Revisiting the Choice of Entity Decision After OBBBA's 2025 Tax Law Changes | Part 1

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Categories:

Advanced QSBS Planning
One Big Beautiful Bill Act

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Section 1202 provides an exclusion from capital gain when a taxpayer sells qualified small business stock (**QSBS**) if all of Section 1202's eligibility requirements have been satisfied.[1] The One Big Beautiful Bill Act (**OBBBA**) further enhanced 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**.

This article focuses on tax-related factors to consider when choosing whether to operate for federal income tax purposes as a partnership (through a state-law limited liability company (**LLC**) or limited partnership (**LP**)) (together, a "**Partnership**") or C corporation. For information addressing the issues arising out of the conversion of a Partnership to C corporation, see the articles "*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*."

Choice of entity issues associated with choosing between operating in an S corporation versus C corporation will be addressed in a separate article. For general information about the intersection of S corporations and QSBS, see "*Advanced Section 1202 (QSBS) Planning for S Corporations*."

Business owners do not possess the proverbial crystal ball that would be necessary for perfect decision making, particularly where the results of decisions may unfold over years. In the end, deciding what business entity to operate through involves making a judgment call based on the imperfect but best available information. The purpose of this article is to expose business owners and professionals to a number of factors that should be

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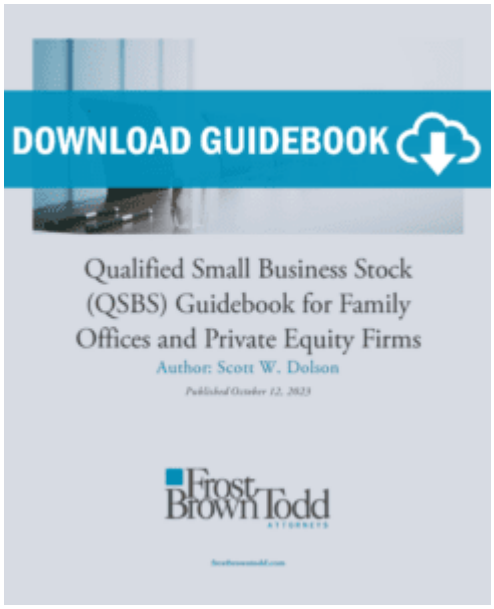
considered during the planning process.

Most states follow the federal treatment of QSBS or do not have an individual income tax, but California, New Jersey, Pennsylvania, Mississippi and Alabama do not follow the federal treatment.[2] This article does not focus on the pros and cons of operating through a state law LLC/LP or corporation.[3]

Part 2 of this article will address modelling as a tool to illustrate different net after-tax proceeds resulting from inputting various tax assumptions relevant to operating a business in either a Partnership or C corporation.

I. What has changed since the 2017 Tax Cuts and Jobs Act?



It has been eight years since the passage of the 2017 Tax Act and several months since OBBBA was signed into law on July 4, 2025. A number of factors to consider when making the choice of entity decision have changed during the past eight years and certainly since the 2024 presidential election.

A. Enactment of OBBBA adds some degree of clarity and stability for future planning. Section 1202's holding period changes now require only a three-year holding period before a partial (50%) gain exclusion can be claimed and a five-year holding

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period before Section 1202 provides for a 100% gain exclusion. Choice of entity planning requires something of a look into a crystal ball regarding tax law and tax authorities three to 10 years in the future. Perhaps the most important takeaway from the passage of OBBBA from a choice of entity planning standpoint is that we are unlikely to see, at least during the remainder of the Trump presidency, increases in corporate or individual tax rates, a reduction or elimination of Section 1202's gain exclusion, or changes to the tax treatment of carried interests.

B. We now have direction regarding tax rates. There was talk during the Biden years of increasing the corporate rate to 28% and the individual tax rate for high income earners to 39.6%. There was also discussion of taxing capital gains at a top marginal income tax rate of 39.6% for taxpayers whose income exceeded $1 million, and discussion of eliminating the tax benefits associated with carried interests. Under OBBBA, tax rates and benefits associated with profits interests (carried interests/promotes) remained unchanged. [4] The highest individual tax bracket remained 37%. For 2025, a 20% capital gains rate applies to those married filing jointly with income exceeding $600,050. A 3.8% net investment income tax continues to be imposed on most capital gains, including gain from the sale of stock. The favorable corporate income tax flat rate of 21% remained unchanged. Section 1061 continued to require a three-year holding period before long-term capital gains treatment applied to carried interests issued to hedge fund, private equity and similar financial industry personnel. Although nothing is certain when it comes to taxes, it seems reasonable to assume for planning purposes that rates will remain where they are today for at least the next several years and perhaps beyond.

C. Section 199A will continue to apply after 2025. Section 199A allows taxpayers to deduct up to 20% of their qualified business income, with many rules and limitations. Section 199A's 20% deduction, which was set to expire after 2025 was made "permanent" as a result of OBBBA, and the phase-in thresholds for limitations have been increased to $75,000 and $150,000 for single and joint filers. Section 199A's qualified business income deduction was originally intended to bring pass-thru entity tax rates more in-line with the 2017 Tax Act's reduction in corporate rates from 35%

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to 21%. But the upshot of these changes is that pass-thru entity equity owners who have significant income continue to be potentially placed at a disadvantage versus the C corporation which benefits from a 21% flat tax rate. If a C corporation can reinvest its net income into the business and owners can eventually sell QSBS and claim Section 1202's gain exclusion, this combination should generally result in tax benefits exceeding those provided through Section 199A.

D. Section 1202 not only avoids the chopping block but emerges enhanced under OBBBA. The Tax Relief for American Families and Workers Act of 2024 (the "**Biden Tax Act**") would have trimmed Section 1202's benefit by approximately two-thirds – a reduction from 23.8% to zero would instead have become a reduction from 23.8% to approximately 16%. The Biden Tax Act was narrowly defeated in the Senate, Donald Trump was then elected President and OBBBA, Trump's signature tax legislation, increased the Section 1202 gain exclusion for stock issued after July 4, 2025, to $15 million from $10 million, increased the size of corporations eligible to issue QSBS from $50 million to $75 million in "aggregate gross assets", and most significantly, added a 50% partial gain exclusion after QSBS is held for three years and a 75% partial gain exclusion after QSBS is held for four years.[5] The full 100% gain exclusion applies to QSBS held for five years.

E. The 2017 Tax Act increased the required holding period for certain holders of carried interests from one to three years. Carried interests have for now avoided further carnage. The tax benefits associated with holdings a carried interest have been under bipartisan attack during the past 10 years. A Biden proposal would have taxed income allocated to carried interests at ordinary income rates for taxpayers with gross income in excess of $1 million. Another proposal included in the "Carried Interest Fairness Act" (CIFA) would have barred the benefits of Section 1202's gain exclusion for holders of carried interests. Section 1061, which was enacted as part of the 2017 Tax Act, increased from one to three years the required holding period before certain carried interest holders can benefit from capital gains treatment, remains the only legislation affecting the tax benefits associated with the carried interest. OBBBA did not further erode the substantial benefits of

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holding a carried interest.

F. Full expensing of domestic research and development expenses made permanent by OBBBA. Amendments to Section 174 made by the 2017 Tax Act required research and experimental (**R&E**) expenditures paid or incurred in taxable years beginning after December 31, 2021, to be capitalized and amortized over five years for domestic research and 15 years for foreign research. New Section 174A reinstated full expensing for domestic R&E expenditures and provides different methods for writing off past capitalized R&E. Foreign R&E remains subject to Section 174's capitalization rules. Section 174A's rules should allow certain corporations as they grow in size to remain under $75 million in "aggregate gross assets" as the calculation looks at the "adjusted tax basis" of assets and when assets are expensed, their tax basis is reduced to zero.[6]

G. Bonus depreciation and other cost recovery incentives included in OBBBA should help businesses stay below $75 million in "aggregate gross assets" for purposes of Section 1202. Under OBBBA, (i) "bonus depreciation" is extended at 100% of tax basis for eligible property acquired and placed in service after January 19, 2025, and generally before January 1, 2030, (ii) a 100% depreciation allowance was introduced for "qualified production property," and (iii) the maximum amount a taxpayer may expense under Section 179 is increased to $2.5 million for taxable years beginning after December 31, 2024 (with inflation indexing for taxable years beginning after December 31, 2025). As with expensing under Section 174A, these rules should allow some corporations to remain under $75 million in "aggregate gross assets" for a longer period during their growth cycle.

H. Modifications of the SALT Cap. OBBBA increased the individual deduction cap for specified taxes (state and local sales, income and property taxes) from $10,000 to $40,000 in 2025, with increases thereafter, but reduced the deduction by 30% of the excess of modified adjusted gross income over $500,000 in 2025 (increasing thereafter). OBBBA disallowed the deduction of these specified taxes by partnerships, effectively abrogating Notice 2020-75 which authorized the pass-thru entity tax provisions enacted by various

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states. The upshot of these changes is that a Partnership's equity owners who have a significant pass-through of "specified taxes" will be placed at a disadvantage versus C corporations that are allowed a full deduction under Section 164 for these taxes at the corporate level.

l. Expansion of estate tax exemption. Prior to the enactment of OBBBA, the estate tax exemption increased year-to-year until for 2025, the exemption reached $13,990,000 for an individual and $27,980,000 for a married couple filing jointly. From 2017 through 2025, there was always the risk that the exemption might be cut through legislation or sunset at the end of 2025, when the exemption amount was expected to revert to an estimated $7 million starting in 2026. Under OBBBA, the estate tax exemption was permanently increased to $15 million per individual and $30 million for married couples, filing jointly. The permanent increased exemption reduces the planning drive to "use it or lose it" that accompanied uncertainty regarding where the exemption would land after 2025.[7]

II. Key factors to consider when deciding whether to operate a business through a C corporation.

Each of the following factors are discussed in further detail below. With respect to some of these factors, advance planning can avoid the problems associated with attributes that do not make the business the ideal candidate for operation in a C corporation (e.g., revenues exceeding what would be needed for capital investment and working capital). We are assuming that a business considering whether to operate as a Partnership or C corporation is either currently in the pre-startup phase or operating as a Partnership.[8]

Factor	Description

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Does the tax status of business owners affect the choice of entity decision?

