How Does a Corporation's S Corporation History Affect a Taxpayer's Eligibility to Claim Section 1202's Gain Exclusion?

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Section 1202 provides an exclusion from capital gains when a taxpayer sells qualified small business stock ("**QSBS**"), assuming all eligibility requirements are satisfied.[1] The One Big Beautiful Bill Act ("**OBBBA**") further enhanced Section 1202's benefits for QSBS issued after July 4, 2025. Section 1045 provides for the tax-free rollover of gain from the sale of QSBS into replacement QSBS, again assuming all eligibility requirements are satisfied. See the **QSBS library** for articles discussing Sections 1202 and 1045.

The federal income tax benefits associated with claiming Section 1202's gain exclusion or rolling over QSBS sales proceeds under Section 1045 are usually significant. Excluding $10 million of capital gain when QSBS is sold translates into $2.38 million (long-term capital gains rate of 20% plus net investment income tax rate of 3.8%) of tax savings at the federal level.[2] OBBBA increased the standard per-taxpayer, per QSBS issuer gain exclusion cap to $15 million for QSBS issued after July 4, 2025. Rolling proceeds from the sale of QSBS into replacement QSBS under Section 1045 not only defers gain but also positions a taxpayer to claim Section 1202's gain exclusion if the replacement QSBS is transferred in a taxable sale or exchange, assuming all eligibility requirements are met.

A determination should be made that each eligibility requirement can be adequately substantiated before a taxpayer claims a QSBS related 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)*."

A key aspect of substantiating eligibility to claim QSBS benefits is establishing whether the stock qualified as QSBS when a taxable transfer occurs and the taxpayer must report capital gain. Everyone associated with QSBS knows that C corporation status

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plays an important role in determining whether stock qualifies as QSBS. What is often less understood, however, is how a history of S corporation status can affect the QSBS status. This article addresses the intersection of QSBS and S corporations.

1. Can stock issued by an S corporation qualify as QSBS?

No.

Section 1202(a)(1) provides a gain exclusion for "qualified small business stock" (QSBS). Section 1202(c)(1)(A) defines "qualified small business stock" means any stock in a C corporation, if as of the date of issuance, such corporation is a "qualified small business." Section 1202(e)(4) defines "qualified small business" as a domestic (US) corporation which is a C corporation. These provisions explicitly confirm that stock is not QSBS unless at the time of issuance, the issuer is a domestic (US) C corporation.

One argument we have seen made is that an S corporation's stock should be treated as having been issued by a C corporation where stock of a newly-organized corporation is issued on Day 1 and the S corporation election is later, but effective back to Day 1. The argument is that the corporation was not an S corporation on Day 1. Unfortunately, tax authorities are clear that when the S corporation election is made effective as of Day 1, the stock issued on Day 1 would be treated as having been issued by an S corporation.

2. Can a former S corporation issue QSBS?

Yes.

A corporation whose tax status changes from that of an S corporation to a C corporation is thereafter eligible to issue QSBS, so long as at the time of issuance all Section 1202 eligibility requirements are satisfied. But, as noted above, any stock issued while the corporation was an S corporation will not qualify as QSBS, even after the corporation converts to C corporation status.

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A common but unfortunate result is for the founders of a former S corporation to discover just before selling their business for a large number that while investors and employees are eligible to take advantage of Section 1202's gain exclusion because the corporation was a C corporation when they were issued stock, the founders are not eligible because their stock was issued while the business operated as an S corporation. As discussed below, this result can be avoided with proper planning.

3. Can Section 1202's gain exclusion be claimed if the issuing corporation (or its successor) is an S corporation when the stock is sold or exchanged?

No.

Section 1202(a)(1) provides a gain exclusion for "qualified small business stock" (QSBS). Section 1202(c) defines "qualified small business stock" means any stock in a C corporation. These two provisions explicitly confirm that the gain exclusion is available only when the issuing corporation is a C corporation at the time the stock is sold or exchanged.

