidiary controlled group."

Under Section 1563(a)(1) (as modified by Section 1202(d)(3)), two corporations are part of the same "parent-subsidiary controlled group" if a corporate stockholder holds more than 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock of a corporate subsidiary. Whether a corporation has the necessary "voting power" generally translates into determining whether it holds stock with the voting power necessary to elect a board of directors. There are instances, however, where voting control isn't determined merely by the power to elect the board of directors, if certain classes of directors or stockholders have supermajority

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voting rights.[5] An example of one complicated "parent-subsidiary controlled group" would be the situation where an S corporation holds 75% of the voting stock of the QSBS issuer, giving it the right to elect a majority of the QSBS issuer's board of directors. In addition, each of the QSBS issuer and the parent corporation holds 75% of the stock of a subsidiary, in each case giving the stockholder corporation the right to elect a majority of the subsidiary's directors. In this scenario, the QSBS issuer, the parent stockholder, the subsidiary of the QSBS issuer, and the other subsidiary of the parent corporation would all be a part of the same "parent-subsidiary controlled group."

Section 1202's 1993 Conference Report confirmed that a ratable share of a subsidiary's assets is included in the calculation of a QSBS Issuer's aggregate gross assets test, based on the percentage of stock owned (by value). Where a subsidiary is issuing the stock being tested, the aggregation rules in Section 1202(d)(3) would also appear to require that the calculation include a ratable share of the parent corporation's assets in a "parent-subsidiary controlled group."

In calculating aggregate gross assets, the value of a noncontrolling investment in corporate stock or other pass-through entity equity interest should be the QSBS Issuer's tax basis. If the QSBS Issuer holds a controlling equity interest in a limited liability company, limited partnership or joint venture, it seems likely that the ratable share rule would apply, with a look-through to the non-corporate subsidiary's assets. There are no Section 1202 tax authorities specifically addressing these issues.

How to substantiate a QSBS Issuer's aggregate gross assets

A recent case highlights how a taxpayer's failure to adequately substantiate the satisfaction of the aggregate gross assets test will result in a failed QSBS-related return position.[6] The taxpayer in *JU v. Commissioner* 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

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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*."[7] 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.

The IRS or the Tax Court could theoretically demand that taxpayers prove satisfaction of the aggregate gross assets test for each day prior to the issuance of QSBS. For QSBS Issuers sitting comfortably below the applicable aggregate gross asset ceiling, annual financial statements for the applicable period and reasonable evidence of the value of any contributed assets (under Sections 118, 351 or 368) should suffice, along with evidence of whether the QSBS Issuer was a part of a parent-subsidiary controlled group. But if the QSBS Issuer was hovering around the applicable aggregate gross assets ceiling, then additional detailed documentation may be necessary to satisfy the evidentiary burden of proof.[8] Under those circumstances, every effort should be made to construct a running Section 1202 asset-side tax balance sheet using all available financial information. If the corporation was the beneficiary of past material property contributions, it may be necessary to obtain an appraisal of those assets in order to include them on the tax balance sheet at their FMV.[9] Taxpayers should keep in mind the fact that the equity credit negotiated by the parties for contributed property does not always equate to actual FMV of the contributed property, although value of equity issued in exchange is likely to be significant factor in determining FMV.

For further discussion of the substantiation of QSBS return positions, see *Substantiating the Right to Claim QSBS Tax Benefits (Part 1)* and *Substantiating the Right to Claim QSBS Tax Benefits (Part 2)*.

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When does Section 1202 require a second "aggregate gross assets" testing?