Individuals, holders o
(LLCs/LPs) and S corp
trusts are eligible to
exclusion. C corpora
the gain exclusion.

Nonresident foreign s
stockholders (e.g., IR
capital gains from th
Section 1202's gain e

Foreign and tax-exer
not want to be alloca
Partnership, and ther
corporation as the op
equity interest throu

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Is the choice between operating a business as a Partnership or corporation dictated by what investors or buyers expect and/or demand?

Typically, software a
corporations becaus
venture capital inves
investors also genera
connected US incom

Some public compan
structure acquisition
stock transactions th
to be a C corporation
exchange as a taxabl
claim Section 1202's
preferable to structu

In contrast, compani
financing that hold su
depreciable property
Partnership, in partic
can be efficiently str
benefiting from a tax
corporation is hard t
of capital gain that ca
1202's gain exclusion

If the business is currently operating as a partnership for federal income tax purposes, will a conversion trigger taxable income?

Section 351's nonrec
generally apply when
deemed to be contrib
the conversion of a p
contributed liabilities
basis of contributed
under Section 357.

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	Under Section 1202(i converted to a corpo are contributed to th QSBS, the tax basis o calculating the gain a 1202 is treated as the contributed property
If the business is currently operating as a partnership for federal income tax purposes, will there be enough appreciation in the value of the business after conversion to make restructuring worthwhile?	There are two conse for purposes of the 1 used, so if property w into the corporation, $100 million. Second the contribution of as be excluded from the exclusion.
	So, conversion makes assumption is that th appreciate substanti
Will the business be able to take advantage of the favorable 21% flat corporate tax rate?	A corporation's incor corporate rate. If a b income, reinvesting t business could result advantage if this is c 1202's gain exclusion
Will the business generate income not required for reinvestment to fuel growth and fund operations?	If a business generat what is needed as wo double taxation (21% 23.8% at the stockho avoid the accumulat potential failure of Se

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Will the business generate taxable income to offset start-up losses?	If the corporate form losses, depreciation through to stockhold eventually generate these early-stage los during the start-up a (R&D) phases should losses passing throug level.
Do the owners of the business have a need for periodic income distributions from the business?	Distributions to cove could expose the par The gold standard fo one where net revenu business and the eco stock is sold, rather t on the business for a
Do the owners of the business anticipate exiting the business through a secondary sale or sale of the entire business?	Section 1202's gain e QSBS is transferred i it reasonable to antic sold within 5–10 year use of Section 1202 g
Will buyers cooperate by purchasing target company QSBS?	In a vacuum, most bu assets rather than st owning a company w there is no inside ass buyers will reduce th loss of future tax writ amortization of good transaction is structu But some buyers (e.g focused on potential comfortable purchas discounting for lack some public compan stock for target comp reorganizations.

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Does the fact that C corporations can participate in tax-free reorganizations under Section 368 make a difference from a planning standpoint?

C corporations can e
reorganizations unde
the opportunity to ex
for stock of a purcha
public company. Par
structure tax-free ex
for purchaser stock b
nonrecognition excha
option and Partnersh
eligible parties to par
reorganizations unde

As vehicles for struct
corporations work be
corporation (allowing
and Partnerships wor
Partnership. C corpo
partnerships as a veh
Section 721 transacti
participants won't be
into a lower-tier part

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Section 1202 has a nu
stockholder-level eli
eligibility requiremer
business activities, w
original issuance, wh
assets" size limitatio
issuer is a domestic (

Is it reasonable to assume that business owners will ultimately be eligible to claim Section 1202's gain exclusion?

For stock issued afte
five year holding peri
stockholder is eligibl
exclusion. Can it be a
will meet these holdi

There are options ava
requirement isn't me
exchanges under Sec
1045 election to exch
replacement QSBS, b
gain exclusion after a
period is optimal.

Those involved in making a choice of entity decision should keep in mind that the conversion from a Partnership to C corporation is generally a one-way trip. Conversion from a C corporation to an entity taxed as a partnership for federal income tax purposes would trigger a deemed sale of the corporation's assets, followed by a taxable liquidating distribution (bringing the transaction squarely within the classic double taxation problem). It may be possible for some C corporations to later elect pass-through tax treatment by making an S corporation election, but S corporations are subject to a number of eligibility limitations including excluding Partnerships and corporations as stockholders, and limiting the equity to a single class of common stock.

A number of the factors identified in the chart below are discussed in further detail in Section V below.

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III. Key factors to consider when deciding whether to operate a business through a Partnership.

Factor	Description
Will the owners of the business be eligible to claim Section 1202 gain exclusion?	**If not, this could weig Partnership over a C**
Are there passive owners who will expect periodic income distributions?	**Periodic income distr made by a C corpora burden. In contrast, Partnership are gene are subject only to ar this rate is higher tha**
Will there be excess accumulations of earnings not required as working capital?	**Businesses that gene required for future op working capital are o operating through a C taxation coupled with the additional 20% ac failure of Section 120**
	The challenge of deal income must be weig benefits of Section 12 alone, an excess inco in favor of the Partne

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	If the business has si time of sale, that mix taxation at a significa otherwise apply if th goodwill.
With respect to the business in question, if a transaction is structured as an asset sale, will there be a significant amount of "hot assets" that generate ordinary income rather than capital gain?	The "hot asset" probl a partnership whethe as an equity or asset additional weight in f sale by a C corporati
	Section 751 "hot asse receivables, Section (depreciation recapt items and Section 125 trademarks or trade
Does a pre-incorporation strategy of operating as a partnership for the purpose of increasing enterprise value prior to converting to C corporation make sense?	Operating initially as asset value before co thereby maximizing S exclusion cap. This s against Section 1202' requirement – the ho until the business is c corporation.
Does the ability of a Partnership to allocate losses to owners affect the planning decision?	Early-stage compani can be passed throug subject to various lim use of such losses

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	With a Partnership, g level, avoiding the th follows the C corpora
Does the ability of a Partnership to avoid the constant threat of double taxation hanging over the C corporation affect the planning decision?	**Compensation is gen corporation level (at level at substantially distributions are not 23.8% at the stockho**
Does the flexibility of a Partnership to make nontaxable property distributions affect the planning decision?	**Appreciated propert by a Partnership with more flexibility than distributed out of a C sale and double taxa transaction can be st reorganization.**
Does the fact that there is an inside basis step-up under certain circumstances via a Section 754 election when equity of a Partnership is transferred affect the planning decision?	**Upon sale of a partne partner, a Section 75 basis of assets, incre amortization deducti of inside asset basis**

IV. Sometimes the best entity choice involves employing a combination of Partnerships and C corporations.

When considering choice of entity, one planning point that should be kept in mind is that it isn't automatically necessary to hold all business assets in either a Partnership or C corporation. In some cases, the best approach would be for the C corporation to hold the operating business and valuable intellectual property rights that would generate substantial gain offset by Section 1202's gain exclusion down the road, while at the same time holding real property, equipment and sometimes IP outside of the corporation in a Partnership and leasing or licensing those assets to generate an income stream from the C corporation to the Partnership's owners.

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Also, when considering whether it makes sense to operate some activities through a Partnership and other activities within a C corporation, consideration should also be given to whether it might make sense to use employ multiple brother-sister C corporations or Partnerships. Section 1202 provides a benefit when stock is treated as being sold or exchanged in a taxable transaction. If multiple activities are undertaken under the umbrella of a single issuer of QSBS (**"QSBS Issuer"**)—for example, a plumbing supply company and a software development business—when a buyer comes along for the plumbing supply company, the sale of that business will be made by the parent QSBS Issuer, resulting in a 21% tax at the corporate level. If the net proceeds are distributed, that distribution will either trigger a 23.8% tax (as a taxable dividend distribution) or if a plan of partial liquidation can be adopted under Section 302, then Section 1202's gain exclusion can be claimed. A different result would have occurred if separate C corporations (QSBS Issuers) were used for the plumbing supply business and software development business. The stock of the plumbing supply business could have been sold and, if applicable, Section 1202's gain exclusion claimed. It might be possible to split two or more activities operating under a single QSBS Issuer into separate C corporations, with the stock of each qualifying as QSBS, but under the rules of Section 355 and in particular Section 355(e), the divisive reorganization needs to be done in advance of undertaking discussions or entering into arrangement involving dispositions of one or other of the applicable activities.

