Planning for the Sale of Qualified Small Business Stock (QSBS)

Dec 08, 2025

Categories:

Advanced QSBS Planning
Qualified Small Business Stock (QSBS)
Tax Law Defined™ Blog

Authors:

Scott W. Dolson

Section 1202 provides an exclusion from capital gain when a stockholder 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 addresses planning for the sale of a corporation whose stockholders hold QSBS and secondary sales of QSBS.

The tax benefits associated with owning QSBS are realized when a taxpayer transfers QSBS in a taxable sale or exchange. Not surprisingly, a significant part of QSBS planning involves sell-side planning for target corporations that have issued QSBS ("**QSBS Issuers**") and taxpayers holding QSBS, which includes both sales of 100% of the QSBS Issuer's tock and secondary sales by founders, employees and investors. These transactions involve planning for stock sales, asset sales, installment sale issues, tax-free exchanges and reorganizations, rollovers of target QSBS into buyer stock and partnership interests. This article also addresses what to consider if QSBS is to be sold prior to meeting Section 1202's holding period requirements or when proceeds from the sale of QSBS exceed the applicable gain exclusion caps.

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The issues facing buyers when QSBS is held by target stockholders or the buyer group wants to maximize future QSBS benefits will be addressed in a separate article, "*Buy-side M&A planning involving Qualified Small Business Stock (QSBS).*"

I. Structuring the sale of a business from the viewpoint of taxpayers holding QSBS.

A. Maximizing the target stockholders' after-tax dollars in connection with the sale of a particular issuer of QSBS ("QSBS Issuer").

The planning goal is to maximize the after-tax dollars in the hands of selling stockholders. Holding QSBS helps, but there are still a number of considerations that must be addressed to ensure that full advantage is taken of Section 1202's gain exclusion.

- **The QSBS Issuer's stock must meet all of Section 1202's eligibility requirements (both taxpayer-level and corporate-level)**. A critical aspect of planning for the sale of QSBS is confirming that the stock is, in fact, QSBS. Monitoring the status of stock as QSBS is an ongoing requirement that commences when QSBS is issued and continues through the transfer of the stock in a taxable sale or exchange. It makes sense to take a close look at eligibility when a secondary sale or business sale process is under consideration. Also, Section 1202's gain exclusion is available only if there is a taxable sale or exchange of QSBS resulting in capital gain. See the section below titled "*Section 1202 has a number of corporate-level and taxpayer-level eligibility requirements – make sure your stock is QSBS and that you can substantiate satisfying each*

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of Section 1202's eligibility requirements." Also, see the article "*A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion*."

- **Section 1202's 100% gain exclusion is available only if target stockholders have held their QSBS for at least five years**. The default Section 1202 plan is generally to hold QSBS for more than five years before transferring shares in a taxable sale or exchange. Obviously, this isn't always possible, and there are several backup planning options if the target stockholders have not achieved a five-year holding period when the QSBS is transferred, including reinvesting original QSBS sales proceeds into replacement QSBS under Section 1045 and structuring nontaxable stock-for-stock exchanges governed by Sections 351 or 368, both of which tact the holding period of the original QSBS with the holding period for the replacement QSBS. And for QSBS issued after July 4, 2025, another option is to sell QSBS after three years and claim a 50% gain exclusion or four years and claim a 75% gain exclusion. Unfortunately, the portion of the gain not excluded is taxed at 28%, along with the 3.8% investment income tax. See the section below titled "*Dealing with Section 1045 rollovers*."

If restricted stock is issued to a service provider, the QSBS holding period does not commence until the restrictions lapse unless a Section 83(b) election is made. If the service provider's QSBS remains restricted when the stock is sold, all of the gain will be treated as compensation income and the holder will not be eligible to claim Section 1202's gain exclusion. See the discussion below and the article "*The Intersection Between Equity Compensation Planning and Section 1202*."

- **Section 1202's gain exclusion is available only if the target stockholders' QSBS is transferred in a taxable sale or exchange (which can include sales, complete corporate liquidations, partial liquidations and stock redemptions)**. Transfers that are treated as taxable sale or exchange transactions are those that result in capital gain, which in turn triggers a taxpayer's right to offset the capital gain with

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Section 1202's gain exclusion if the stock transferred is QSBS. The consideration paid in a taxable sale transaction can be money or other property (including equity) or a mixture of both. Purchase consideration might be paid at closing or might include deferred payments governed by Section 453's installment sale rules.

A merger involving the target corporation where the merger consideration is cash or other property (notes, gold bars) is treated as a taxable stock sale, triggering the potential application of Section 1202's gain exclusion or the option of rolling over original QSBS proceeds into replacement QSBS under Section 1045. The same holds true if there is an exchange of target QSBS for buyer-entity equity in an exchange that does not meet the requirements of Sections 351 or 368 (i.e., a "failed" reorganization or exchange). Some acquisitions combine a stock sale with a stock redemption (typically, a leveraged buyout – LBO transaction) and are typically treated as a sale transaction where all of a stockholder's shares are transferred.

Taxable exchanges of QSBS for a liquidating distribution corporation of money and/or other property pursuant to a plan of complete liquidation are governed by Section 331, and generally trigger the right to claim Section 1202's gain exclusion. Section 1202's gain exclusion can also be triggered by distributions pursuant to a plan of partial liquidation governed by Sections 302(e) and 346.**[2]** Partial liquidations generally apply when a corporation sells the assets of a qualified trade or business activity or distributes those assets in kind. Finally, a redemption can be treated as a taxable exchange of QSBS, triggering the right to claim Section 1202's gain exclusion. Section 302's rules govern the determination of whether a redemption consideration is treated as payment for stock or a dividend.**[3]**

Target stockholders generally favor stock sales because the transaction will typically result in 100% capital gains, trigging the right to claim Section 1202's gain exclusion. Target management and stockholders also favor stock sales because unknown liabilities go with the target company and are the responsibility of the target company post-closing. Buyers might look for stronger post-closing

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indemnification language when the transaction is a stock purchase, but in some cases target sellers insure over post-closing indemnification obligations with a representation and warranty insurance policy. Finally, the choice of stock versus asset transactions may be driven by regulatory and practical issues associated with transferring assets rather than stock.

Buyers typically favor asset acquisitions over stock acquisitions, although many technology-company transactions are structured as stock acquisitions, and many financial buyers and public companies looking for tax-free stock exchanges gravitate towards stock deals. Buyers correctly believe that they are less likely to inherit unknown and contingent liabilities when the transaction is structured as an asset purchase. Also, buyers will not receive a tax basis step-up in the corporation's assets, which is good for future depreciation of personal property and 15-year amortization of purchase goodwill under Section 197 if the transaction is structured as a stock purchase.