Typically, passing Section 1202's "aggregate gross assets" is a one-time requirement, with the testing occurring when stock is issued and applicable for the period prior to and immediately after issuance. But if the QSBS Issuer undertakes a Section 351 nonrecognition exchange or Section 368 tax-free reorganization, it appears that there would a retesting of the issuing corporation's "aggregate gross assets." Support for the conclusion that there is a retesting required under Section 1202(h)(4) can be found in that clause's reference to QSBS or non-QSBS being issued in the exchange. The IRS concluded in Private Letter Ruling (PLR) 9810010 (3/6/1998) that "Controlled" stock distributed in a Type D reorganization (split-up) was QSBS not subject to the limitations of Section 1202(h)(4)(B) because the stock of "Distributing" was QSBS and that "Controlled" was a qualified small business at the time of the reorganization, which would have included the requirement that Controlled's "aggregate gross assets" were below the $50 million ceiling. For more discussion of when a second "aggregate gross assets" testing is required when reorganizations, recapitalizations, stock exchanges and stock splits occur, see *Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)*.

Managing aggregate gross assets

If management is looking to issue QSBS, but the corporation's aggregate gross assets are approaching $75 million, careful attention should be paid to the Section 1202 tax balance sheet, in particular how and when cash is infused into the business and how that cash is used (i.e., does the cash hit the balance sheet in terms of capitalized expenditures or assets or is it expensed when spent?). If the owners of a partnership want to incorporate but passing the aggregate gross assets test appears to be an issue, one strategy would be to exclude non-essential assets and lease or license those assets to the C corporation. Also, if the partnership engages in multiple separate business activities, consideration could be given to separating those activities into multiple C

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corporations.

This strategy may also make sense in connection with managing future exits. Attention can be paid to the timing of stock issuances, converting stock rights and convertible debt into stock and drawing down committed capital and debt (which is accompanied by additional cash or other assets on the balance sheet).

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

- Exploring Section 1202's Active Business Requirement
- 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] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. Many but not all states follow the federal income tax treatment of QSBS. For QSBS issued prior to July 5, 2025, the required holding period is greater than five years. For QSBS issued after July 4, 2025, the required holding period starts at three years for a 50% gain exclusion and increases to five years for a 100% gain exclusion.

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[2] This example assumes a 20% capital gains rate, plus a 3.8% net investment income tax. Additional tax saving may be available at the state level. In addition to the $10 million or $15 million per-taxpayer, per-corporation gain exclusion cap, there is a separate cap equal to 10 times the aggregate tax basis of QSBS sold in a tax year, which can result in more than an aggregate $10 million or $15 million million gain exclusion depending on a taxpayer's aggregate tax basis on whether the QSBS is sold over more than one year.

[3] A discussion of the OBBBA can be found in the article *One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors*. The amendments to Section 1202 include a reference to Section 1223 which has the effect of blocking the conversion of pre-OBBBA QSBS into post-July 4, 2025, QSBS through stock-for-stock exchanges or in connection with the reinvestment of pre-OBBBA sale proceeds into replacement QSBS under Section 1045.

[4] Some tax practitioners believe that the language of Section 1202 supports the argument that property hitting the Section 1202 balance sheet in a Section 118, 351 or 368 contribution is valued at FMV only for the initial contribution and thereafter would be included on the Section 1202 balance sheet at its actual adjusted tax basis.

[5] See Technical Advice Memorandum 9452002 (12/30/1994); *Alumax Inc. v. Commissioner*, 109 T.C. 133 (1997), *aff'd* 165 F.3 822 (11th Cir. 1999); *Framatome Connectors USA Inc. v. Commissioner*, 118 T.C. 32 (2002), *aff'd* 94 AFTR 2d 2004-5820 (2nd Cir. 2004).

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

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

[8] One example of a complicated aggregate gross assets analysis was where a QSBS issuer was well below the $50 million mark at the beginning of a year and well above the $50 million mark at year-end. Stock being vetted for QSBS eligibility was issued in the middle of the year. In order to determine whether the QSBS issuer passed the aggregate gross assets test, it was necessary to look at month-by-month inventory numbers, as inventory was constantly being added through draws on a line of credit and sold in the ordinary course of the company's business operations.

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[9] One thing to keep in mind in connection with reviewing the financial records of a corporation that has participated in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization, is that the Treasury Regulations issued under those statutes require the inclusion of a statement setting forth information about the transactions, including the estimated value of the contributed property.

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