KBF ADVISORY

Section 1202

QUALIFIED SMALL BUSINESS STOCK

A COMPREHENSIVE GUIDE TO THE QSBS EXCLUSION

Updated for P.L. 119–21 (The One Big Beautiful Bill Act)

AGENDA

Introduction to Corporate Tax

Background — Why QSBS, History & Core Requirements
Section I — The OBBBA Changes
Section II — Corporate Requirements
Section III — Shareholder Requirements & Exclusion Mechanics

WHY QSBS?

"…[T]argeted relief for investors who risk their funds in new ventures, small businesses, and specialized small business investment companies will encourage investments in these enterprises. This should encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing."

— H.R. Rep. No. 103-111, at 831 (1993) (House Comm. on the Budget).

HISTORY OF SECTION 1202

Evolution of the Exclusion

1993	2009	2010	2025
50%	**75%**	**100%**	**50%/75%/100%**
Omnibus Budget Reconciliation Act Pub. L. No. 103–66, § 13113	**American Recovery and Reinvestment Act** Pub. L. No. 111–5, § 1241 Stock issued after February 17, 2009 and on or before September 27, 2010	**Small Business Jobs Act** Pub. L. No. 111–240, § 2011 100% exclusion for stock acquired after September 27, 2010; originally set to sunset, the 100% exclusion was extended by later acts and made permanent by the Protecting Americans from Tax Hikes Act of 2015 (Pub. L. No. 114–113, div. Q, § 126)	**One Big Beautiful Bill Act** Pub. L. No. 119–21, § 70431 Only for stock acquired after July 4, 2025, percent exclusion determined depending on holding period in the stock sold

** The Biden administration briefly proposed curtailing the exclusion in the House version of the Build Back Better Act, H.R. 5376, 117th Cong. § 138150 (2021), but those rollbacks were dropped before enactment. See Benjamin M. Willis & Ryan J. Dobens, Building Back Biden's American Start-Up, Tax Notes Federal, Nov. 29, 2021.*

CORE REQUIREMENTS FOR QSBS QUALIFICATION

All five conditions below must be satisfied for stock to qualify under Section 1202.

1	**Eligible Issuer** Must be a **domestic C corporation.**
2	**Qualified Small Business Requirement** To meet the qualified small business requirement, the corporation's aggregate gross assets must be **$50 million or less** at issuance of stock (including proceeds received) under pre-OBBBA rules (stock issued on or before July 4, 2025). For stock issued **after July 4, 2025** under the OBBBA, this threshold is raised to **$75 million** (inflation-adjusted for tax years beginning after 2026).
3	**Active Business** The corporation must operate as an **active eligible business** for substantially all of the shareholder's holding period of the stock (i.e., the period before sale).
4	**Original Issuance** Stock must be acquired **directly from the corporation** in exchange for cash, property (but generally not other stock), or services.
5	**Holding Period** **Pre-OBBBA (stock issued on or before July 4, 2025 and after September 27, 2010):** Stock must be held for **more than 5 years** to qualify for the full 100% exclusion. Post-OBBBA (stock issued after July 4, 2025): The OBBBA introduces partial exclusion tiers: **50% exclusion at 3 years, 75% exclusion at 4 years, and the full 100% exclusion 5 years or more.**

Section I

THE OBBBA CHANGES

OBBBA: A NEW ERA FOR QSBS

HIGHER GAIN CAP

Per-issuer gain cap raised from $10M to $15M, with inflation adjustments for tax years beginning after 2026 — allowing larger exits to qualify.

LARGER ASSET THRESHOLD

Gross asset threshold increased from $50M to $75M, with inflation adjustments for tax years beginning after 2026, enabling more growth-stage companies to qualify at issuance.