Against the backdrop of sellers favoring stock sales and buyers favoring asset purchases, sellers should steer any sale process towards a stock sale from the outset, whether that means letting the business broker or investment banker know the importance of structuring the transaction as a stock sale or letting any prospective buyer know that a stock sale is a "nonnegotiable" requirement for any successful transaction. Obviously, buyers are free to disregard any seller "requirement" and make an offer to purchase assets. Some buyers will calculate to the penny the lost tax benefits of the tax basis step-up and reduce their offer accordingly and other buyers will ignore the issue and focus on whether the target company will be accretive to current and future earnings. Some purchase agreements include a "tax indemnity" provision making the buyer whole for lost tax benefits associated with acquiring stock rather than assets. Other purchase agreements include a "tax indemnity" provision making the target (and its stockholders) whole for lost tax benefits associated with structuring the transaction as an asset rather than stock sale. The bottom line is that there is no customary adjustment to the purchase consideration associated with aiming for a stock rather than asset transaction and adjustments to purchase consideration,

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either upwards or downwards, based on the structure of the acquisition will often be driven by how attractive the target company is to buyer(s) and how competitive the sale process is. Obviously, if the target stockholders are able to shield a significant amount of capital gain from income using Section 1202's gain exclusion, some downward adjustment to the purchase consideration based on lost goodwill amortization at the buyer level won't dissuade the target stockholders from negotiating heavily for a stock deal. Also, the availability of net operating losses to offset gain at the corporate level might change the equation. An asset sale where gain is offset by NOLs, followed by a complete liquidation puts target stockholders in the same position they would be with a pure stock sale.

- **The amount of Section 1202 gain exclusion available to target stockholders with respect to a particular QSBS Issuer is subject to caps, but the aggregate gain exclusion can be increased through advance planning**. Each taxpayer has a per-QSBS Issuer "standard" cap of $10 million for QSBS issued prior to July 5, 2025, which was increased to $15 million for QSBS issued after July 4, 2025. Since each taxpayer has this separate per-QSBS Issuer gain exclusion cap, taxpayers should consider spreading QSBS among two or more taxpayers when the stock is first issued, or gifting shares to other taxpayers (e.g., individuals or non-grantor trusts) prior to entering into definitive sale agreements. There are also tax authorities supporting the argument that each spouse has a separate gain exclusion cap when they file joint returns, but that issue has not been addressed in tax authorities interpreting Section 1202. Another strategy is to take advantage of the "10X Cap," which provides for a cap equal to 10 times the aggregate tax basis of QSBS sold by a taxpayer in a taxable year by a taxpayer. Taxpayers may be able to take advantage of the 10X Cap by acquiring additional QSBS for money or property contributions. If a taxpayer's Section 1202 tax basis arises out of the contribution of appreciated property in exchange for QSBS, the taxpayer is not entitled to offset capital gain with the Section 1202 gain exclusion to the

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extent the gain arises from pre-incorporation appreciation. See the article "*Maximizing Section 1202's Gain Exclusion*."

- **Target stockholders must be prepared to substantiate that they have met all of Section 1202's eligibility requirements when taking a return position claiming QSBS benefits**. Under the tax laws, the taxpayer bears the burden of proving that he falls within the clear scope of a gain exclusion.**[4]** The United States Supreme Court and the Tax Court have held that an exclusion from gross income must be narrowly construed. The combination of these factors escalates the importance of being prepared to clearly substantiate that each and every eligibility requirement has been satisfied when claiming a QSBS benefit. See the articles "*Substantiating the Right to Claim QSBS Tax Benefits – Part 1*" and "*Substantiating the Right to Claim QSBS Tax Benefits – Part 2*."

B. What if the sale transaction is structured as an asset sale?

As discussed above, target stockholders and target companies generally prefer stock sales for tax and business reasons. Asset sales can trigger double taxation unless the corporation has NOLs to offset against the corporate level gain. Buyers typically prefer asset purchases for tax and business reasons. Buyers enjoy a step-up in the tax basis of purchased assets and can amortize goodwill over 15 years under Section 197. Although target stockholders and company management usually advocate for a stock sale structure, in some cases the best or only offer will come from a buyer who demands an asset purchase transaction. In some cases, the double tax burden triggered by an asset sale will be too onerous to move forward, but as seen below, not always.

It is important to understand that from a tax perspective (including taking advantage of Section 1202's gain exclusion), all is not lost if a transaction is structured as an asset sale. When a C corporation sells assets, there is a 21% flat tax at the corporate level on the spread between the corporation's tax basis in the transferred assets and the purchase consideration. Assuming the corporation's stockholders hold QSBS, the corporation can adopt a plan of

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complete liquidation upon completion of the sale and distribute the net assets to the corporation's stockholders. Section 1202's gain exclusion can be claimed in connection with the taxable "exchange" governed by Section 331 of stock for liquidation proceeds.

Limiting the federal tax burden to a 21% flat corporate tax will generally be a slightly better result than if the business sold assets and was structured as an S corporation or a partnership (for tax purposes). But, if a transaction is structured as an asset sale and the target stockholders are not able to claim Section 1202's gain exclusion, the transaction will result in double taxation of the sale proceeds and will usually achieve the worst after-tax result.

C. Tax treatment of a partial sale, partial redemption (leveraged buyout – LBO) transaction.

Many transactions are structured as a straightforward sale of stock to a third party and are clearly taxable sale transactions governed by Section 1001. However, some transactions are structured as partial sale, partial redemption transactions. This structure is sometimes used where the target has money that the parties want to flush out of the corporation in connection with the sale transaction or the transaction is being partially financed through borrowing at the target level. The transaction should be treated as a sale under Section 302(b), with the target stockholders eligible to claim Section 1202's gain exclusion where a QSBS Issuer redeems (buys back) a portion of its stock, and the combination of stock sold to the third party buyer and redeemed by the QSBS Issuer results in a complete termination of the target stockholder's holdings of QSBS. If a target stockholder's interest in the corporation is not completely terminated in the transaction, the treatment of the redemption consideration as a dividend or taxable exchange will be tested under Section 302's rules. The parties should structure the transaction to qualify under Section 302(b)(1)'s "meaningful reduction" test or Section 302(b)(2)'s "substantially disproportionate" test where sale treatment is desired. When testing redemptions under Section 302, the constructive ownership rules under Section 318 are applicable.

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The consequences of the partial sale, partial redemption transaction structure were addressed in *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir., 1954). The IRS adopted the *Zenz* approach in Revenue Rulings 75-447 and 55-745, stating that the sequence of events is irrelevant if both steps are part of an overall plan to reduce or terminate a shareholder's interest.**[5]**

D. Installment sale transactions.

QSBS sale transactions often include deferred installments of purchase consideration, earn-out arrangements, and escrow covering various liabilities or contingencies. If any of these contingent or scheduled payments are deferred to a subsequent year, the arrangement generally falls within the scope of installment sale treatment under Section 453, and the deferred payments are treated as additional purchase consideration eligible for capital gains treatment and Section 1202's gain exclusion in the year of payment. Even earn-out payment streams that give the appearance of royalty payments (e.g., a payment stream of $.50 per widget sold, or a percentage of the target company's net sale of its pharmaceutical products) generally are treated as installment payments of purchase consideration. The exception to the application of the installment sales rules are situations where the taxpayer elects out of the installment sale treatment or where the open transaction doctrine first articulated in *Burnet v. Logan*, 283 U.S. 404 (1931) applies (see Section I.E. below).