4. Can Section 1202's gain exclusion be claimed if there is some period of S corporation status after QSBS is issued by a domestic (US) C corporation?

Yes, but only if Section 1202's "substantially all" requirement is satisfied.

Section 1202(a)(1) provides a gain exclusion for "qualified small business stock" (QSBS). Section 1202(c)(2)(A) provides that stock is not QSBS unless, during substantially all of the taxpayer's holding period for such stock, the corporation issuing the QSBS is a C corporation. No tax authority addressing Section 1202 defines "substantially all." Other tax authorities interpreting the phrase "substantially all" suggest that the phrase would be interpreted to mean somewhere between 80% and 95% of the applicable time period.

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5. Can an S corporation own QSBS?

Yes. But there are some limitations that should be kept in mind.

Section 1202(g) provides that "pass-thru" entities can own QSBS and that an S corporation is a pass-thru entity. If an S corporation acquires QSBS, taxpayers who were stockholders on the date the S corporation acquired the QSBS are eligible to claim Section 1202's gain exclusion when the S corporation sells the QSBS and capital gain flows through on Schedule K-1s.

A stockholder's eligibility to claim Section 1202's gain exclusion is limited to the "interest" held (shares of S corporation stock) on the date the S corporation acquired QSBS. The same holds true with respect to the ability to participate in the rollover of proceeds from the sale of a QSBS investment into replacement QSBS under Section 1045. Section 1202 does not provide that a transferee of S corporation stock steps into the shoes of the transferor with respect to the "interest" of the transferor in the S corporation's QSBS. This is a problem both with respect to gifting and transfers at death of S corporation stock. If an S corporation intends to acquire QSBS, all voluntary transfers should occur before the S corporation acquires QSBS. What happens when S corporation stock is transferred at death is a grey area — there is no explicit tax authority supporting the position that the transferee (the estate or beneficiaries) can benefit from the deceased stockholder's "interest" in QSBS. Nor does Section 1202 provide that stock retains its QSBS status if distributed in-kind — this would in any event trigger a deemed taxable sale of the QSBS. All of this makes S corporation ownership of QSBS possible but certainly troublesome from a planning standpoint.

6. What is the best way to convert an operating business from an S corporation to a C corporation if the owners want to maximize QSBS benefits?

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If a corporation merely terminates its S election, none of stock issued while an S corporation would later qualify for QSBS treatment, but stock issued after conversion would potentially be eligible for QSBS status. Understandably, S corporation stockholders want the benefits of holding QSBS when the decision is made to convert. Typically, this is accomplished through a restructuring that results in the S corporation becoming a stockholder of a C corporation that issues QSBS to the S corporation and owns and operates the historic business. In many cases a Type F reorganization is part of the restructuring. If a restructuring is undertaken, any appreciation in the business assets prior to the restructuring is not eligible to offset with Section 1202's gain exclusion, but the S corporation stockholders should be able to offset gain associated with future appreciation with Section 1202's gain exclusion.

For example, if S corporation stockholders restructure at a point when the corporation's assets are valued at $10 million (assume zero tax basis), and the S corporation holding company later sells QSBS for $150 million, the first $10 million of gain would not be eligible for Section 1202's gain exclusion, but the next $100 million (10 times $10 million) would be eligible for exclusion applying Section 1202's "10X gain exclusion cap."

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

7. How does the presence of subsidiaries affect planning and restructuring?

When business owners want to pursue the tax benefits associated with QSBS ownership, the typical restructuring of the S corporation involves a restructuring that begins with a Type F reorganization followed by a contribution of the resulting 100% membership interest to a newly-organized domestic (US) C corporation in a Section 351 exchange, or in some cases merely involves a direct contribution by the S corporation of assets into the corporation in a Section 351 exchange. The ownership by the S corporation of equity interests in other business entities can complicate this restructuring and must be handled properly to ensure that the new

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C corporation issuing QSBS will meet Section 1202's eligibility requirements.