V. Business issues that point towards selecting the Partnership or the C corporation.

A. Sometimes there exists a standard default entity for the chosen business activity. Some start-ups operate in a business community and investor environment that results in the Delaware C corporation being the default entity choice. Examples of this might include the typical Silicon Valley startup looking for venture investment in SAFEs or preferred stock of a C corporation. Founders, investors and business and tax professionals operating in that "community" are familiar with the legal documentation

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associated with Delaware state-law corporation start-ups and the features of C corporation taxation. There might be some tax benefits associated with first operating as a Partnership, but there is often little interest in exploring those opportunities when the priority is raising capital and seeking participation from third parties who take for granted that they will be associating with a business operated through a Delaware C corporation. If there is an expectation that there will be foreign investment into the entity, that would strongly suggest either the business be operated through a Delaware corporation or if a Partnership is selected, then foreign investment will be run through a blocker corporation. The same would be true for the use of blocker corporations by tax-exempt investors looking to avoid being allocated unrelated business taxable income (UBTI). See the article "*An Introduction to the Use of Blocker Corporations in M&A Transactions*."

At perhaps the opposite end of the spectrum from the software/AI startup that defaults to state-law corporation and tax status are businesses such as professional firms that are not engaged in qualified activities under Section 1202, and businesses that generate significant tax losses available to pass-through to owners, or generate significant cash revenues that must be distributed to support equity owners. Most businesses falling into this category will default towards selecting a Partnership. There are some professional practices that are operated as professional corporations who strive to annually distribute close to 100% of profits as compensation, but these arrangements are rare today given the absence of any distinct advantage with respect to the tax treatment of benefits, which drove some professional firms to operate in the past through corporations. For multi-state professional practices, one benefit of operating in corporate form is that owners who function as W-2 employees are not required to deal with quarterly estimated or annual tax filings in multiple states. [9]

B. State tax and regulatory treatment of Partnerships and corporations. Business owners need to be aware of any peculiarities of their state's tax or regulatory laws dictate the use of one type of business entity over another. For example, California requires LLCs to pay a franchise tax of at least $800 that doesn't

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apply to LPs. Also, most licensed professionals in California, including law firms, cannot operate through an LLC for their practice due to state law restrictions.[10] Public companies are generally state-law corporations taxed as C corporations, with the exception of certain businesses operated as publicly traded partnerships (generally taxed as a C corporation but as a partnership with sufficient qualifying income), regulated investment companies (RICs) or real estate investment trusts (REITS).

C. Federal, state or local regulatory treatment of Partnerships or state-law corporations. In most instances, whether a business is operating in a Partnership, a state-law corporation or an LLC/LP that has checked the box to be taxed as a corporation will not be relevant under applicable federal, state or local laws and regulations. But, business owners and professionals should confirm whether there are any laws applicable because of the nature of the business activities that would dictate the choice of entity. Those federal laws might require operating through a state-law corporation or a business entity treated as a corporation for federal income tax purposes.

D. Does the business plan/exit strategy steer business owners in the direction of an entity choice? In some situations, the founders' plan for the business will drive the choice-of-entity decision. For example, one of the several key tax benefits associated with selecting the C corporation are the tax benefits associated with holding QSBS. But those benefits are only unlocked when QSBS is sold and capital gain is excluded. If there is a reasonable and firm plan to retain ownership of the business for a lengthy period of time (e.g., 10 or more years) and perhaps transfer equity among family generations, the tax benefits of selling QSBS is reduced as an element to consider in the decision-making process. Likewise, if the reasonable and relatively firm plan is to sell the business before reaching the five year holding period mark, then Section 1202's 100% gain exclusion would not be available (see the discussion of holding period below), and while the potential for a Section 1045 election exists, the benefits of partial gain exclusion or holding QSBS would certainly take back stage to other factors.

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In some cases, the business plan or circumstances direct business owners to undertake secondary sales of founder equity, often in connection with capital raises, or partial recapitalizations involved the sale of a minority equity stake, or in some cases, majority equity stake in the business. Secondary sales can be structured as stock sales, which opens the door for claiming Section 1202's gain exclusion in connection with the secondary sale if all eligibility requirements are met. If the business is operating as a Partnership, a secondary sale of a partial equity interest coupled with a Section 754 election allows for an inside asset basis step-up reflecting the purchase consideration.

E. Does the M&A marketplace for the type of business involved steer business owners in the direction of an entity choice?

Some founders go into the business start-up process with a clear goal with respect to exit. For example, this is often the case with business rollups where the founders expect to roll up a number of operating companies and then exit through sale to a private equity or strategic (industry) buyer. When that appears likely, a survey of the potential buyers and the industry may steer founders towards a C corporation structure, which facilitates future tax-free reorganizations under Section 368 (stock-for-stock exchanges) or equity sales to private equity buyers coupled with a rollover of equity into a corporate acquisition entity (which helps preserve QSBS status for the rollover equity if the transaction is structured to fall within the scope of Sections 351 or 368) or in some cases, a Partnership (which doesn't preserve QSBS status for the rollover equity).

On the other hand, a look at the industry and potential buyers may suggest that buyers would want to acquire assets in order to benefit from a tax basis step-up and subsequent 15 year amortization of purchase goodwill under Section 197, or alternatively if the sale is a stock sale, a reduced purchase price reflecting the buyer's forgone goodwill amortization. Also, some business activities routinely involve equity sales (e.g., where retaining the historic EIN is a priority) or asset sales (where the liabilities of the target company are a significant issue, driving buyers to structure transactions as asset purchases).

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F. Tax procedure and related issues associated with choice of entity planning.

- **Operating through a Partnership creates the potential that owners must file multiple tax returns**. Stockholders of C corporations do not receive Schedule K-1s with respect to the C corporation's income and are not required to report the that income on their tax returns at the federal, state or local level. In contrast, equity owners of Partnerships receive federal and state Schedule K-1s showing the pass-through of taxable income that must be included on federal, state and perhaps local returns in multiple jurisdictions depending on where the Partnership engages in business activities and where the taxpayer resides. The pass-through of taxable income can create tax issues for tax-exempt and foreign investors which can be avoided through the use of "blocker" corporations or C corporate companies.
- **Self-employment tax issues**. There are no self-employment tax issues for C corporation stockholders. A LLC taxed as a partnership would need to be structured property for passive investors to qualify for treatment as "limited partners" for purposes of the taxable operating income passing through on a Schedule K-1 not to be treated as self-employment income. If the Partnership is a limited partnership, the taxable operating income passing through to limited partners is generally not subject to self-employment taxes.
- **Net investment income tax imposed under Section 1411**. Planning to avoid application of the 3.8% net investment income tax (**NIIT**) favors operating through the C corporation. For limited partners in a Partnership, partnership income, including capital gains, will be subject to the NIIT if the partnership activity is passive with respect to the partner under Section 469. This is typically the case for limited partners, as they generally do not materially participate in the partnership's business. Taxable income passing through to LLC members on a Schedule K-1 may be subject to NIIT, but the application of the NIIT depends on several factors: (1) the nature of the LLC's activities, (2) the member's level of

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participation (passive or non-passive), and (3) the type of income reported on the Schedule K-1. If the LLC is engaged in a trade or business that is a passive activity for the member, or is a business of trading in financial instruments or commodities, the member's share of income from that activity is generally subject to the NIIT. If the LLC is engaged in a non-passive trade or business (i.e., the member materially participates), the member's share of ordinary business income is generally not subject to the NIIT. Capital gains arising out of the sale of C corporation stock is generally subject to the 3.8% NIIT. But the NIIT does not apply to the portion of capital gains excluded pursuant to the Section 1202 gain exclusion.

- **Dealing with the partner-employee status problem**. The IRS takes the position that an individual cannot be both a partner and employee of the same partnership for federal income tax purposes. This is a disadvantage of operating through a Partnership as many employees do not want to deal with self-employment income filing requirements. There are ways of structuring around this problem, but persons involved must be aware of the problem and address it during the structuring and planning process.
- **Substantiation of Section 1202's gain exclusion.** For those business owners who choose to operate their business within a corporation with the expectation that they will later qualify for claiming Section 1202's gain exclusion, an important aspect of that plan is to be able to successfully substantiate their eligibility to claim that gain exclusion when the time comes to take a return position that the stock sold was, in fact, QSBS. The taxpayer's failure in *Ju v. U.S.*, 170 Fed. Cl. 266 (Ct. Fed Cl. 3/18/2024) is instructive. Tongzhong Ju acquired stock in 2003, but produced financial information at trial only for the 2009-2011 period. In spite of the fact that corporation's "aggregate gross assets" 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. Ju failed to introduce into evidence financial information for the 2003

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period. The IRS successfully argued that the financial records for the 2009-2011 period were not credible evidence of the corporation's aggregate gross assets when the stock in question was issued in 2003. 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*." The bottom line is that it would be nothing less than a tax planning tragedy to make a choice of entity selection and other key decisions such as a stock versus asset sale or the rollover of funds under Section 1045 into replacement QSBS based on reasonable expectations of the benefits of those planning moves and then then fail to adequately substantiate qualification. The articles "*Substantiating the Right to Claim QSBS Tax Benefits – Part 1*" and "*Substantiating the Right to Claim QSBS Tax Benefits – Part 2*" address in detail how to succeed in substantiating QSBS return positions, including obtaining representations from QSBS Issuers, the issue of disclosure by funds to partners/members on Schedule K-1s and other partnership communications and the role of attestations, tax opinions, and tax insurance.

VI. A deeper dive into tax issues that point towards selecting either the Partnership or C corporation.

The tax issues addressed below can weigh heavily in selecting to operate through a Partnership or C corporation.