The instructions for Schedule D provide guidance on how to claim Section 1202's gain exclusion with respect to installment payments. If the aggregate gain amount payable to a particular taxpayer doesn't exceed the standard gain exclusion cap, the taxpayer should consider electing out of installment sale treatment and claiming all of the gain exclusion in the year of sale. Section 1045 provides that QSBS proceeds must be rolled over into replacement QSBS within 60 days after closing the sale of QSBS. Based on this language, the safest approach would be to rollover an amount equal to both the up-front and deferred payments within 60 days after closing. However, there is a position based on tax authorities that the 60-day clock for reinvestment into replacement QSBS should

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run off the date each installment payment is due rather than only within 60 days after the initial the closing date.

Under Section 453A, an interest factor is charged on the tax amount deferred by the installment sale rules under Section 453 if the aggregate face amount of a taxpayer's installment obligations outstanding at the close of a taxable year exceeds $5 million. Tax authorities support the position that the $5 million amount is applied separately by a taxpayer and spouse with respect to their respective installment obligations.**[6]**

The issue of whether the Section 453A interest amount is payable even where the installment payment would be excludable when paid under Section 1202 has not been addressed in tax authorities. In order to avoid this issue, taxpayers should consider electing out of installment sale treatment under Section 453 if 100% of the sales proceeds can be excluded from gain under Section 1202 (e.g., $5 million is paid to the taxpayer at closing and an additional $10 million is paid over four years). But as discussed below, taxpayers whose sale of QSBS falls within the scope of the installment sale rules have a good argument that Section 453A should not apply to the excludable deferred gain.

Under Section 453A, interest is payable on a taxpayer's "deferred tax liability" which is defined to be "*the product of (A) the amount of gain with respect to an obligation which has not been recognized as of the close of such taxable year, multiplied by (B) the maximum rate of tax in effect under section 1 or 11, whichever is appropriate, for such taxable year*." Under the Internal Revenue Code, there is "realized gain" and "recognized gain." A gain is "realized" when a taxpayer sells or otherwise disposes of property for more than its adjusted basis. Gain is then "recognized" when the tax law requires the taxpayer to report that gain as income on a tax return for the year, making it subject to tax. Section 1001 provides that "***except as otherwise provided in this subtitle****, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized* (emphsis added)." Both Sections 1001 and 1202 are part of Subtitle A of the Internal Revenue Code. Given that "recognized gain" means the portion of gain realized from a stock sale that is included in a taxpayer's gross income and

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subject to tax, the reference in Section 453A to **gain recognized** rather than **gain realized** supports the conclusion that Section 453A's interest charge does not apply where the taxpayer is entitled to exclude gain realized under Section 1202. The same conclusion applies if the taxpayer elects to roll gain over into replacement QSBS under Section 1045.

E. Potential application of the "open transaction doctrine."

The open transaction doctrine established in the Supreme Court's *Burnet v. Logan* decision allows a taxpayer to recover basis before recognizing gain if the value of the right to future payments is so speculative that it cannot be reasonably ascertained at the time of sale. The IRS's position is that the open transaction doctrine is applied in "rare and extraordinary circumstances."**[7]** One example of where the open transaction doctrine might apply is the sale of a pharmaceutical development corporation's stock where the purchase consideration includes an open-ended contingent payment equal to a percentage of annual net sales of the corporation's pharmaceutical product. Here, the IRS would likely argue that Section 453 has detailed rules for reporting gain on contingent payment sales in Temporary Treasury Regulation Section 15a.453-1(c) that include circumstances where there is no stated maximum and no fixed payment period. Temporary Treasury Regulation Section15a.453-1(c)(4) provides for a 15 year recovery of basis for sales of property that have no stated maximum selling price and no fixed payment period and further elaborates that *"[i]f the agreement neither specifies a maximum selling price nor limits payments to a fixed period, a question arises whether a sale realistically has occurred or whether, in economic effect, payments received under the agreement are in the nature of rent or royalty income*." But in rebuttal, the taxpayer would point out that these regulations focus on whether a drug product should be considered sold or merely licensed in circumstances where the "sale" has no stated maximum selling price and no fixed payment period. While reference to the temporary regulation's language might make sense if the sale in question involves the sale (or license) of a drug product, it language hardly seems applicable if the transaction instead involves the sale of a corporation's stock. Where the

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transaction involves a stock sale, applying the principles established in *Burnet v. Logan* makes more sense than arguing that the sale of a corporation's stock should instead be treated as licensing its products.

If there is an open transaction, as payments are received, they are first applied to recover the taxpayer's basis. Only after the basis is fully recovered does the taxpayer recognize gain, and such gain is recognized as payments are received. Section 1202's gain exclusion would be claimed as payments are received under the applicable contingent payment arrangement. With respect to making an election to rollover proceeds under Section 1045, the same issues addressed in Section I.D. with respect to the timing of the Section 1045 election would likely apply. A sale that is treated as an open transaction does not fall within the scope of Section 453's rules and the interest provisions of Section 453A are inapplicable.

F. Transactions that include an exchange of target company stock or assets for buyer equity.

Some sale transactions include an exchange of target company stock or assets for buyer stock or other equity, or an exchange of target company stock or assets for a combination of buyer equity and money (referred to as "boot").

If target company stock is exchanged for buyer stock in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization, the exchange is generally nontaxable except to the extent that the target stockholders received boot, or in the case of a Section 351 transaction, the liabilities assumed exceed the aggregate tax basis of the target property exchanged. Section 1202 further provides that the stock received in such exchange continues the original QSBS holding period, and when sold, the gain will be eligible for Section 1202's gain exclusion, with the amount of the future exclusion depending on whether the buyer stock is also QSBS. If the replacement stock is non-QSBS (e.g., the exchange of QSBS for public company stock), then the holding period for the replacement QSBS includes the holding period for the original QSBS but when the replacement QSBS is sold, the gain that can be excluded is limited to the amount of gain deferred when the Section

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351 nonrecognition exchange or tax-free reorganization occurred. A typical reason why the buyer stock would not qualify as QSBS would be the failure of the buyer to satisfy Section 1202's "aggregate gross assets" limit when the buyer stock is issued in the exchange.

A typical tax-free reorganization involving QSBS is an exchange in a merger (Type A reorganization – Section 368(a)(1)(A)) of target company QSBS for a mixture of stock and money, with at least 40% of the overall buyer consideration consisting of buyer stock. The target corporation stockholders can exchange their target company QSBS for buyer stock on a non pro-rata basis. Often, management staying on with the target company post-acquisition rolls over a disproportionate percentage of their equity into buyer stock. Tax-free reorganizations can also be structured as an assets for stock exchange (Type C reorganization) or stock-for-stock exchanges (Type B reorganization). See the article "*Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock*."