The first step in the planning process is to determine whether the S corporation owns equity interests in other business entities, and if so, whether the equity is stock of domestic (US) C corporation or qualified S corporation subsidiary, equity in a partnership, equity in a foreign business entity taxed as a C corporation or pass-through for federal income tax purposes, or a disregarded LLC, along with the percentage ownership interest by vote and value. Information about the subsidiary's cap table may be necessary to fully understand what interest the S corporation holds. Once this information is pulled together, it can be factored into the planning process based consideration of the issues addressed below.

Relevance for purposes of Section 1202's "aggregate gross assets" test

Section 1202(d) provides that a corporation cannot issue QSBS if its "aggregate gross assets" exceeded $75 million prior to or will exceed $75 million immediately after the planned stock issuance.[3] Section 1202(d)(2)(B) provides that contributed property must be included in the "aggregate gross assets" calculation at the property's fair market value (FMV). Equity interests are generally treated as "property" under the Internal Revenue Code, and there is no reason to assume that isn't the case for purposes of the $75 million test.**[4]** So, when the S corporation contributes equity to a C corporation in the Section 351 exchange, the FMV of the equity interests held by the S corporation must be considered when applying the "aggregate gross assets" ceiling test.

When the assets of an S corporation are contributed to a C corporation in a Section 351 exchange, there is a question of whether Section 1202(d)(2)(B) or Section 1202(d)(3) applies for purposes of factoring in the value of equity interests. Section 1202(d)(2)(B) provides that the FMV of contributed "property" (which would include equity interests in corporations) applies in calculating the corporation's "aggregate gross assets." So, applying this requirement, if the FMV of a 100% owned subsidiary is $10

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million, that amount would be factored into the "aggregate gross assets" calculation. But Section 1202(d)(3) provides that if the S corporation owns a "subsidiary," the new C corporation parent and the contributed subsidiary are "*treated as 1 corporation for purposes of this subsection*." If this rule is applied a subsidiary whose stock is worth $10 million that has only $1 million in money and zero tax basis in other property would be factored into the "aggregate gross assets" calculation at $1 million. There are no tax authorities outside of the language of Section 1202 itself that direct how to reconcile Section 1202(d)(2)(B) and Section 1202(d)(3) when sufficient stock is contributed to a C corporation to qualify as a "subsidiary." The most likely result would seem to be that the Tax Court would look to the language of Section 1202(d)(2)(B) which expressly addresses valuing contributed property at its FMV for purposes of the "aggregate gross assets" test.

Relevance for purposes of Section 1202's "active business requirement"

Section 1202(c)(2) provides that a taxpayer's stock is not QSBS unless the issuing corporation has met the "active business requirement" during substantially all of the taxpayer's holding period for the stock. Section 1202(e)(1)(A) provides that a requirement for a corporation qualifying as an active business is that "*at least 80 percent (by value) of the assets of such corporation in the active conduct of 1 or more qualified trades or businesses*." The 80% test runs throughout a taxpayer's holding period for the applicable QSBS. Although Section 1202(c)(2)'s "substantially all" requirement has not been defined by tax authorities, the requirement would likely be satisfied if the 80% test was met for 80% to 95% of the applicable timeline. Only assets used by a corporation in actively conducting qualified business activities count towards satisfying the 80% test. Section 1202(e)(3) lists business activities that are not "qualified trade or business" activities. Section 1202(e)(2) confirms that a corporation engaging in start-up or research and development activities intended to result in qualified activities can meet the "active conduct" requirement. As discussed below, consideration should be given to

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leaving equity interests behind in an S corporation's restructuring if the contribution of those assets might cause the C corporation to fail the 80% test.