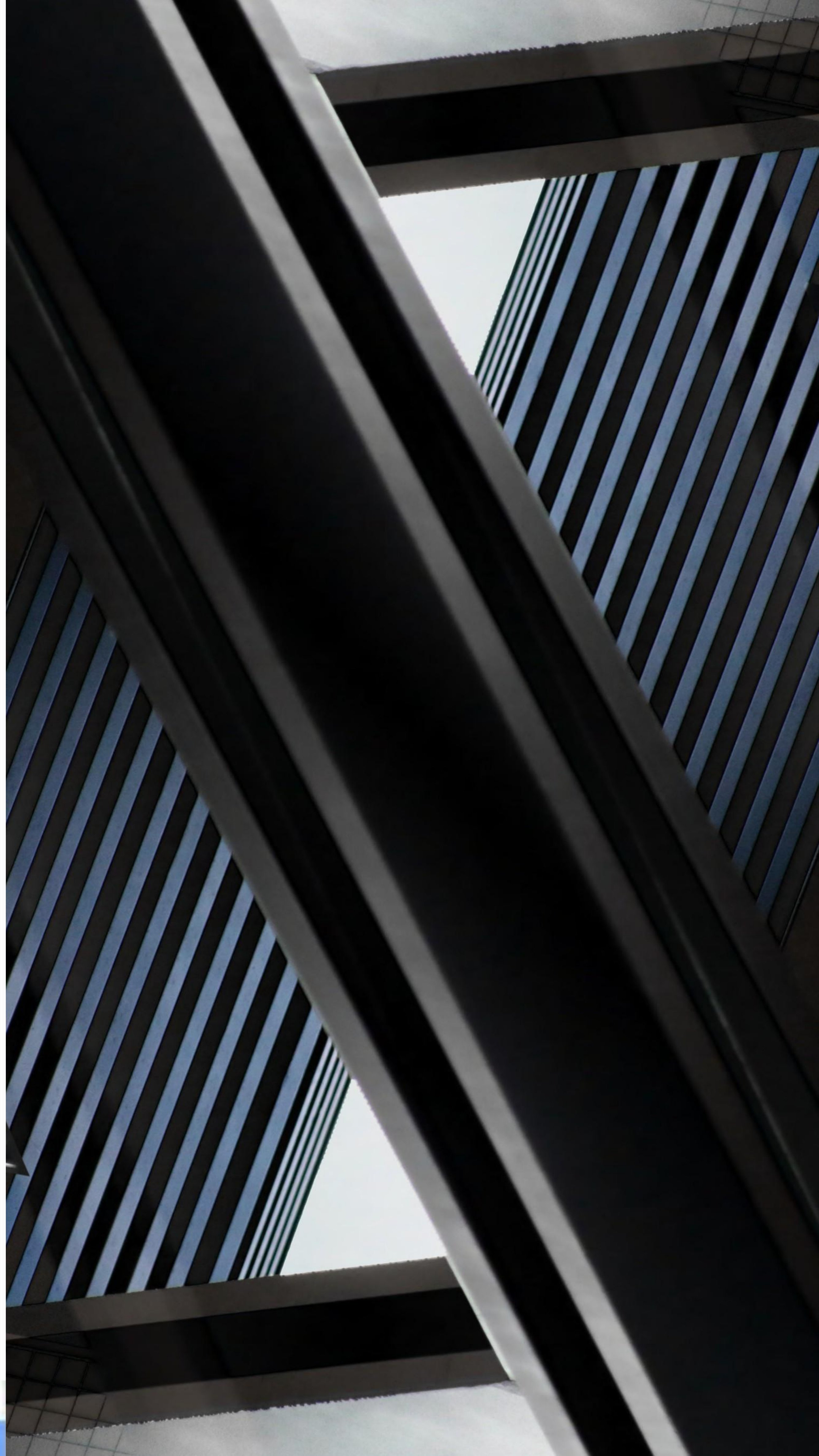
NEW TIERED HOLDING PERIOD

Introduces 50% exclusion at 3 years and 75% exclusion at 4 years, rewarding exits before the 5-year mark.

EFFECTIVE DATE

Changes apply only to stock issued after July 4, 2025.

Pre-existing QSBS remains governed by pre-OBBBA rules and cannot be reset into a benefit under the new rules.



IN DETAIL: HIGHER GAIN CAP

APPLIES TO QSBS ISSUED AFTER JULY 4, 2025

PRE-OBBBA

$10M

POST-OBBBA

$15M

50% increase in the per-issuer gain exclusion

INFLATION-INDEXED

$15M cap is adjusted annually for inflation for tax years beginning after 2026.

10× BASIS ALTERNATIVE PRESERVED

Generally, taxpayer excludes the greater of $15M (reduced by prior year exclusions on stock of the same issuer) or 10× adjusted basis in the QSBS disposed of in the tax year.

Source: Section 1202(b)(1); Pub. L. No. 119–21, § 70431(b).

IN DETAIL: LARGER ASSET THRESHOLD

APPLIES TO QSBS ISSUED AFTER JULY 4, 2025

PRE-OBBBA

$50M

POST-OBBBA

$75M

50% increase to the aggregate-gross-assets ceiling

INFLATION-INDEXED

$75M ceiling indexed for inflation for tax years beginning after 2026. Companies that previously crossed $50M may now re-qualify to issue QSBS (for new issuances after July 4, 2025) under the new $75M test.

TESTED AT ALL TIMES AND IMMEDIATELY AFTER

Aggregate gross asset threshold applies generally at all times before and immediately after the stock issuance.