A target corporation can exchange property for a partnership interest (LP or LLC interest), which is generally a nontaxable exchange under Section 721. Whether the target company meets Section 1202's "active conduct" requirement when it has lower-tier partnerships is addressed in the article "*Exploring the Role of Partnerships in Qualified Small Business Stock (QSBS) Planning*."

The exchange of target company QSBS for a partnership interest is also generally nontaxable at the time of the exchange under Section 721, but when the partnership interest is later sold, the taxpayer will not be eligible to claim Section 1202's gain exclusion.**[8]**

Based on the treatment outlined above, target stockholders who have not held their QSBS long enough to meet Section 1202's holding period requirement should consider pursuing a stock-for-stock exchange falling qualifying under Sections 351 or 368. If a buyer wants to include an equity rollover as a part of the transaction, target stockholders who want to preserve the QSBS status of their shares generally would either want to structure the transaction as a Type A reorganization (Section 368(a)(1)(A)), with

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at least 40% of the aggregate buyer consideration being buyer stock or to retain a minority position in target company stock until a subsequent sale transaction occurs. It may be possible to structure a transaction to include a Section 351 nonrecognition exchange, but this is less common given the usual requirement that both the target stockholders and the buyer stockholders contribute their shares to a newco corporation. If Section 351 is being relied upon to structure the exchange of QSBS, Section 1202(h)(4)(D) requires that the acquiring corporation control the QSBS Issuer immediately after the exchange. Target stockholders who have meet Section 1202's holding period requirement or who are being asked to exchange stock-for-equity in a transaction that does not maintain QSBS status on a going-forward basis should instead consider structuring the rollover component of the transaction as a taxable sale, which allows the taxpayer to either claim Section 1202's gain exclusion or a Section 1045 rollover into replacement QSBS.

II. Dealing with equity rollovers when holding QSBS.

Many buyers expect target stockholders to roll over some percentage of their target company equity into buyer equity – 20% is typical, but the percentages range from 10% to 40%.

Nontaxable rollovers can be structured as stock for stock exchanges under Section 351, but that structure is unusual unless the buyer is forming a newco-corporation to become a QSBS Issuer and platform company. For example, a private equity firm might organize a corporation to acquire a target corporation's stock for $60 million in cash and stock consideration. The private equity firm would cause cash to be contributed to the newco-corporation and the target corporation stockholders would then contribute their target corporation stock. If the transaction fits within the scope of an acquisitive Section 351 nonrecognition exchange, target stockholders are taxed only on the money "boot" received in the exchange. The stock-for-stock element of the exchange would generally be nontaxable. Section 1202(h)(4)(D) requires that the acquiring corporation control the QSBS Issuer immediately after the

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exchange. If the buyer-corporation is eligible to issue QSBS, the target stockholders will continue to hold QSBS with a tacked holding period. If the newco-corporation's "aggregate gross assets" exceed $75 million immediately after the global Section 351 exchange ($50 million if the transaction occurred prior to July 5, 2025), the stock issued by the newco-corporation would not qualify as QSBS. In that case, the target stockholders should consider structuring the rollover as taxable, freeing them to either claim Section 1202's gain exclusion or roll over their original target corporation sales proceeds into replacement QSBS under Section 1045.

If the intention is for the rollover fall within the scope of a tax-free Type A reorganization (merger), at least 40% of the purchase consideration must consist of buyer stock. Boot received in a Type A reorganization need not be shared equally among the target stockholders. In some transactions, the management team not only remains with the target company post-closing but also receives a greater percentage of purchase consideration in the form of stock. For example, where 40% of the aggregate consideration is stock, the management team might receive 80% of their consideration in the form of stock, with the target company's investors receiving a disproportionate share (or all) of the cash consideration.

Exchanges of target company QSBS for buyer non-stock equity (e.g., LLC or LP partnership interests) will be nontaxable exchanges under Section 721, but the non-stock equity received in the exchange is not QSBS.**[9]** The target company stockholders should consider whether the transaction can be structured as a fully taxable sale, followed by a reinvestment into a buyer affiliate as necessary. These target stockholders can then roll proceeds over under Section 1045 into replacement QSBS or claim Section 1202's gain exclusion if available.

A final possible structure for the "rollover" is for target company stockholders to retain some percentage of target company stock, with the ultimate intention being to sell their remaining target company equity in the next liquidity event.

See the article "*Dealing With the Rollover of the Management Team's Equity and Equity Rights in a Sale Transaction*."

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III. Partial recapitalizations involving transfers of QSBS.

Partial recapitalizations often involve a partial sale of a QSBS Issuer to financial buyers (e.g., private equity firms or family offices). The buyer may acquire a minority (e.g., 49%) or majority (e.g., 51%) stake in the target QSBS Issuer. If the acquisition is by means of an original issuance of stock by the QSBS Issuer to the buyer, then the status of the target stockholders' shares as QSBS should not be affected, but the QSBS Issuer's ability to issue additional QSBS, including the stock acquired by the buyer, may be affected by the potential failure of the "aggregate gross assets" test (addressed elsewhere in this article). If any of the proceeds are distributed out as a dividend, Section 1202's gain exclusion will not be available as a dividend does not qualify for "sale or exchange" treatment under Section 1001. If some of the proceeds are distributed out of the target corporation in redemption of shares, whether the redemption will be accorded "sale or exchange" treatment under Section 1001 will be governed by the rules of Section 302.

If some or all of the stock acquired by the buyer in a partial recapitalization is purchased directly from target stockholders holding QSBS, the sale of the stock will generally be governed by Section 1001, triggering the right to claim Section 1202's gain exclusion if all eligibility requirements are satisfied. If Section 1202's holding period requirement is not satisfied, target stockholders generally will have the option of electing under Section 1045 to roll proceeds over from their original QSBS investment into replacement QSBS.

IV. Secondary sales and redemptions involving QSBS.

Secondary sales of stock occur when an existing stockholder sells shares to outside investors or back to the corporation in a redemption transaction. Many secondary sales occur in connection with a capital raise by the QSBS Issuer. Secondary sales generally are intended to provide some liquidity to stockholders before there is a business-wide liquidity event or IPO. If the stockholder

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participating in a secondary sale is holding QSBS and the sale is to a third party, the rules regarding sale treatment under Section 1001 discussed elsewhere in this article generally apply, and the selling stockholder should be able to claim Section 1202's gain. If the secondary sale involves a redemption by the QSBS Issuer, the rule of Section 302 will govern whether the redemption is treated as a dividend (with no corresponding Section 1202 gain exclusion) or a "sale or exchange" governed by Section 1001, for which Section 1202's gain exclusion would apply.