Ownership by the S corporation of corporate stock or securities

Section 1202(e)(5) provides that if a corporation doesn't hold "*more than 50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent in value of all outstanding stock*" of a corporation, the FMV of such stock or securities will be a "bad" asset for purposes of calculating whether the 80% test has been satisfied. Conversely, if the ownership qualifies as ownership of stock of a "subsidiary," the corporation will be treated as owning its ratable share of the subsidiary's assets (i.e., they are "good" assets) and conducting its ratable share of the subsidiary's activities. The same principles apply where the equity interest is in a foreign corporation that is either listed as a corporation under the Section 7701 regulations or has filed a US check-the-box election to be treated as a corporation. The language of Section 1202 does not suggest that foreign assets or equity interests are automatically treated as "excluded" assets for purposes of the 80% test.

Section 1202(e)(6)(B) provides an exception for portfolio stock and securities that represents invested working capital reasonably expected to be used within two years in the qualified trade or business. These investments of working capital are treated as "good" assets for purposes of the 80% test; provided, however, if working capital, including investment assets, exceed 50% of the FMV of the corporation's assets after the corporation has operated for two years, the excess over 50% will be treated as a "bad" asset for purposes of satisfying the 80% test.

See the discussion below for other planning concerns when stock is contributed in exchange for stock in a Section 351 exchange.

Ownership of qualified S corporation subsidiary stock (QSub)

A subsidiary cannot have the status of a QSub unless it is a 100% owned domestic (US) corporation 100%. If the stock of a QSub is

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contributed to a C corporation in a restructuring, the corporation's QSub status will terminate. The FMV of the stock of the subsidiary should be included as a "good" asset in the calculation of whether the 80% test is satisfied, assuming the QSub is actively conducting a qualified activity. Nevertheless, consideration should be given to whether the QSub should be converted to a disregarded LLC prior to the restructuring. If the QSub is engaged in excluded activities or holds "bad" assets such as excess working capital or investment assets, consideration should be given to excluding those assets from those contributed to the C corporation.

Ownership by the S corporation of partnership interests

If the S corporation holds equity in a tax partnership, then consideration needs to be made whether a QSBS issuer would be considered actively conducting business through that lower-tier partnership. See the article "*Exploring the Role of Partnerships in Qualified Small Business Stock (QSBS) Planning*." If the partnership interest isn't sufficient to support consolidation or the assets or activities of the partnership are not qualified for purposes of Section 1202, restructuring planning will involve considering whether the partnership interest should be excluded from contribution to the C corporation.

Ownership by the S corporation of a disregarded LLC interest

An S corporation is treated as owning directly the assets held by a disregarded LLC subsidiary. As such, the FMV of the assets held by the LLC subsidiary when contributed to the C corporation will either count toward or against satisfaction of the 80% test depending on whether those assets are "good" or "bad" assets for Section 1202 purposes.

Relevance for purposes of Section 1202's limitation on portfolio stock and securities

Section 1202(e)(5)(B) provides that "*a corporation shall be treated as failing to meet the [active business requirement" for any period during which more than 10 percent of the value of its assets (in*

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excess of liabilities" consists of stock or securities in other corporations which are not subsidiaries of such corporation (other than assets described in [Section 1202(e)(6)]." This provision functions separately from the 80% test, although the same portfolio stock and securities that are "bad" assets for purposes of the 80% test will count toward towards triggering the application of Section 1202(e)(5)(B). The reference to Section 1202(e)(6) is intended to exclude investments of working capital in portfolio stock and securities from being "bad" assets for purposes of Section 1202(e)(5)(B).

Relevance for purposes of Section 351 stock for stock exchanges governed by Section 1202(h)(4)

Section 1202(h)(4) addresses the exchange of QSBS for either QSBS or non-QSBS in a Section 351 exchange or tax-free reorganization. If a taxpayer exchanges QSBS for stock in a Section 351 exchange, the taxpayer will have a right to claim at least some Section 1202 gain exclusion when the replacement stock is sold, if the applicable Section 1202 eligibility requirements are satisfied and the exchange satisfies Section 1202(d)(4)(D)'s requirement that the corporation issuing the replacement stock be in "control" (within the meaning of Section 368(c)) of the corporation whose stock is being exchanged.