A. Section 1202's holding period requirement. If Section 1202's gain exclusion is not available to a taxpayer because the required three to five year holding period requirement is not met, it may be possible to structure a secondary sale or sale of all of the corporation's stock as a stock-for-stock exchange governed by either Section 351 or Section 368 (in which case, some or all of Section 1202's benefits can be preserved to be claimed at a later date when the replacement stock is sold) or the transaction can be structured as a taxable sale, with the taxpayer rolling the proceeds over into replacement QSBS within 60 days. Section 1045 is

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basically a like-kind exchange provision for QSBS. The taxpayer may be eligible to claim Section 1202's gain exclusion when the replacement QSBS is sold at a later date if all of Section 1202's eligibility requirements are satisfied. However, finding suitable replacement QSBS opportunities can be a challenge. See "*Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer*," "*Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045*," and "*Part 2 –Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045*." With either tax-free exchanges or the Section 1045 rollover, the holding period for the original QSBS carries over to the holding period for the replacement QSBS.

The potential for exchanging QSBS for other QSBS or non-QSBS under Sections 351 and 368, the ability to roll original QSBS proceeds over under Section 1045's, and OBBBA's reduction of the required holding period for obtaining at least a partial benefit under Section 1202 weighs heavily in favor of selecting the C corporation for businesses which might otherwise have been concerned that Section 1202's gain exclusion would be out of reach because of holding period issues when stock was sold. Booking a big gain coupled with a short holding period is a good problem, but an even better one results where the taxpayer can claim Section 1202's gain exclusion.

A sale where Section 1202's 100% gain exclusion can be claimed against the full amount of proceeds is the clear winner in terms of after-tax dollars. The clear loser is a corporate asset sale, followed by a second level of tax when the corporation's net proceeds are distributed in a liquidation where Section 1202's gain exclusion is not available.

B. Taking advantage of the 21% corporate tax rate; the impact of potential future changes in corporate tax rates. One of the key benefits of operating in corporate form is the 21% tax rate (reduced from 35% effective prior to January 1, 2018). A planning strategy that doesn't rely on the availability of Section 1202's gain exclusion is to operate a closely-held business as a C corporation in order to benefit from the 21% tax rate (contrasted with the pass-through at ordinary income rates up to 37% for pass-through entities), and to

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retain a significant amount of net revenues within the corporation to fund growth. With respect to funds distributed out of the corporation on an annual basis, the goal would be to limit the distributions to deductible salary and bonus payments in order to avoid the C corporation double taxation problem (i.e., taxation at the corporate level and again at capital gains rates at the stockholder level). The plan would be to grow the corporation, retain as much of the corporation's revenues as possible within the corporation, and then sell the corporation's stock and either pay the 23.8% federal tax rate (20% capital gains plus 3.8% investment income tax) or shelter some or all of the income from federal taxes by claiming Section 1202's gain exclusion.

The advantage of the corporation over the Partnership during the operating years is that net revenues taxed at the corporate level and retained for growth purposes are taxed at a 21% federal rate while income passed through by a Partnership is taxed at rates up to 37% (35% for income of $501,050 to $751,600 for married individuals filing joint returns). The lower corporate rate allows more "after-tax" dollars to be reinvested back into the business than would occur if instead the net income was taxed at individual rates and a tax distribution was made to cover the spread between the 21% corporate tax rate and the individual marginal tax rates.

C. Will the equity owners of a business qualify for Section 1202's gain exclusion? A key reason for selecting the C corporation is the potential for the corporation's stockholders to claim Section 1202's gain exclusion. Each taxpayer holding a corporation's QSBS has a potential $10 million gain exclusion for QSBS issued prior to July 5, 2025, and a $15 million gain exclusion for QSBS issued after July 4, 2025.[11] This potential for millions of dollars of federal income tax savings, along with saving at the state level in many states, is perhaps most attractive features of the C corporation for founders of start-ups and owners of small businesses.

A number of eligibility requirements at both the corporate level and taxpayer level must be met before Section 1202's gain exclusion is available. Whether the equity owners of a business will benefit from Section 1202's gain exclusion is a key planning issue. One problem

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with choice of entity planning involving Section 1202 is that a taxpayer won't benefit from the gain exclusion for years after the choice of entity decision is made. QSBS issued today won't qualify for the 100% gain exclusion for five years. Nevertheless, the decision whether to stay with a Partnership or operate as a C corporation must be made with the best information available and reasonable assumptions regarding how events will play out in the future. The article "*A Section 1202 Walkthrough – The Qualified Small Business Stock Gain Exclusion*" introduces each of those eligibility requirements and a number of other articles included in the **QSBS LIBRARY** address those issues in detail.

D. Corporate-level eligibility requirements (including nature of business activities and "aggregate gross assets" limitation). Although many activities are qualified business activities under Section 1202, Section 1202(e)(3) lists a number of activities that are excluded and Section 1202(3)(7) excludes the ownership, dealing in, or renting of real property.[12] If it appears that a business might engage in some level of excluded activities, careful attention will need to be paid to whether the business will be able to maintain qualified small business status throughout its owners' holding period for their equity. Section 1202 has additional limits on ownership of minority interests in corporate stock or securities and real property that should also be considered.[13]

Stock issued prior to July 5, 2025, is not QSBS if the corporation had more than $50 million in "aggregate gross assets" prior to or after the stock was issued. After July 4, 2025, the $50 million limit was increased to $75 million.[14] Once QSBS is issued, the corporation's "aggregate gross assets" can increase beyond the size limit, but once the size limit has been passed, no more QSBS can be issued by the corporation. "Aggregate gross assets" generally means a corporation's cash and adjusted tax basis of other assets, with the proviso that appreciated property contributed tax-free is valued at fair market value. Section 1202's size limit affects choice-of-entity planning in several ways. First, if a business is operating as a pass-thru entity and the fair market value of its properties have already exceeded $75 million, the corporation won't be able to issue QSBS if it converts to a corporation unless sufficient assets are excluded to bring the "aggregate gross assets" below $75 million.

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Second, the size limit may be an issue if a business is expected to initially fall under the $75 million mark but is expected to rapidly exceed that size limit. This may impede issuance of QSBS to investors and later stage employees, which can reduce the attractiveness of operating in corporate form.

The issuer of QSBS must be a domestic (US) C corporation and the issuer must remain a domestic (US) C corporation for at least substantially all of a taxpayer's QSBS holding period. The business entity must also be a C corporation when the QSBS is sold. There are no statutory restrictions on the ability of the QSBS issuer to hold foreign assets. Section 1202 does not address the ownership of foreign corporate subsidiaries by the QSBS issuer or the acquisition of subsidiaries by the QSBS issuer. Neither the IRS nor the Tax Court have answered how they view these issues, many of which are addressed in the articles included in the **QSBS LIBRARY**.

E. Section 1202's holding period issue. For QSBS issued prior to July 5, 2025, Section 1202's gain exclusion is not available until the stock is held by a taxpayer for more than five years. For QSBS issued after July 4, 2025, a partial gain exclusion is available for QSBS held for three years (50%) and four years (75%) and a full 100% gain exclusion is available after five years. Section 1202's holding period requirements present planning challenges both when considering a choice of entity, and when operating as a C corporation, if a sale is scheduled prior to satisfying the necessary holding period requirements.

The founders of start-ups and closely-held businesses usually anticipate that an exit won't occur for at least three years and often five years, so Section 1202's holding period requirements generally don't present a significant challenge. Nevertheless, an awareness of the lengthy holding period requirement, and in particular the five-year holding period requirement for obtaining a 100% gain exclusion, should be taken into account as part of the planning process. Prior to OBBBA, the options available to stockholders selling QSBS prior to achieving a five-year holding period were paying capital gains taxes on the stock sale, selling the QSBS and reinvesting the proceeds under Section 1045 and structuring a tax-deferred stock-for-stock exchange under Sections 351 or 368.[15]

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Partnerships are not free from holding period issues. In an asset sale, there is the possibility of short-term capital gain treatment if any capital gains or Section 1231 assets do not have the necessary 12 month holding period when sold. A short-term holding period can also apply to a slice of an equity interest in the Partnership if any portion of the equity interest is attributable to property contributed to the corporation that has a short-term holding period.

Section 1061 is applicable to carried interest (profits interests under Revenue Procedures 93-27 and 2001-43) held in Partnerships.[16] Section 1061 requires certain holders of carried interests (profits interests under Revenue Procedures 93-27 and 2001-43) to have a three-year holding period before being eligible for capital gains treatment in connection with the sale of an equity interest or pass-through of gain from an asset sale. Section 1061 could also apply to a upper-tier Partnership holding QSBS. If QSBS is sold by an upper-tier Partnership prior to achieving a three-year holding period, holders of profits interests falling within the scope of Section 1061 would either need to treat the proceeds as short-term capital gain or roll the proceeds over under Section 1045 into replacement QSBS.

F. Whether the business has owners that would be eligible to benefit from Section 1202's gain exclusion. Individuals, trusts and Partnerships and S corporations can take advantage of Section 1202's gain exclusion. C corporations cannot claim Section 1202's gain exclusion. Foreign taxpayers who are not required to file a US tax return are generally not subject to US taxation on capital gains arising out of the sale of stock in domestic (US) corporations. Likewise, nonprofits and retirement accounts are not generally required to pay taxes when selling stock, whether or not that stock is QSBS. See the article "*Structuring the Ownership of Qualified Small Business Stock (QSBS) – Is There a Role for Roth IRAs?*"

G. Whether there will be potential problems associated with the accumulation of cash and investment assets in a C corporation. Many businesses operating in C corporations gainfully reinvest net revenues in expanding the business or maybe just burn cash as they engage in start-up and research and development

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activities while generating little revenues. But for some businesses, operation in a C corporation would present a challenge in terms of dealing with excess money not required for reinvestment in the business.