In some instances, the amount paid for stock sold in a secondary sale exceeds the then-applicable Section 409A value for the QSBS Issuer's common stock. For example, a founder might sell common stock in a secondary sale, with the sale price equal to the price paid by investors at that time for preferred stock. Certain tax professionals have suggested that under those circumstances, the IRS might argue that any amount paid for common stock in excess of the then-applicable Section 409A valuation for common stock should be treated as taxable compensation rather than consideration for the sale of stock, especially when the secondary sale is arranged through the QSBS Issuer. There are no tax authorities concluding that a Section 409A valuation controls the value placed on stock in secondary sales or expressly addressing this issue in the context of Section 1202. Ultimately, the issue of whether a corporation's common stock has been sold for an amount in excess of fair market value will be a question of fact. If it is determined that the amount paid for a service provider's common stock exceeded the then-fair market value of the common stock, applying the general valuation rules expressed in Revenue Ruling 59-60, 1959-1 C.B. 237, there is a possibility that the IRS would argue that this excess amount should be treated as compensation.

V. Dealing with rollovers of QSBS proceeds into replacement QSBS under Section 1045.

Section 1045 allows the seller or QSBS which has been held for at least six months to roll QSBS sales proceeds over into a replacement QSBS investment. The rollover must be completed

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within 60 days after closing of the sale of the original QSBS. But note that there are arguments supporting the position that this 60 days period should commence upon receipt of installment payments governed by Section 453. For additional articles addressing Section 1045, see "*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*," and "*Finding Suitable Replacement Qualified Small Business Stock (QSBS) – A Section 1045 Primer*."

There are generally two circumstances where taxpayers selling QSBS might make an election under Section 1045 to roll over original QSBS proceeds into replacement QSBS in order to avoid triggering immediate taxation and to keep alive the future possibility of claiming Section 1202's gain exclusion. First, taxpayers often consider rolling proceeds over when they have not reached the five-year holding period mark. When a Section 1045 election is made, the holding period of an original QSBS investment is tacked onto the holding period for the replacement QSBS investment under Section 1223(13). Second, taxpayers who have QSBS proceeds exceeding the applicable cap can claim the maximum Section 1202 gain exclusion, coupled with reinvesting the excess proceeds into replacement QSBS investments. Sections 1202 and 1045 do not aggregate the original QSBS investment with the replacement QSBS investment for purposes of Section 1202's gain exclusion caps.

We have also seen taxpayers who elect to incorporate with the belief that the business will be sold within a year. Under those circumstances, the plan would be to sell the original QSBS and purchase replacement QSBS, which effectively rolls proceeds from the sale of from one business activity into another activity on a tax-free basis. Obviously, this strategy only makes sense if a taxpayer has a place to reinvest the sales proceeds, and where the corporation issuing the replacement stock is clearly a QSBS Issuer.

Target stockholders who are being asked to exchange QSBS for partnership interests (LP or LLC interests) generally make the exchange on a nontaxable basis, but the equity received in the exchange will not be eligible under Section 1202, and the taxpayer will not have the right to claim Section 1202's gain exclusion in

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connection with the exchange. Target stockholders should instead consider structuring the transaction as a taxable transaction, allowing for either the claiming of Section 1202's gain exclusion or the election to roll proceeds over into replacement QSBS under Section 1045. We have seen transactions where the target stockholders are paid cash for their target company stock and then both elect to reinvest proceeds in replacement QSBS under Section 1045 and separately invest into the buyer entity.**[10]**

VI. Key aspects of Sections 1202 and 1045 that should be kept in mind by target stockholders.

A. Section 1202 has a number of corporate-level and taxpayer-level eligibility requirements – make sure your stock is QSBS and that you can substantiate satisfying each of Section 1202's eligibility requirements.

Taxpayers holding stock that they believe would qualify for Section 1202's gain exclusion or a Section 1045 tax-free exchange for replacement QSBS, should take reasonable steps to confirm that they do hold QSBS. Ideally, efforts to substantiate the status of stock would begin when the stock is first issued and continue throughout the taxpayer's holding period for the QSBS.

Whether the interested person is a taxpayer considering selling QSBS in a secondary sale or a QSBS issuer considering entering into a sale process or entertaining an offer, it usually makes sense to seek advice from tax advisors. The taxpayer or corporation can obtain an "attestation" confirming QSBS eligibility or seek a tax opinion addressing each eligibility requirement in greater depth. Tax insurance is now available to insure against losses arising out of taking of QSBS return positions.

Three Section 1202 eligibility requirements that are often possible issues for holders of the stock of domestic (US) C corporations (one of the requirements) are (1) Section 1202's "aggregate gross assets" QSBS issuer size limitations ($50 million for QSBS issued prior to July 5, 2025, and $75 million for QSBS issued after July 4, 2025), (2) the "80% test" (80% by value of assets must be used in qualified activities during substantially all of the taxpayer's QSBS holding period), and (3) limitations on the amount of real property

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investments, corporate stock investments, cash and investment assets. For a further discussion of QSBS eligibility requirements, see the article "*A Section 1202 Walkthrough: The Qualified Small Business Stock Gain Exclusion*" and other articles in the QSBS Library.

The ability of a taxpayer to substantiate the claiming of QSBS benefits is critical. For a further discussion of how to substantiate QSBS related return positions and maintain a "QSBS File," along with considering the role of tax advice, attestations, tax opinions and tax insurance, see the articles "*Substantiating the Right to Claim QSBS Tax Benefits – Part 1*" and "*Substantiating the Right to Claim QSBS Tax Benefits – Part 2*."

B. Section 1202's gain exclusion is available only if the applicable holding period requirements are satisfied.

For QSBS issued prior to July 5, 2025, taxpayers are eligible to claim Section 1202's gain exclusion only if their holding period exceeds five years. For QSBS issued after July 4, 2025, taxpayers are eligible to claim a 50% gain exclusion after achieving a three-year holding period, a 75% gain exclusion after four years, and a 100% gain exclusion after five years.

Establishing the start date for a QSBS holding period is often, but not always, straightforward. For most taxpayers, the date QSBS was issued by the QSBS issuer is the start date. If restricted stock is issued to a service provider, the start date would be the earlier of the issuance date if a Section 83(b) election is made or the date the restrictions lapse. If the stock was issued upon exercise of convertible debt, a warrant or option, the issuance date would be the conversion date. The holding period of a taxpayer who received QSBS as a gift, "at death" of the previous holder or as a partnership distribution dates back to the start-date of the original holder. The holding period of a taxpayer who exchanged QSBS for stock (QSBS or non-QSBS) in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization dates back to the holding period start-date for the original QSBS. This paragraph covers many but not all possible holding period issues. Confirming the applicable QSBS holding period is a critical aspect of planning for potential sellers of

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QSBS.

Section 1045 requires that a taxpayer have at least a six-month holding period for QSBS before being eligible to make a Section 1045 election to roll QSBS proceeds over into replacement QSBS.