If stock contributed to the corporation in the Section 351 exchange is not an exchange of QSBS falling within the scope of Section 1202(h)(4) (i.e., where the control requirement is satisfied), then the stock issued by the C corporation will not qualify as QSBS. For example, if 9% of the value of the S corporation's assets consist of non-QSBS, 9% of the stock issued to the S corporation in the Section 351 exchange will be non-QSBS. Section 1202(c)(1) does not include an exception for working capital investments in stock, so those investments should be liquidated prior to exchanging property for stock in the Section 351 exchange. There are several reasons why the stock of a subsidiary might not qualify as QSBS, including when the subsidiary is a non-domestic corporation.

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One possible approach for avoiding the exchange of non-QSBS owned by an S corporation for non-QSBS issued by the new C corporation would be to first liquidate the subsidiary into the S corporation before contributing its assets into the new C corporation in a Section 351 exchange. Before adopting this approach, taxpayers should consider the possible assertion of the liquidation-reincorporation doctrine or the step transaction doctrine.

Section 1202's basis rules

Section 351(i)(1)(B) provides that when property is exchanged for QSBS, the basis of stock in the hands of a taxpayer "*shall in no event be less than the fair market value of the property exchanged* ." If the S corporation contributes corporate stock or a JV interest to a C corporation in exchange for QSBS, the tax basis of the QSBS will equal the FMV of the contributed equity for Section 1202 purposes. For example, if the S corporation contributes stock with a basis of $1,000 and FMV of $10,000 to a C corporation in a Section 351 exchange, the tax basis of the stock for capital gains purposes would be $1,000, but for Section 1202 purposes would be $10,000. When the stock is sold for $25,000, there would be $24,000 of capital gain and $15,000 of gain for purposes of Section 1202's gain exclusion, which has the effect of excluding pre-incorporation gain from the benefits of Section 1202's gain exclusion.

Please contact the authors, Scott Dolson or Brian Masterson, if you want to discuss any Section 1202 and Section 1045 issues by video or teleconference. You can also visit the **QSBS & Tax Planning Services page** to learn more about our team and read our latest insights and analysis.

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[1] There are a number of articles on the FBT Gibbons 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 of original QSBS sales proceeds into replacement QSBS. See *FBT Gibbons' QSBS library.* For a discussion of OBBBA, see the article

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authored by Scott Dolson and Brian Masterson, "*One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors*."

Section 1202 has gain exclusion caps that generally functions to limit a stockholder gain exclusion from a single issuer of QSBS to the greater of $10 million or 10 times the stockholder's aggregate basis in QSBS sold during the taxable year for stock issued prior to July 5, 2025, and $15 million or 10 times the stockholder's aggregate basis in QSBS sold during the taxable year for stock issued after July 4, 2025, subject to subsequent inflation adjustments set forth in amended Section 1202.

This article focuses on federal income taxes. Many states follow the federal treatment of QSBS. California, Pennsylvania, Mississippi and Alabama do not have a corresponding gain exclusion.

[2] See endnote 1.

[3] For QSBS issued prior to July 5, 2025, the ceiling was $50 million rather than $75 million.

[4] Corporate stock and partnership interests are treated as "property" for purposes of the requirement property be exchanged for stock to qualify for nonrecognition treatment under Section 351.

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- Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide
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- Can Stockholders of Employee Staffing Companies Claim Section 1202's Gain Exclusion?
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- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The QSBS Gain Exclusion
- A SPAC Merger Primer for Holders of Qualified Small Business Stock
- Determining the Applicable Section 1202 Exclusion Percentage When Selling QSBS
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- Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045

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