Owners of C corporations must be aware of the existence of the 20% accumulated earning tax that can be imposed in addition to the basic 21% income tax if a corporation is found to be accumulating cash and investment assets beyond the corporation's reasonable working capital needs. One method of managing excess cash is to pay it out as deductible compensation, and/or establish other leasing, licensing or management fee arrangements that create deductible payment cash streams.

Another potential additional tax is the personal holding company tax that imposes a 20% penalty tax on personal holding company income if a corporation meets the ownership and income tests. A domestic corporation meets the "stock ownership test" if, at some time during the last half of the taxable year, more than 50% (in value) of the corporation's outstanding stock was owned, directly or indirectly, by five or fewer individuals. The "income test" is met if 60% or more of the corporation's "adjusted ordinary gross income" is "personal holding company income" which is defined to include dividends, interest, rents, and certain royalties (excluding royalties that qualify as active business computer software royalties). Personal holding company income does not include capital gains from the sale or exchange of property used in a trade or business or ordinary operating income.

In addition to the threat represented by the accumulated earning tax and personal holding company tax, excess working capital (cash/investment assets) held by a QSBS Issuer can cause the corporation to fail Section 1202's "active business requirement." Cash held by a corporation that is not earmarked for working capital needs does not count towards satisfying Section 1202's ongoing 80% Test. Investment assets and stockholder loans that do not represent cash management for necessary working capital (and stockholder loans will rarely satisfy this requirement) are also "bad" assets counting against satisfying Section 1202's 80% Test. After a corporation has operated for two years, Section 1202 provides that

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the amount of cash and investment assets held for working capital needs that exceeds 50% of the value of all of the corporation's assets are "bad" assets counting against satisfying the 80% Test.

Excess working capital and cash can be an issue for a potential purchaser of a C corporation's stock. If a tax audit is performed and the possible imposition of the accumulated earning tax on the corporation is identified as an issue, it can result in the buyer demanding a purchase price reduction, escrow of funds or other means of dealing with the potential IRS imposition of the penalty taxes for past years. Managing working capital and excess cash can be an ongoing problem to solve for some corporations. For further discussion see "*Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide*."

H. Planning when there is a need to distribute earnings out of a C corporation. Business plans where the C corporation form is selected often anticipate paying out reasonable compensation and reinvesting the balance into the business, coupled with planning to eventually sell stock, thereby limiting tax consequences to payment of a 23.8% tax if capital gains apply or potentially avoiding taxation altogether on the exit if claiming Section 1202's gain exclusion is available. Some business owners want an income stream from the business and not all owners work for the business so the income stream can for the most part be structured as deductible salary and bonus payments. When these circumstances arise, careful planning needs to be undertaken upfront to determine whether certain assets such as real property, equipment or intellectual property assets should be held out of the C corporation structure and leased or licensed to the business, generating deductible payments at the corporate level and a flow of money to the outside owners of the LLC or LP leasing or licensing assets to the QSBS Issuer. Also, it might be possible to offset the taxable income generated by lease or license payments against asset depreciation or expensing. Another potential tool would be to structure a management services arrangement between the QSBS Issuer and an outside LLC as another means of generating a deductible flow of funds from the QSBS Issuer to outside parties. Obviously, attention would need to be paid regardless of how the transactions are structured to ensure that the payments are reasonable and "ordinary and necessary" to

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support the deductibility of the payments at the corporate level.

I. Section 351 nonrecognition exchange issues (versus Section 721 nonrecognition exchanges) associated with the contribution of appreciated property. The tax treatment accorded the contribution of appreciated property differs between C corporations and Partnerships. The default treatment of appreciated property contributed to a C corporation is for the transfer to be treated as a deemed taxable sale of the property. But the exchange of appreciated property for stock will be nontaxable if the contribution qualifies as a Section 351 nonrecognition exchange or is a part of a Section 368 tax-free reorganization. When a corporation is first organized, any property contribution by one or more contributors, including the contribution of intellectual property, should fall within the scope of Section 351 and be accorded tax-free treatment. But, with a C corporation, later contributions of appreciated property often will not satisfy Section 351's "control" requirement (i.e., the contributors hold at least 80% of the corporation's stock after the exchange). Section 351 has a number of other requirements that should be considered when contributing appreciated property. See "*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*" for a further discussion of property contributions to C corporations.

In contrast to Section 351's 80% control rules, the contribution of appreciated property to a Partnership is governed by Section 721, which generally permits any contribution of appreciated property to a Partnership to be accomplished on a tax-free basis, even where the contributors are mere minority owners of the Partnership after completion of the exchange of property for equity interests in the Partnership. The ability to contribute appreciated property to a Partnership without regard to the "control" issues associated with Section 351 is one of the Partnership's attractive features.

J. Comparing the tax treatment associated with the distribution of money or appreciated property by the C corporation and the Partnership. Generally, the ability and flexibility to distribute money and property out of a Partnership

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without triggering tax consequences at the entity and equity owner levels is a feature that favors the Partnership over the C corporation. But the ability to redeem corporate stock, and structure partial and complete liquidations, all of which potentially unlocks the ability of stockholders to claim Section 1202's gain exclusion, can level the playing field between the Partnership and C corporation, and in some cases tips the choice in favor of the C corporation.

- **Money distributions**. If money is distributed by a Partnership, the distribution does not trigger taxable income until the amount distributed exceeds the equity owner's tax basis in the Partnership. If the money distribution is in redemption of the equity owner's interest in the Partnership, then it will generally be treated as a sale transaction and be taxable to the extent that the money distributed exceeds the equity owner's tax basis in the Partnership, with the character of the gain generally being a mixture of capital gain and ordinary income. In contrast, a money distribution by a C corporation will generally trigger dividend treatment (generally taxed at 23.8%). If the redemption qualifies for exchange treatment under Section 302, the stockholder will generally be taxed on the distribution at capital gains rates to the extent that the amount of money distributed exceeds the tax basis in the stockholder's stock, unless the redemption payment qualifies for Section 1202's gain exclusion.
- **Property distributions**. Section 731(a) provides that distributions of appreciated property from a Partnership are generally nontaxable, except to the extent that money distributions exceed outside tax basis, and to the extent a disproportionate share of marketable securities are distributed or income triggered by reductions in the sharing of partnership liabilities. In contrast, Section 311(b)(1) provides that a distribution of appreciated property from a C corporation triggers deemed sale treatment at the corporate level (21% tax on gain from the deemed sale), followed by dividend treatment (generally 23.8% tax rate) at the stockholder level.

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- **Corporate distributions pursuant to a plan of complete liquidation**. If a plan of complete liquidation is adopted and the liquidation undertaken, distributions of money and property will be treated as being made in exchange for the stockholders' stock, taxable to the stockholder to the extent that the money and property distributed exceeds the stockholders' tax basis in their stock. Taxpayers holding QSBS are eligible to claim Section 1202's gain exclusion in connection with a complete liquidation if all eligibility requirements under Section 1202 are met, including the holding period requirement. Also, taxpayers would be eligible to rollover proceeds from the complete liquidation into replacement QSBS under Section 1045.
- **Corporate distributions pursuant to a plan of partial liquidation.** Under Sections 302(b)(4) and 302(e), if a corporation experiences a substantial reduction of business (i.e., one involving ceasing to conduct a qualified trade or business that has been actively conducted for at least five years prior to the redemption and not acquired in a taxable transaction during that period or amounting to a genuine contraction of the corporate business, such as the sale or cessation of a significant business segment) operations in connection with a sale of assets and distribution of proceeds or a distribution of the applicable assets and the corporation adopts a plan of partial liquidation, the distribution of property or money is treated as a payment in redemption of stock (with basis recovery) rather than dividend treatment. The distribution among stockholders can be pro rata and no actual redemption of corporate stock is required.

K. Section 1202's "10X" gain exclusion cap and pre-incorporation operation as a Partnership. Section 1202 includes a 10X gain exclusion cap that potentially allows stockholders to exclude up to 10 times the tax basis of property contributed to a C corporation in exchange for QSBS. For purposes of the Section 1202 tax basis rules, appreciated property is contributed into the C corporation at fair market value, even when the contribution is made in connection with a tax-free exchange under Section 351, which creates planning opportunities associated with the

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contribution of appreciated property, including partnership assets. It is possible to initially operate a business in partnership form and then convert the partnership into a C corporation through one of several available methods and gain an advantage with respect to the potential aggregate gain exclusion through operation of the 10X cap rules. The benefits gained by waiting to incorporate must be balanced against the fact that the holding period for Section 1202 purposes in the QSBS issued in exchange for the property (i.e., the exchange that gives the contributor tax basis) doesn't commence until the QSBS is actually issued, which might be an issue down the road if a liquidity event occurs before Section 1202's holding period requirement is satisfied, and in particular in terms of maximum benefit, the five year holding period has been achieved. See "*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*."

L. The ability to participate in tax-free transactions such as Section 368 tax-free reorganizations weighs in favor of the corporation. An attractive feature of the C corporation is its ability to participate in tax-free reorganizations under Section 368. A C corporation can merge into another corporation and avoid tax on the portion of the consideration consisting of the stock of the acquiring corporation. A C corporation can also generally undertake stock for asset exchanges, stock for stock exchanges and recapitalizations under Section 368 and corporate divisions under Section 355 on a tax-free basis. The ability to engage in these transactions presents an advantage when the need applies, but certainly does not typically represent a reason to scrap consideration of the potential benefits of operating in Partnership form. Partnerships can often merge and divide on a tax-free basis, but in some instances, the Partnership cannot contribute assets to a C corporation or merge into a C corporation on a tax-free basis unless Section 351 is available, which requires that the contributors control the corporation immediately after the property contribution.