Drafting note: *Pub. L. No. 119–21, § 70431(c)(2) cross-references Section 1202(b) for the inflation adjustment to the gross-assets threshold; the substantive threshold is in Section 1202(d). JCT Blue Book (JCS-1-25) at 185 n.911 notes a technical correction may be needed to correct the cross-reference from Section 1202(b)(4) to Section 1202(d)(4); see also ACTEC, Comments on the One Big Beautiful Bill Act, Nov. 10, 2025, § III.B.*

IN DETAIL: NEW TIERED HOLDING PERIOD

APPLIES TO QSBS ISSUED AFTER JULY 4, 2025

HOLDING PERIOD 3+ YEARS	HOLDING PERIOD 4+ YEARS	HOLDING PERIOD 5+ YEARS
$50M Partial exclusion available after just 3 years	**$75M** Increased exclusion at the 4-year mark	**$100M** Full exclusion (unchanged from prior law)

Source: Section 1202(a); Pub. L. No. 119–21, § 70431(a).

Former AMT Preference: *Historically, QSBS eligible for only a 50% or 75% exclusion was required to treat 7% of the excluded gain as a tax preference item for purposes of the alternative minimum tax (AMT). See Section 57(a)(7). However, excluded gain on QSBS acquired after September 27, 2010, does not need to apply the preference (this is relevant to stock issued post-OBBBA).*

Section II

CORPORATE REQUIREMENTS

Qualifying the Issuer

WHAT IS "QUALIFIED SMALL BUSINESS STOCK"?

Section 1202(c) defines QSBS as stock that satisfies all of the following:

- Acquired at original issuance in exchange for money, property (not stock), or services;
- Issued by a domestic C corporation;
- Issued after August 10, 1993;
- Issuer is considered a Qualified Small Business as of the date of issuance; and
- Issuer satisfies the Active Business Requirement and remains a C corp for substantially all of the taxpayer's holding period.

QUALIFIED SMALL BUSINESS REQUIREMENT

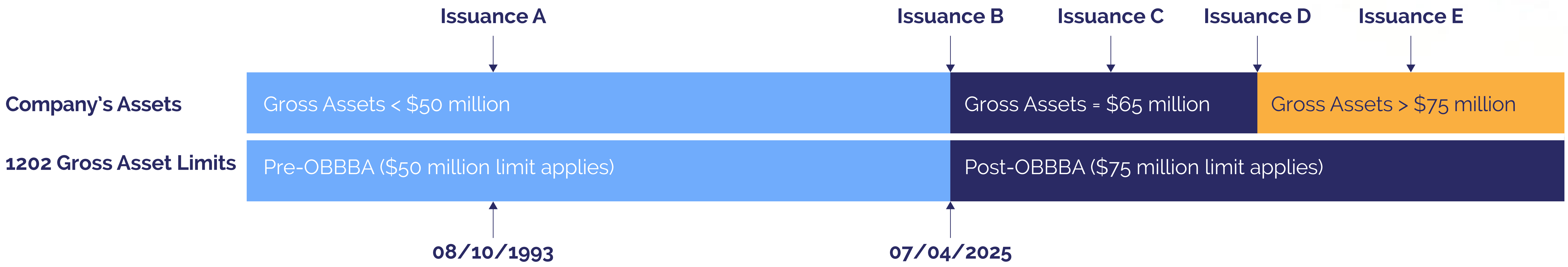
- **The Rule.** A domestic C corporation is a qualified small business only if the aggregate gross assets of the corporation (and any predecessor) do not exceed $75M post-OBBBA / $50M pre-OBBBA under both of the following tests:

  - **Pre-issuance test** (Section 1202(d)(1)(A)) — at all times on or after August 10, 1993 and before the issuance.
  - **Post-issuance test** (Section 1202(d)(1)(B)) — immediately after the issuance, taking into account amounts received in the issuance.

- **Aggregate Gross Assets.** Cash + adjusted bases of all other property held by the corporation. See Section 1202(d)(2)(A).

  - **Exception.** However, the fair market value is used ("FMV") for contributed property. See Section 1202(d)(2)(B).

IN DETAIL: HIGHER GAIN CAP



- Issuance A – Good QSBS (Gross assets are < $50 million at a time when the $50 million limit applied)
- Issuance B – NOT Good QSBS (Gross assets exceed $50 million limit)
- Issuance C – Good QSBS (Gross assets are < $75 million at a time when the $75 million limit applied)
- Issuance D – NOT Good QSBS (Gross assets immediately after issuance exceed $75 million)
- Issuance E – NOT Good QSBS (Gross assets exceed $75 million both before and after the issuance)

NOTE: *Issuance B did not become good QSBS after the passage of OBBBA because the $75 million limit only applies to issuances after its passage (i.e., after July 4, 2025).*

Also, the Company's assets did not exceed $75 million before issuance D, but the money raised caused its assets to exceed that amount.