C. Maximizing the amount of gain exclusion (including gifting QSBS) – Section 1202's gain exclusion caps.

For QSBS issued prior to July 5, 2025, Section 1202 caps a taxpayer's standard per-issuer gain exclusion at $10 million. For QSBS issued after July 4, 2025, the per-QSBS issuer cap is increased to $15 million. In addition to the "standard" gain exclusion cap, Section 1202 has a separate but intertwined cap tied into a taxpayer's aggregate tax basis in an issuer's QSBS (the 10 times tax basis cap). The gain exclusion cap with respect to a QSBS issuer applies to capital gains arising directly out of a taxpayer's sale of QSBS or capital gain passing through on the taxpayer's Schedule K-1. The "10X Cap" is particularly significant for investors who make large money investments into QSBS issuers or when appreciated property is contributed to a corporation in exchange for QSBS (e.g., when a partnership conversion occurs).

Section 1202 permits the gifting of QSBS by one taxpayer to another taxpayer. Each taxpayer has separate non-aggregated gain exclusion caps, which provides taxpayers with the opportunity to increase the aggregate gain exclusion amount by spreading QSBS among family members through direct gifts or transfers into non-grantor trusts. Another possible strategy is to contribute appreciated property in exchange for QSBS to take advantage of the10X Cap. Any planning for increasing the aggregate gain exclusion ideally should be undertaken in advance of entering into a binding agreement to sell QSBS. For further discussion of planning to maximize Section 1202's gain exclusion, see the article "*Maximizing Section 1202's Gain Exclusion*."

Another possible way of increasing a taxpayer's aggregate gain exclusion is to reinvest provides under Section 1045 into replacement QSBS. For example, a taxpayer might sell $20 million of Corporation A QSBS, claim Section 1202's exclusion on $10 million of

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the gain and reinvest $5 million into two replacement QSBS investments. The taxpayer will have a potential separate exclusions with respect to gain from the sale of the replacement QSBS issued by Corporations B and C. A taxpayer who is lucky or good enough to rollover proceeds on a tax-fee basis under Section 1045 into multiple successful investments in replacement QSBS can substantially increase the aggregate gain exclusion arising out of the original Corporation A QSBS. See the articles "*Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045*," and "*Part 2 – Reinvestment QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045*."

D. Section 1202's gain exclusion is triggered only when there is a taxable sale or exchange of QSBS.

The right to claim Section 1202's gain exclusion is triggered when there is a taxable sale or exchange of a taxpayer's QSBS. Generally, when a transfer of QSBS triggers the reporting of long-term capital gain on a Form 8949 or Schedule E, the taxpayer should be eligible to claim Section 1202's gain exclusion. Transactions structured as taxable stock sales (whether the consideration is money, other property consideration or taxable equity exchanges) or cash-out mergers generally qualify. Under some circumstances, a stock redemption governed by Sections 302 qualifies as a taxable exchange triggering the right to claim the gain exclusion. Both distributions pursuant to a partial liquidation governed by Sections 302(b)(4), 302(e) and 346, or a distribution of liquidation proceeds pursuant to a plan of complete liquidation pursuant to Sections 346 and 331(a) should trigger the right to claim the gain exclusion. If a sale transaction includes deferred purchase consideration, the transaction would generally be reported following the installment sale rules unless the taxpayer elects out of installment sale treatment and the taxpayer would follow IRS rules regarding claiming Section 1202's gain exclusion in connection with the receipt of installment payments.

E. Taxpayers can exchange QSBS for stock (either QSBS or non-QSBS) in a Section 351 nonrecognition exchange or Section 368 tax-free reorganization.

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Section 1202(h)(4) provides that if QSBS is exchanged for other stock (either QSBS or non-QSBS) in a Section 351 nonrecognition exchange (so long as the corporation issuing the replacement stock holds 80% of the original QSBS issuer's stock after completion of the exchange) or Section 368 tax-free reorganization, then the replacement stock is either QSBS (if QSBS is exchanged for QSBS) or "non-qualifying QSBS" where the QSBS is exchanged for non-QSBS.

The replacement stock is QSBS if all of Section 1202's eligibility requirements are satisfied with respect to the corporation issuing the replacement QSBS, including Section 1202's $75 million "aggregate gross assets" limitation. If the replacement stock is QSBS, then the holding period and status tacks seamlessly from the original QSBS to the replacement QSBS and the holder will be eligible to claim Section 1202's gain exclusion if the holding period requirements are met when the replacement QSBS is sold if all eligibility requirements are met at that point for the combination of the original and replacement QSBS.

The replacement stock is "non-qualifying QSBS" if the corporation issuing the replacement stock in the exchange is not eligible to issue QSBS (e.g., "aggregate gross assets" exceeding $75 million). If a target stockholder receives "non-qualifying QSBS," when that stock is sold, if Section 1202's holding period requirements are met at that point, the taxpayer is eligible to claim Section 1202's gain exclusion to the extent of the gain deferred when the original QSBS was exchanged for the replacement QSBS. For example, if Corporation A's QSBS with a tax basis of zero and FMV of $100 per share is exchanged for Apple stock that is later sold for $200 per share and the taxpayer has a tacked holding period between the original QSBS and the Apple stock of greater than five years, then the taxpayer would have a $200 capital gain per share and should claim a $100 Section 1202 gain exclusion.

F. Taxpayers can rollover proceeds from the sale of QSBS into replacement QSBS under Section 1045.

Proceeds from the sale of QSBS held for at least six months can be rolled over into replacement QSBS under Section 1045. Taxpayers

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usually roll proceeds over under Section 1045 when they sell QSBS before obtaining the desired (or necessary) holding period to claim Section 1202, but some taxpayers will elect to roll over proceeds in excess of their gain exclusion cap. For example, if a founder sells $30 million of QSBS and claims a $10 million gain exclusion, the founder can elect under Section 1045 to roll over up to $20 million of proceeds into replacement QSBS.

If the taxpayer rolls over 100% of the proceeds, no gain is recognized on the sale of the original QSBS and any gain, whether capital gain or capital gain sheltered by Section 1202's gain exclusion will be determined when the replacement QSBS is sold. If less than 100% of the proceeds from the sale of the taxpayer's original QSBS is rolled over into replacement QSBS, then amount of gain deferred will be the amount in excess of the taxpayer's aggregate tax basis for the original QSBS sold. Proceeds from the sale of the original QSBS must be rolled over into the replacement QSBS within 60 days after the sale of the original QSBS. If the original QSBS is sold in an installment sale with deferred payments, a conservative interpretation is that only the amount of proceeds reinvested within 60 days of the closing date would qualify for a tax-free rollover under Section 1045.

Treasury Regulation Section 1.1045-1 deal with Section 1045 rollovers when the QSBS is held by an entity taxed as a partnership for federal income tax purposes. The regulations refer to the rollover by partners of an amount equal to their interest in the partnership's capital when the QSBS was acquired (assuming that interests hasn't declined), which suggests that the holder of a pure carried interest (profits interest under Revenue Procedure 93-37) on the date that the partnership acquired the QSBS would not be entitled to roll over any proceeds under Section 1045.

