

Qualified Small Business Stock (QSBS)

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QSBS (Code Section 1202) Background

Under Code Section 1202, taxpayers who are issued corporate founder or investor qualified small business stock (QSBS) for cash, services, or other property (excluding stock) can potentially exclude at least \$10 million of gain on the sale of their QSBS at the federal and often state levels if they satisfy Section 1202's five year holding period requirement. A wide variety of business activities qualify under Section 1202, including many software, biotechnology, pharma and manufacturing.

Additional Code Section 1202 and 1045 articles can be found [here](#) on FBT's website.

Code Section 1045 Background

Under Code Section 1045, taxpayers who sell QSBS prior to satisfying Section 1202's the five-year holding period requirement can elect to roll over their QSBS proceeds into replacement QSBS investments. QSBS proceeds can be rolled over into third-party replacement QSBS investments or the taxpayer can organize a new C corporation and commence start-up activities or undertake to acquire the assets or equity of a qualified small business.

Legislative Outlook

Code Section 1202 has been around since 1993 and enjoys strong support in U.S. venture communities as an incentive for encouraging investment in start-up companies. Although the potential exists for the benefits of Section 1202 to be reduced or eliminated during the coming years, more legislative attention has been paid to increasing the capital gains rates for high income taxpayers and the corporate tax rate above the historically low 21% rate currently enjoyed by domestic corporations. If enacted, an increase in the capital gains rates could result in even more attention being paid to structuring investments to fall within the scope of a qualified small business under Section 1202.

FBT's QSBS and Tax Planning Practice

Scott Dolson and Frost Brown Todd's (FBT's) tax planning team have substantial expertise and experience handling Section 1202 and Section 1045 projects for founders, investors, venture firms, venture funds, PE firms, PE funds, family offices, wealth planners, investments bankers, accountants and attorneys.

FBT's QSBS practice involves: (i) helping clients navigate through their choice of entity decision, and in particular their decision whether to operate as a C corporation with the hope of benefiting from the Section 1202 gain exclusion; (ii) helping client satisfy Section 1202's and Section 1045's eligibility requirements; and (iii) helping clients prepare for a potential future IRS audit by documenting their eligibility to claim the Section 1202 gain exclusion.

FBT's QSBS practice encompasses the following:

Assisting businesses:

- helping them make choice of entity decisions
- converting partnerships (LLC/LPs) to corporations, along with related start-up tax planning
- restructuring their businesses that are operating as S corporations for the purpose of positioning owners to reap various business and tax benefits, including the Section 1202 gain exclusion
- providing tax advice and tax opinions, when appropriate, with respect to Section 1202 and Section 1045 issues
- advising founders, management teams and investors with respect to Section 1202's and Section 1045's eligibility and documentation requirements
- restructuring business assets and activities to attain and maintain qualified small business status, including businesses engaged in multiple activities or with operating through subsidiaries or joint venture investments
- advising them with respect to the interaction of equity compensation arrangements with Section 1202
- advising them with respect to the interaction of various equity and equity rights, including convertible debt, SAFEs, stock options, and stock grants with Section 1202
- providing Section 1202 and Section 1045 tax planning in connection with M&A transactions, including those involving equity rollovers
- helping companies formulate their communications with investors, including representations and covenants supporting QSBS eligibility

Assisting founders and service providers:

- advising taxpayers how to expand Section 1202's usual \$10 million cap on the gain exclusion
- planning for the rollover of QSBS proceeds under Section 1045, including utilizing newly formed C corporations for start-up activities or to serve as a vehicle to acquire qualified small businesses
- advising taxpayers with respect to remedying Section 1202 eligibility problem
- providing Section 1202 and Section 1045 tax planning in connection with M&A transactions, including those involving equity rollovers
- addressing gift and estate transfer issues, including working with Delaware and Nevada trusts and estate and trust counsel in various jurisdictions throughout United States
- advising them with respect to the interaction of equity compensation arrangements with Section 1202
- advising them with respect to the interaction of various equity and equity rights, including convertible debt, SAFEs, stock options, and stock grants with Section 1202

Assisting investors:

- documenting eligibility for claiming Section 1202's gain exclusion or a Section 1045 rollover of QSBS proceeds.
- providing tax advice and tax opinions with respect to Section 1202 and Section 1045 issues
- advising taxpayers with respect to efforts to expand the basic \$10 million or 10X cap on the Section 1202 gain exclusion
- addressing gift and estate transfer issues, including working with Delaware and Nevada trusts and estate and trust counsel in various jurisdictions throughout United States

- planning for the rollover of QSBS proceeds under Section 1045, including forming C corporations as vehicles for start-up activities and as acquisition vehicles

Assisting investment funds:

- QSBS planning for holders of carried interests, including tax opinions with respect to the sharing of Section 1202 gain exclusion by holders of carried interests
- QSBS planning for the holding of QSBS through LLCs/LPs
- documenting eligibility for claiming the Section 1202 gain exclusion
- planning for the rollover of QSBS proceeds under Section 1045, including the use of newly formed corporations as vehicles for start-up activities or as vehicles for acquiring a qualified small business

Additional Code Section 1202 and 1045 articles can be found [here](#) on FBT’s website.

FBT's Tax Planning Team

The tax planning team assists FBT business attorneys with entity structuring, financing and M&A transactions. The tax planning team also functions as a “destination team” for clients seeking specialized partnership, M&A, venture financing (including QSBS) and state and local (SALT) tax planning assistance. The tax planning team includes the following attorneys:



[Scott Dolson](#) - Tax Planning team leader and co-chair of the firm's Private Equity industry team. Practice areas include tax planning, M&A, and outside general counsel



[Marty Mooney](#) - Practice areas include tax planning with deep experience working with pass-thru entities



[Melanie McCoy](#) - Team leader of the firm's Estates, Trusts and Wills team. Practice areas include estate planning and trust work



[Chris Coffman](#) - Practice areas include tax planning and pass-thru entity/real estate development tax work



[Dylan Grafe](#) - Practice areas include tax, closely held business transactions, mergers & acquisitions, and startups and emerging businesses.



[Chris Tassone](#) - Practice areas include federal, state, and local tax planning and corporate work

About Frost Brown Todd: Frost Brown Todd is a regional law firm of over 500 attorneys spanning a nine-state footprint. Our tax practice works closely with businesses, founders and investors (spanning individuals, family offices and PE firms) to assist them in their efforts to qualify for Section 1202's generous tax benefits.