M. A further discussion of the advantages and disadvantages of operating a business as a Partnership. The leading partnership tax treatise lists the following "*advantage of the partnership tax*

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scheme over the scheme that applies to C corporations," which the Treatise cites as being "*numerous and substantial*":[17]

- *Tax losses generally flow through directly to the equity owners as current deductions;*
- *No double tax occurs upon the sale or liquidation of the business;*
- *Distributions by partnerships of appreciated property generally do not cause the partnerships to recognize gain; and*
- *Under §§ 743(b) and 754, a purchaser of a partnership interest can effectively obtain a cost basis in its share of the partnership's assets.*

The McKee treatise has the following to say about the disadvantages of operating in partnership form:

- *Although corporations can generally acquire other corporations on a tax-free basis under the § 368 reorganization rules, there are no comparable provisions allowing corporations to acquire partnerships in tax-free transactions. Careful planning, however, can often overcome this limitation.*
- *Historically, the non-tax characteristics of state law corporations (which are per se corporations for tax purposes) are better known and understood by investors and their advisors, and the law relating to state law corporations is more developed and better defined than the law relating to partnerships or LLCs. This comfort gap continues to narrow, except in the publicly traded space, where the corporate legal form continues to dominate. Importantly, under § 7704, with limited exceptions, a publicly traded partnership is taxed as a C corporation.*
- *There may be some distinctions under state law that favor corporate employees as to the quantity and quality of tax-favored retirement benefits and other fringe benefits that can be made available to them. Generally, however, the quality and quantity of such benefits are the same under federal law*

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regardless of whether the employer is a corporation or a partnership.

Not mentioned by McKee is a significance complexity of partnership taxation. Hundreds of pages have been written about drafting tax allocation provisions in partnership agreements.

The McKee treatise reaches the conclusion that the partnership tax scheme is generally superior to the corporate tax scheme. As stated above, the benefits of operating in partnership form are significant and should be carefully taken into consideration. The combination of these tax benefits with the introduction of LLC Acts in the 50 states in the 1980s and 1990s has fueled the widespread use of LLCs taxed as partnerships over the last 30 to 40 years for many closely-held businesses throughout the United States. As a consequence, most business and tax professionals are familiar with LLCs and partnership taxation, but fewer professionals are familiar with operating through C corporations and QSBS planning. The level of familiarity with LLCs and corresponding lack of familiarity with QSBS planning is itself an issue in the choice of entity process, forcing business owners to seek advice from the fewer professionals who are familiar with QSBS and C corporation planning.

The approach in the McKee chapter addressing "choice of entity" illustrates the now-historical bias favoring Partnerships. The McKee treatise does not directly compare operating in corporate form versus a Partnership, and does not discuss the benefits and impact of Sections 1202 and 1045. The goal of this article is to provide business owners with the tools necessary to make an informed choice of entity decision.

N. Factoring into the planning process the pass-through of losses to equity owners. C corporations do not pass through profit or loss to stockholders. One of the pluses of owning stock versus an interest in a Partnership is that there is no risk of phantom income (allocation of income with no corresponding cash distribution) or need to deal with Schedule K-1 income and other tax items that might involve filing tax returns in multiple states. On the other hand, ownership of an interest in a Partnership carries with it the possibility that losses can be passed through on a Schedule K-1

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that can be used by equity owners, subject to tax basis, at-risk and passive loss limitations. A common strategy is to operate through a Partnership in the start-up/research and development stages in order to enjoy the offset of those losses against invested capital before converting to C corporation form. Waiting to convert both allows for the pass-through of losses and also allows for a potential 10X tax basis gain exclusion if the value of the assets contributed from or within the Partnership have appreciated.

Typically, even a business that involves the ongoing purchase of assets that can be depreciated, amortized and/or expensed may want to consider converting into a C corporation, but certainly modelling the benefits of operating through the C corporation versus Partnership makes particular sense under these circumstances. Ultimately, if the business is expected to generate substantial business goodwill that would fuel a substantial price at exit, the back-end benefits of operating through a C corporation and claiming Section 1202's gain exclusion might overwhelm the benefits of operating through the Partnership.

O. The tax benefits associated with tax basis build-up with a Partnership. Section 1202 presents an opportunity to claim a significant gain exclusion when corporate stock is sold. The existence of this potential tax benefit weighs heavily in the balance between the Partnership and the C corporation. But, the tax treatment of Partnerships also lends itself to creating a favorable tax situation when equity interests are sold. If $1,000 of net ordinary taxable income is allocated to an equity owner on a 2025 Schedule K-1, and the equity owner is also the tax liability, the owner's tax basis will increase by $650. The equity owner can then receive a later $650 distribution without triggering additional tax or offset his $650 tax basis increase against sales proceeds if he exits by selling his equity interest. In contrast, if a C corporation has $1,000 of income in 2025, the stockholders neither incur income nor have an outside stock basis increase associated with that corporate level income. In many cases, the benefits associated with QSBS would ultimately outstrip the tax basis increase, even with the potential benefit of Section 199A, because of the potential for an outsized Section 1202 gain exclusion when the business is sold.

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P. Factoring into the equation Section 199A's qualified business income deduction. Section 199A allows non-corporate taxpayers (including individuals owning equity interests in a Partnership) to deduct up to 20% of qualified business income ("**QBI**") earned in a qualified trade or business, including QBI passed through from a Partnership. The deduction was intended to reduce the tax rate on qualified business income to a rate that is closer to the 21% corporate rate, but the maximum effective individual rate after the deduction is generally 29.6% (37% x (100% – 20%), which remains higher than the corporate rate. The Section 199A deduction is subject to several additional limitations: it applies only to QBI (excluding investment income, reasonable compensation, and guaranteed payments), and is unavailable for income from specified service trades or businesses (such as health, law, accounting, consulting, etc.) for taxpayers above a certain taxable income threshold ($197,300 single / $394,600 joint). For taxpayers above the threshold, the Section 199A deduction is limited to the **lesser** of: (a) 20% of QBI, or (b) **greater** of (i) 50% of the W-2 wages with respect to qualified trade or business activities, or (ii) the sum of 25% of the W-2 wages with respect to the qualified trade or business activities, plus 2.5% of the unadjusted basis immediately after the acquisition of all qualified property. The QBI for each of a taxpayer's qualified trades or businesses are aggregated and then are subject to a second limitation equal to the excess of (a) the taxable income for the year, over (b) the sum of net capital gain. The total deduction is also capped at 20% of the taxpayer's taxable income (less net capital gain). The bottom line is that the Section 199A deduction when it is available brings the tax rate for a Partnership down to a rate that contrasts favorably with the combined rate when corporate income is subject to double taxation. But when corporate income is subject only to the 21% rate at the corporate level because a corporation's net income is reinvested in the business (which defers or allows for a complete elimination of the second level of tax when Section 1202 is available), the individual marginal rates, even as adjusted by the Section 199A deduction, compare unfavorably with the 21% corporate rate.

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Q. Avoiding phantom income associated with the Partnership. One potential problem of owning equity in a Partnership is that taxpayers may be allocated taxable income on Schedule K-1s without any corresponding cash distribution to fund payment of the tax liability. This is a risk associated with owning an interest in a Partnership that cannot be eliminated, but can be mitigated by putting in place an agreement to make mandatory tax distributions. There is no corresponding concept of phantom income associated with the ownership of C corporation stock.

R. Potential future tax liabilities under partnership audit rules. Being a partner in a Partnership carries with it the risk that there will be an audit at the partnership level that will result in additional tax liability for partners. Partners leaving a partnership and having their interest redeemed should consider pursuing indemnification from the partnership if a tax liability arises after departure. Likewise, the partnership and remaining partners might negotiate for an affirmative agreement that the departing partner remains obligated for a pro rata share of any tax liabilities arising with respect to the applicable past years.

VII. Comparing the incentive compensation arrangements available to Partnerships and C corporations.

A comprehensive discussion of incentive compensation arrangements is beyond the scope of this article. See the article "*The Intersection Between Equity Compensation Planning and Section 1202*."

The typical incentive compensation arrangements used by Partnerships are contractual bonus arrangements, nonqualified stock (equity) options, capital interest grants (both restricted and unrestricted) and profits interests (under Revenue Procedure 93-27). For C corporations, the typical incentive compensation arrangements are contractual bonus arrangements, nonqualified stock options, incentive stock options, restricted stock grants and unrestricted stock grants.

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There is substantial overlap between the available options and planning issues associated with structuring incentive compensation arrangements for Partnerships and C corporations. The most significant differences between the two are the availability of profits interests when operating through a Partnerships and the availability of Section 1202's gain exclusion when operating through a C corporation.

A. Planning with profits interests. Under Revenue Procedure 93-27, a profits interest (aka carried interest) is a partnership interest that would not share in any proceeds if the partnership's assets were sold for their fair market value on the date of issuance and the net proceeds distributed to the partners. A capital interest is an interest other than a profits interest (i.e., one that would receive a penny or more upon liquidation). The issuance of a profits interest to a service partner does not trigger immediate tax consequences even though it is issued to compensate the service partner. The service partner is treated as owning the interest on the date of issuance and capital gains can be passed through on Schedule K-1 (subject to the potential application of Section 1061). Under Revenue Procedure 2001-43, even a restricted profits interest is generally treated as being owned by the service partner on the date of issuance. The profits interest is a powerful tool because it combines the favorable tax attributes of no immediate taxation upon issuance and participation in capital gains when the business is eventually sold or when the service partner is bought out. Capital gains treatment is available even though the profits interest is actually a tool for compensating the service provider. This favorable tax treatment is why carried interests have been criticized and attacked over the past decade and why Congress passed Section 1061 in 2017 to extend the required holding period for capital gains from 12 months to three years for certain issuances of carried interests.