G. What taxpayers and target corporations should avoid if they want to maximize their QSBS tax benefits in a sale transaction.

A key eligibility requirement for claiming Section 1202's gain exclusion is structuring a transaction as a taxable sale or exchange. From a tax standpoint, target corporations with stockholders who hold QSBS should avoid structuring a transaction as an asset sale. If

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a corporation sells assets, taxable gain will be taxed at the flat 21% corporate tax rate. The target corporation may then be able to adopt a plan of complete liquidation and distribute the net proceeds to stockholders in a transaction treated as a taxable exchange under Section 331, but there will have been a 21% tax imposed at the corporate level.

If a corporation's stockholders are eligible to claim Section 1202's gain exclusion, consideration should be given to avoiding tax-free exchanges of the QSBS for buyer equity, particularly if the buyer equity is non-QSBS or non-stock equity. The exchange of QSBS for LLC or limited partnership equity interests may be tax free under Section 721, but the ability to claim Section 1202's gain exclusion will be forfeited. The better approach may well be to lock-in Section 1202's gain exclusion and, if necessary, reinvest proceeds with a full purchase tax basis into the purchaser entity.

Taking a page out of the preceding paragraph, target stockholders who roll over some or all of their QSBS into purchaser non-stock equity in a tax-free rollover (Section 721 nonrecognition exchange of property for a partnership interest) have lost their right to claim Section 1202's gain exclusion when the purchaser non-stock equity is ultimately sold. Target stockholders should first explore whether the transaction can be restructured as a stock-for-stock exchange under Sections 351 or 368. If a stock-for-stock exchange is not on the table, then target stockholders who have the necessary holding period to claim Section 1202's gain exclusion should negotiate for a taxable sale or exchange transaction structure. And, if target stockholders participating in the rollover do not have the necessary holding period to claim Section 1202's gain exclusion but desire to roll proceeds over under Section 1045, those stockholder should also negotiate for a taxable sale or exchange transaction structure. Although the cash burden may make it difficult, the target stockholder could both invest proceeds into the purchaser equity and at the same time roll a like amount over into replacement QSBS of the target stockholder's choosing.

H. Avoiding pre-sale corporate-level or taxpayer-level actions that destroy QSBS status.

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Both corporate management and stockholders must be familiar with Section 1202's eligibility requirements and what actions would cause outstanding QSBS to lose its status, or never qualify as QSBS. The following is not an exhaustive list of ways taxpayers and QSBS issuers can forfeit the QSBS status of outstanding stock.

A corporation's equity must qualify as "stock" in the hands of a stockholder in order to trigger the commencement of the taxpayer's holding period. Convertible debt and options are not "stock" until stock is issued upon exercise. Restricted stock is not "stock" in the hands of a service provider until the restrictions lapse or the stockholder makes a timely Section 83(b) election. A SAFE instrument does not clearly qualify as "stock" for purposes of Section 1202. Stockholders who transfer their QSBS to a family LLC or LP forfeit QSBS status, unless the stock is distributed back to the original transferor.

A corporation must continue to satisfy Section 1202's 80% test for substantially all of the holding period for its stockholders' QSBS. QSBS status will be lost if a recapitalization results in QSBS being exchanged for non-QSBS (e.g., the corporation fails the aggregate gross assets test when the exchange of stock-for-stock is made in the recapitalization).

VII. Structuring pre-sale business activities with the intent to maximize QSBS benefits.

A. Best practices for maximizing the benefits of owning QSBS.

If obtaining the benefits of Section 1202's gain exclusion is an important goal, efforts should be made throughout the QSBS Issuer's existence to ensure that (i) the corporation meets all of the corporate-level eligibility requirements, (ii) founders, employees and investors hold "stock" for federal income tax purposes, with the clock running on meeting Section 1202's holding period requirements, (iii) stockholders understand Section 1202's rules and how to avoid actions that would destroy the QSBS status of their stock, and (iv) efforts are made to create a "QSBS File" of documents and other background information necessary to

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substantiate satisfaction of each Section 1202 eligibility requirement at both the corporate and taxpayer levels. For a discussion of whether SAFE instruments qualify as "stock" for federal income tax purposes, see the article "*Guide to the Federal Income Tax Treatment of SAFEs*."

B. Who owns QSBS is a relevant factor to consider in the planning process.

Individuals, "Pass-thru" entities such as S corporations or LLCs/LPs taxed as partnerships for federal income tax purposes, and trusts (grantor and non-grantor) are eligible to own and sell QSBS. C corporations cannot claim Section 1202's gain exclusion. The issuer of QSBS must be a domestic (US) C corporation. Foreign owners and US tax-exempt owners do not need Section 1202's gain exclusion. These fundamental aspects of how Section 1202 functions should be kept in mind when structuring the ownership of business activities and the issuance and ownership of QSBS.

Financial investors are often interested in owning QSBS indirectly through LLCs or LPs taxed as partnerships ("**Upper-Tier Partnerships**") so that they can issue carried interests (profits interests under Revenue Procedure 93-27) in the Upper-Tier Partnership to financial personnel. Section 1202 provides that when QSBS is held by an Upper-Tier Partnership, the right to claim Section 1202's gain exclusion is no greater than the "interest" held by each partner in the Upper-Tier Partnership when the Upper-Tier Partnership first made its investment in QSBS. Some tax professionals have concluded that the reference in the Section 1045 Treasury Regulations to "interest in capital" should be interpreted to apply not only to the right to make a Section 1045 election but also to the right to claim Section 1202's gain exclusion. Since the holder of a profits interest has no "interest in capital" with respect to a pure profits interest on the date the Upper-Tier Partnership acquires QSBS, under this interpretation of tax law, holders of profits interests would not share Section 1202's gain exclusion. But based on Section 1202's reference to "interest" rather than "interest in capital" and additional interpretive support in tax authorities, it seems reasonable that a holder of a profits interests has a return position to claim Section 1202's gain exclusion

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when capital gain passes through from the sale of QSBS on a Schedule K-1.

Information for family offices and PE firms who are structuring ownership of QSBS can be found in the article "*Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms*."

C. Structuring issues associated with undertaking multiple activities.

If multiple business activities are undertaken within a single C corporation (QSBS Issuer) and a buyer wants to acquire only one activity, separating the wanted from the "unwanted" assets can be accomplished in several ways, but any way that it is accomplished will result in a taxable sale at the corporate level (21% flat tax rate) of either the wanted or unwanted assets. But it should generally be possible to avoid double taxation. For instance, the QSBS issuer can sell the assets of one activity to the buyer, adopt a plan of partial liquidation, and distribute the proceeds out to stockholders who benefit from taxable exchange treatment with respect to the distributions under Sections 302(b)(4), 302(e) and 346, triggering the right to claim Section 1202's gain exclusion. If Section 1202's gain exclusion isn't available to stockholders or the distribution doesn't qualify for partial liquidation treatment, then a sale of corporate assets/activity followed by a distribution of the net proceeds would be subject to double taxation. For these and other reasons, consideration should be given to structuring the holding of business activities so that each activity is held in a separate (brother-sister) C corporation. If a QSBS issuer finds itself holding multiple activities and there is the possibility of a future sale of one of the activities, or the activities are not compatible from an investment, funding, regulatory or other standpoint, consideration should be given to dividing the activities into two corporations using a Type D reorganization. See the article "*Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)*."