C corporations do not have an equivalent incentive compensation tool, although founder stock and structuring the issuance of "cheap" common stock creates compensation arrangements that are economically and tax-wise similar to profits interests. Also, it is possible to structure using a Partnership as a holder of QSBS and issue profits interests at the stockholder level. Whether a holder

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of a profits interest in a Partnership holding QSBS is entitled to claim Section 1202's gain exclusion when capital gains pass through on a Schedule K-1 is not resolved, there is a reasonable return position that the holder should, in fact, be entitled to offset the capital gain allocation with Section 1202's gain exclusion.

B. Planning with QSBS issued by a C corporation. A significant difference between undertaking incentive compensation planning with the C corporation versus a Partnership is the potential availability of QSBS when planning with a C corporation. Section 1202 provides that QSBS can be issued for services. Under Section 83, a service provider won't be treated as owning stock granted by a corporation and the holding period won't commence for purposes of Section 1202 unless the stock is either unrestricted when issued (i.e., generally not subject to vesting requirements) or the service provider files a Section 83(b) election in connection with receipt of the stock grant. If the stock is unrestricted when issued or the Section 83(b) election is filed, the service provider will be treated as receiving compensation in connection with the issuance equal to the difference between the fair market value of the stock and what, if anything, is paid for the stock. Given the potential benefits of holding and selling QSBS, the potential for issuance of QSBS can serve as a significant incentive, providing service providers a very meaningful and tax favored way of having "skin in the game" with their employer. For early-stage start-ups, issuance of unrestricted common stock (or restricted stock coupled with a Section 83(b) election) can often be accomplished with acceptable immediate tax consequences. After a corporation has appreciated significantly, approaches for dealing with the up-front tax consequences include coupling the stock grant with a bonus used to pay the taxes or loaning the money to the service provider who then in turn purchases the stock at its then-fair market value. For a loan arrangement, the service provider should issue to the employer a recourse promissory note that includes periodic interest payments and other terms recommended by tax professionals.

Although the issuance of QSBS by a C corporation represents a potentially significant incentive tool, many business owners who are eligible to issue QSBS nevertheless elect to adopt nonqualified

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option plans or structure contractual bonus arrangements (e.g., phantom stock plans, etc.) as an alternative to adding additional stockholders. Nonvoting stock can be issued to service providers if participation in voting is an issue for business owners. Finally, if and when a incentive compensation plan is adopted, business owners should confirm that the corporation remains eligible to issue QSBS.

VIII. Should the right to take ordinary losses under Section 1244 with respect to the transfer of corporate stock at a loss impact the choice of entity decision?

Under Section 1244, an individual stockholder can claim an ordinary loss (rather than capital loss) of up to $50,000 per year (or $100,000 on a joint return) from the sale or worthlessness of "Section 1244 stock." For most stockholders, an ordinary loss is more beneficial than a capital loss as it allows an offset against gross income, including wages, dividends, interest, etc. Section 1244 losses are not first offset against capital gains. Section 1244 losses not only reduce a stockholder's income taxed at ordinary income rates, but also are not subject to the annual $3,000 net capital loss limitation. Section 1244 stock is stock issued for money or property by a domestic "small business corporation" that meets a gross receipts test. A "small business corporation" is one where at the time of the issuance of the applicable stock has not received more than $1 million for stock in money and property and more than 50% of the corporation's aggregate gross receipts within the five most recent taxable years are derived from operating income rather than rents, royalties, dividends, interest, etc. For more details regarding qualification as Section 1244 stock, see the article "*Claiming an Ordinary Loss Under Section 1244 for an Investment in a Failed Start-up*."

While on its face Section 1244's treatment of losses seems attractive, the reality is that the limitations on the annual dollar amount that can be claimed as ordinary loss and the limitations on the scope of a "small business corporation" drastically reduce the significance of Section 1244 from a planning standpoint. While it is

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nice to take advantage of the right to claim an ordinary loss if a failed investment happens to fall within the scope of Section 1244, few would select a corporation over a Partnership because of the potential availability of Section 1244's ordinary loss.

IX. The problem of trying to mix S corporations with QSBS.

QSBS must be issued by a domestic (US) C corporation. Any stock issued by an S corporation will never qualify as QSBS. If S corporation stockholders want to obtain the benefits of QSBS with respect to their outstanding S corporation stock, a restructuring resulting in the S corporation becoming a stockholder of a newco-C corporation will need to be undertaken to allow for a partial benefit. [18] The newco-C corporation can also issue additional QSBS.

Section 1202 requires that the QSBS issuer remains a C corporation during substantially all of the taxpayer's QSBS holding period and that the business entity is a C corporation when its equity is sold. A C corporation will cease meeting these requirements if it converts to an S corporation for federal income tax purposes. An S corporation can own QSBS and when the S corporation sells its QSBS, the S corporation's owners should be able to claim Section 1202's gain exclusion to the extent of their "interest" in the S corporation when it acquired shares of QSBS.

Choice of entity issues associated with choosing between operating in an S corporation or C corporation will be addressed in a separate article. For general information about the intersection of S corporations and QSBS, see "*Advanced Section 1202 (QSBS) Planning for S Corporations*."

X. Will the benefits of Sections 1202 and 1045 be reduced or eliminated by future legislation?

QSBS has enjoyed bi-partisan support over the past 32 years. At the same time, efforts have been made by some to reduce or eliminate the benefits of QSBS, including most recently, legislation reducing the gain exclusion from 100% to 50% and making the gain

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exclusion unavailable to holders of profits interests. In connection with the introduction of the Small Business Investment Act, the National Venture Capital Association commented that "*QSBS has a proven track record of promoting long-term investment in high-risk startups across our nation,'said NVCA President and CEO Bobby Franklin. NVCA is proud to support Congressman Kustoff's Small Business Investment Act, which would ensure this critical tax incentive continues to help drive innovation and economic growth*" and describes the Small Business Investment Tax Act as "*major progress for QSBS reform.*"[19] The Angel Capital Association commented that "*Rep. Kustoff's bill will drive the much-needed capital formation from early stage investors across the country that is needed to keep entrepreneurs moving forward with the innovative ideas and companies that will continue to drive economic growth for years to come.*"[20] But, OBBBA's enhancements to Section 1202's benefits are likely to spur additional criticism. Professor Victor Fleisher has previously commented that

> *a better name [for Section 1202] would be the 'angel investor loophole.' Angel investors and venture capitalists, of course, argue that these are precisely the type of start-ups that tend to create new jobs, and thus they should be encouraged, not taxed. Perhaps the low tax rate encourages angels to put more money into start-ups instead of index funds. On the other hand, it is not clear that the tax break is necessary to encourage investment that would not otherwise take place . . . . Tax is not a first-order consideration.*[21]

Adam Looney blogged that the QSBS gain exclusion "*has little justification on economic grounds, accrues almost entirely to the highest-income taxpayers, and will prove costly with a 20 percent corporate rate; it should be repealed.*"[22]

The Treasury disclosed in a report on tax expenditures that Section 1202's gain exclusion was estimated to cost $44.55 billion during the period 2025 through 2034.[23] The Joint Committee on Taxation estimated that OBBBA amendments will increase Section 1202's cost by an additional $17.186 billion over the same period.[24]

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The fact that the benefits of owning QSBS take five years to fully ripen means that possible legislative changes are always a wild card planning issue. While the enhancement of Section 1202 as part of OBBBA suggests that a reasonable assumption should be that the benefits of owning QSBS will not be reduced or eliminated over the next several years, whether QSBS might come under attack after the 2028 election is anybody's guess. The best that can be said from a planning standpoint is that the benefits of QSBS have not been reduced through legislation since 1993, and in fact the reverse is true – legislation enhancing the benefits of QSBS have been passed several times during the past 32 years.

XI. Will the benefits of QSBS be affected by newly-issued IRS Treasury Regulations or tax authorities?

One unusual aspect of Sections 1202 and 1045 is that although those statutes have been around for decades, the Treasury Department has limited regulations to one set under Section 1202 involving the "anti-churning" redemption limitations and one set under Section 1045 involving operating through partnerships. Tax authorities are also quite limited, consisting of legislative history, a few court decisions, a Chief Counsel Advice memorandum and several private letter rulings. As a result, there are many grey areas associated with key QSBS planning issues, which introduce an additional degree of risk and uncertainty for some taxpayers and perhaps opportunity for other taxpayers. The absence of a body of tax authorities necessitates reliance on tax professionals with experience dealing with QSBS issues, a commodity which sometimes seems in short supply. Word on the street today is that the Treasury Department has been working on Section 1202 regulations, but as of November, 2025, no proposed regulations have been circulated for public comment. The Office of Tax Policy and Internal Revenue Service 2025-2026 Priority Guidance Plan issued on September 30, 2025, does continue to include Section 1202 guidance (i.e., the issuance of proposed regulations) as a priority for allocating Treasury Department and IRS resources. An additional degree of uncertainty has been created by the Executive

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Branch's dislike of administrative regulations and the Supreme Court's decision in *Loper Bright Enterprises v. Raimondo*, 603 U.S. 369 (2024), which may cause the Treasury Department to be more cautious about issuing regulations that might be considered by federal courts to extend beyond merely interpreting Section 1202. The best that can be said on this topic is that when undertaking a choice of entity analysis and considering the benefits of QSBS that largely are based on statutory interpretation with little or no additional guidance, it must be acknowledged that there is a possibility that either future Treasury Regulations or other tax authorities might affect both past and future planning and the availability of the benefits of holding and selling QSBS.

XII. Does it make a difference whether the business entity is a state law corporation or an LLC or LP that has "checked-the-box" to be taxed as a corporation?

Treasury Regulation Section 301.7701-1(a) provides that "*[w]hether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law* ." A state-law corporation will either operate as a C or S corporation (if an election on Form 2553 has been filed) for federal income tax purposes. A multi-owner LLC or LP defaults to partnership tax status but can "check-the-box" by filing a Form 8832 (or Form 2553 for an S corporation) to elect to be taxed as a corporation. If that occurs, the entity will remain a state-law LLC or LP, with the governing provisions generally set forth in the applicable LLC or LP agreement and the default state law statutes while the entity will be taxed as a C corporation (assuming no S corporation election is made). An LLC/LP taxed as a corporation is no different than a state-law corporation with respect to tax treatment for federal income tax purposes. The equity interests in the LLC/LP are treated as "stock" for federal income tax purposes. Some business owners and their professionals prefer the governance flexibility of the LLC/LP form over that of a corporation with its officers and directors. Sometimes the decision is made to

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convert an LLC/LP taxed as a partnership to a corporation by merely checking-the-box rather than the other available methods. Other available methods to convert would include conversion of the entity under a state-law conversion statute, merging the LLC/LP into a new state law corporation or contributing the LLC/LP equity to a new state-law corporation. See "*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*."

Because investors and buyers often favor transactions with state-law Delaware corporations, a business owner's first choice generally will be to organize a new Delaware corporation for either a new business start-up or as the ending business entity when the transaction involves the conversion of an LLC or LP from partnership to corporate tax status. Both domestic and foreign equity and debt investors have developed a certain comfort level with Delaware corporations, the Delaware General Business Law and Delaware courts, which causes business owners to naturally gravitate towards that entity choice. Obviously, businesses that don't involve this outside equity or debt investors may elect to either go the check-the-box route when C corporation status is desired and/or use non-Delaware LLCs/LP or corporations. If the Delaware corporation is selected, those involves will need to familiarize themselves with the workings of the Delaware corporate franchise tax to avoid a "gotcha" tax burden.

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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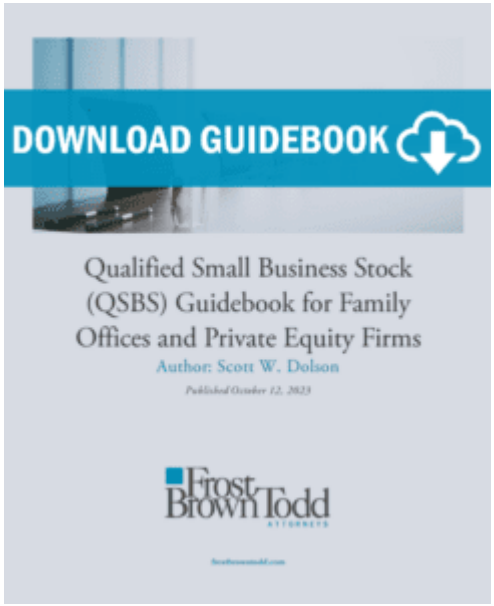
More QSBS Resources



- Exploring Section 1202's Active Business Requirement
- Substantiating the Right to Claim QSBS Tax Benefits | Part 2
- Substantiating the Right to Claim QSBS Tax Benefits | Part 1
- 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?

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- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion
- 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

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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 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 a 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 a taxable year for stock issued after July 4,

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2025.

The modelling in Part 2 of this Article addresses only the federal income tax treatment of items. The state and local tax treatment of income differs from state to state.

[2] Beginning January 1, 2026, New Jersey will join those states following the federal treatment of QSBS.

[3] See Section XIII. Most venture financed start-ups elect to operate through a Delaware corporation. Some corporations are organized in what are considered tax-friendly jurisdictions such as Nevada and Wyoming, but there are few court decisions interpreting corporate law in those states. Some limited liability companies "check-the-box" and operate as a C or S corporation for federal income tax purposes while remaining LLCs for state law purposes. But this approach is uncommon for start-ups seeking investment from venture capitalists.

[4] The 2025 federal income tax brackets are as follows:

Tax Rate	For Single Filers	For Married Individuals Filing
10%	$0 to $11,925	$0 to $23,850
12%	$11,925 to $48,475	$23,850 to $96,950
22%	$48,475 to $103,350	$96,950 to $206,700
24%	$103,350 to $197,300	$206,700 to $394,600
32%	$197,300 to $250,525	$394,600 to $501,050
35%	$250,525 to $626,350	$501,050 to $751,600
37%	$626,350 or more	$751,600 or more

[5] Section 1202(b)(5) provides for a cost-of-living inflation adjustment to $15 million cap for taxable years beginning after 2026. Section 1202(b)(4) provides for a cost-of-living inflation adjustment to the $75 million aggregate gross assets amount for taxable years beginning after 2026.

[6] There has been disagreement among tax professionals whether capitalized research and experimentation (R&E) expenditures should be treated as "property" for purposes of Section 1202. Some professionals believe that capitalized R&E is an intangible asset on the balance sheet and as such qualifies as "property" in the

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determination of whether a corporation satisfies the "aggregate gross assets" test under Section 1202(d). Other professionals believe that R&E expenditures are merely deferred expenses subject to amortization, but not "property" for Section 1202 purposes. Revenue Ruling 77-253, 1977-2 C.B. 40 suggests that capitalized R&E should be treated as property (i.e., a capital asset) for federal income tax purposes only if the expenditures can be associated with the development of a specific product. Where R&E expenditures are not associated with specific property, they would be treated as deferred expenses subject to amortization under Section 174 but not "property" for federal income tax purposes, presumably including for purposes of Section 1202(d)'s "aggregate gross assets" calculation. On a going forward basis, these issues will be largely moot under the new Section 174A regime for domestic R&E expenditures. But under Section 174, these issues remain applicable to foreign R&E expenditures. How the amendment of tax returns to expense past capitalized R&E expenditures functions for purposes of Section 1202(d)'s "aggregate gross assets" test is unclear.

[7] The Wall Street Journal reports that the estate tax law changes mean that more than 99.8% of people dying annually will avoid the estate tax. See Marc Vartabedian's July 14, 2025, article "*Trump's Tax Law Sweetens Secondary Deals in Venture Capital*." at https://www.wsj.com/articles/trumps-tax-law-sweetens-secondary-deals-in-venture-capital-38125eea?msockid=2bc0bf21cba8604d19caa97bcac961b7.

[8] The decision whether to continue to operate as an S corporation or convert to a C corporation will be addressed in a future article and is currently addressed in "*Advanced Section 1202 (QSBS) Planning for S Corporations*," which also addresses the mechanics of conversion of an S corporation to C corporation and associated tax issues.

[9] State tax filings have become somewhat less of a burden at the owner level in recent years as many states allow Partnerships to file composite returns.

[10] Section 17701 of the California Corporations Code which addresses practicing law in California through professional entities

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provides in part that "*Nothing in this title shall be construed to permit a domestic or foreign limited liability company to render professional services, as defined in subdivision (a) of Section 13401 and in Section 13401.3, in this state.*"

[11] See endnote 5.

[12] 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,*
>
> *(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.*

[13] See Section 1202(e)(5)(B) for the limit on ownership of portfolio stock or securities and Section 1202(e)(7) for the further limits on ownership of real property.

[14] See endnote 5.

[15] Under Section 1202, QSBS can be exchanged for QSBS or non-QSBS in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization. In either case, the holding period for purposes of Section 1202 carries over from the original QSBS to the replacement stock. If QSBS is exchanged for QSBS, the QSBS status and holding period carries over seamlessly into the replacement QSBS. Where QSBS is exchanged for non-QSBS, the taxpayer can

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claim Section 1202's gain exclusion to the extent of the gain deferred at the time of the exchange, assuming the holding period requirement is satisfied when the replacement QSBS is sold.

[16] Revenue Procedure 93-27, 1993-2 CB 343 and Revenue Procedure 2001-43, 2001-2 CB 191.

[17] McKee, Nelson, Whitmire & Brodie: *Federal Taxation of Partnerships & Partners* (WG&L) at ¶2.02.

[18]See the article "*Advanced Section 1202(QSBS) Planning for S Corporations*."

[19] Major Progress for QSBS Reform—Maintaining the Momentum – Angel Capital Association at Major Progress for QSBS Reform—Maintaining the Momentum – Angel Capital Association.

[20] Congressman Kustoff Introduces the Small Business Investment Act | Congressman David Kustoff at Congressman Kustoff Introduces the Small Business Investment Act | Congressman David Kustoff.

[21] 'Tax Extenders' That Slip Under the Radar – The New York Times

[22] Adam Looney, The Brookings Institution, Up-Front Blog, "*The next tax shelter for wealthy Americans: C-corporations*" (November 30, 2017) at The next tax shelter for wealthy Americans: C-corporations | Brookings. Looney's blog focused on proposals to reduce the corporate income tax rate to 20% in connection with a bill that ultimately was enacted as the Tax Cuts and Jobs Act of 2017.

[23] Tax Expenditure Budget for Fiscal Year 2026 at Tax Expenditure Budget for Fiscal Year 2026.

[24] JCX-29-25 | Joint Committee on Taxation at www.jct.gov.

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