An additional potential benefit of using multiple brother-sister C corporations is that there will be separate standard (i.e., $15 million) gain exclusion caps applicable to each corporation, unless the IRS is

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successful arguing that the two corporations should be consolidated applying a government-favorable anti-tax avoidance type doctrine.

D. Including upper-tier partnerships and lower-tier partnerships in the business structure.

Other issues that arise regularly when structuring the ownership and entity structure of QSBS Issuers are those involving the use of upper-tier partnerships (e.g., investment funds) holding QSBS, or lower-tier partnerships owned by the QSBS Issuer and sometimes used to facilitate the tax-free roll-up of target companies under the QSBS Issuer C corporation platform. Another issue that frequently arises when structuring ownership arrangements with C corporations that are used as acquisition platforms are efforts to maximize the rollup of target companies while remaining under the "aggregate gross assets" limit (now $75 million). For more discussion of the relevant structuring and planning issues, see the article "*Exploring the Role of Partnerships in Qualified Small Business Stock (QSBS) Planning*."

E. Incentive compensation planning.

Another area of pre-sale focus is structuring incentive compensation for employees and other service providers. When QSBS is involved, there is a greater focus on issuing restricted and unrestricted stock grants since employees can only take advantage of Section 1202's gain exclusion if they sell "stock." Restricted stock is not "stock" until the restrictions lapse, or a timely Section 83(b) election is made. Stock options, warrants, phantom equity, restricted stock units and other bonus arrangements are not "stock" for purposes of Section 1202. See the article "*The Intersection Between Equity Compensation Planning and Section 1202*."

F. Planning to increase the aggregate gain exclusion amount.

Finally, pre-sale planning should include consideration of whether the "standard" $10 million or $15 million (depending on when QSBS

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was issued) per-taxpayer gain exclusion cap will be sufficient to cover the potential capital gain amounts arising out of a sale of an issuer's QSBS, or whether efforts should be made to expand the number of taxpayers holding the corporation's QSBS through gifting, or increase a taxpayer's aggregate tax basis in QSBS through property contributions in exchange for the issuance of additional QSBS. Early-stage planning involving QSBS that is expected to later sell for a large number has the benefit of dramatically increasing wealth transfer (e.g., reducing gift tax consequences) and federal income tax benefits. Because it isn't always possible to bring out the crystal ball to predict which start-ups will succeed, later stage planning can also achieve good results in terms of increasing Section 1202's aggregate gain exclusion amount. See the article "*Maximizing Section 1202's Gain Exclusion*."

G. What to do if the business is being operated through an S corporation.

If a business is operating as an S corporation and the decision is made to restructure to take advantage of Section 1202's gain exclusion, the parties should make sure that the restructuring maximizes the future potential Section 1202 gain exclusion. A seller of stock issued by an S corporation is not eligible to claim Section 1202's gain exclusion and S corporation stock cannot be exchanged for QSBS. See "*Advanced Section 1202 (QSBS) Planning for S Corporations*."

The holding period for QSBS issued in an S corporation restructuring (e.g., Type F reorganization) does not commence until the stock is issued. If a sale of the business is anticipated prior to the third anniversary of the restructuring, business owners should think twice before restructuring an S corporation to own QSBS. Exceptions to this general rule might apply if owners have a place to reinvest their original QSBS proceeds under Section 1045, or if there is a reasonable presumption that the exit will be structured as a stock-for-stock exchange (Section 368 tax-free reorganization or Section 351 nonrecognition exchange).

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-

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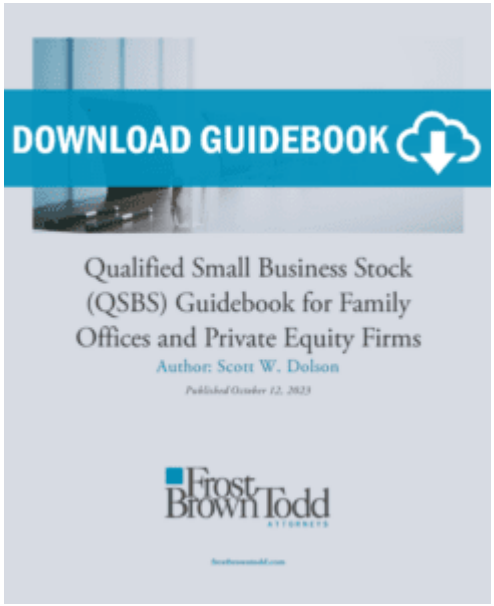
related analysis curated by topic, from the choice of entity decision and Section 1202's gain exclusion to Section 1045 rollover transactions.

More QSBS Resources



- Revisiting the Choice of Entity Decision After OBBBA's 2025 Tax Law Changes | Part 1
- Exploring Section 1202's Active Business Requirement
- Substantiating the Right to Claim QSBS Tax Benefits | Part 2
- 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?

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- Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide
- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations
- Can Stockholders of Employee Leasing or Staffing Companies Claim Section 1202's Gain Exclusion?
- Qualified Small Business Stock (QSBS) Guidebook for Family Offices and Private Equity Firms
- 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 reflects changes to Section 1202 made by the One Big Beautiful Bill Act (OBBBA) signed into law on July 4, 2025. For additional discussion of OBBBA, see the article "*One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors*."

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[2] See also Treasury Regulation Section 1.346-1.

[3] Under Section 304, if one or more persons are in control (generally, 50% or more by vote or value) of both the target corporation and the acquiring corporation, the transaction is not treated as a simple sale of stock but instead is treated as a distribution in redemption of the stock of the acquiring corporation, triggering application of Section 302's rules addressing whether the payment should be treated as a dividend or a payment accorded "sale or exchange" treatment. These rules can affect whether the target stockholders are eligible to claim Section 1202's gain exclusion in connection with the payment.

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

[5] See IRS Field Service Advisory Memorandum 199952001 (1999).

[6] See Technical Advice Memorandums (TAMs) 9853001 and 9853002 (1/04/1999).

[7] IRS Chief Counsel Advisory Memorandum (CCA) 200451030. Treasury Regulation Section 1.1001-1(a) provides that *"[t]he amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value*." See also Notice 2000-26 , 2000-1 CB 954 (4/11/2000).

[8] See Treasury Regulation Section 1.1045-1(f).

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[9] See endnote 6.

[10] Depending on how the transaction is structured, the IRS might assert the "step transaction doctrine" or "sham transaction doctrine" in an attempt recharacterize sale and reinvestment arrangements as a nontaxable reinvestment.

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