ACTIVE BUSINESS REQUIREMENT

Active Conduct Requirement - Section 1202(c)(2) / (e)

- During substantially all of the shareholder's holding period, at least 80% (by value) of the corporation's assets must be used in the active conduct of one or more qualified trades or businesses.

- Corporation must be an eligible corporation (excluding Domestic International Sales Corporations (DISCs), Regulated Investment Companies (RICs), Real Estate Investment Trusts (REITs), REMIC, and cooperatives) that is taxed as a "C" corporation.

Disqualified Trades or Businesses — Section 1202(e)(3)

- Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees.

- Any banking, insurance, financing, leasing, investing, or similar business.

- Any farming business (including the business of raising or harvesting trees).

- Any business of producing or extracting products of a character with respect to which a deduction is allowable under Section 613 or Section 613A (percentage depletion — oil, gas, and other mineral extraction).

- Any business of operating a hotel, motel, restaurant, or similar business.

IRS GUIDANCE: ACTIVE BUSINESS REQUIREMENT

Rulings on "Qualified Trade or Business"

- ✓ PLR 201436001 (May 2014) — Pharmaceutical research & development for experimental drugs not in field of health services.
- ✓ PLR 201717010 (Jan. 2017) — Laboratory testing/reporting not in field of health services or a business where the principal asset of the business is the reputation/skill of one or more employees.
- ✓ PLR 202125004 (Mar. 2021) — Medical device fabricator not in field of health services or a business where the principal asset of the business is the reputation/skill of one or more employees.
- ✓ PLR 202114002 (Jan. 2021) — Insurance agent not performing brokerage services.
- ✓ PLR 202144026 (Aug. 2021) — Medical technology software development was not in field of health or a business where the principal asset of the business is the reputation/skill of one or more employees.
- ✗ CCA 202204007 (Nov. 2021) — Property rental facilitation was considered ineligible brokerage services.
- ✓ PLR 202221006 (Mar. 2022) — Pharmaceutical distributor not in health or a business where the principal asset of the business is the reputation/skill of one or more employees.
- ✓ PLR 202319013 (Feb. 2023) — Enterprise cloud application software not in a business where the principal asset of the business is the reputation/skill of one or more employees.
- ✓ PLR 202342014 (Jul. 2023) — Data migration/management not engaged in consulting.
- ✓ PLR 202352009 (Oct. 2023) — Staffing agency not engaged in field of consulting services or a business where the principal asset of the business is the reputation/skill of one or more employees.
- ✓ PLR 202418001 (Feb. 2024) — Medical testing/reports not in field of health services or a business where the principal asset of the business is the reputation/skill of one or more employees.

Note: *Since Rev. Proc. 2024-3 (and subsequent annual no-rule lists), the IRS will not rule on whether a business is a "qualified trade or business" under Section 1202(e)(3); no new PLRs are being issued on this question.*

THE SECTION 199A OVERLAP WITH SECTION 1202

Shared Statutory “DNA” — Section 199A(d)(2) Borrows from Section 1202(e)(3)(A)

- Section 199A(d)(2)(A) defines a "specified service trade or business" by reference to all of Section 1202(e)(3)(A) — health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, and similar fields.

- Minor changes only: Section 199A drops "engineering & architecture" and adds "owners". Also, adds "investing, investment management, trading, or dealing in securities, partnership interests, or commodities." (Internal citations omitted).

Illustrative Example — "Health" under Treas. Reg. § 1.199A-5(b)(2)(ii)

- "Health" covers medical services by physicians, nurses, dentists, etc., but expressly excludes research, testing, manufacture, or sale of pharmaceuticals or medical devices. Parallel carve-outs exist for the other fields.

The IRS's Disclaimer

- "[T]he guidance in proposed [Section] 1.199A-5(b) applies only to section 199A, not sections 1202 and 448." — Preamble to Prop. Regs. See REG-107892-18, 83 Fed. Reg. 40,884 (Aug. 16, 2018).

Note: *For Section 199A purposes, the language of Section 1202(e)(3)(A) is applied without regard to the words "engineering, architecture," and by substituting "employees or owners" for "employees."*

ASSET-CLASS LIMITATIONS

- **Stock or securities in other corporations — Section 1202(e)(5)(B):** the active-business requirement fails for any period during which more than 10% of the value of the corporation's assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries (other than assets described in the working capital exception (discussed later)).
  - A "subsidiary" — under Section 1202(e)(5)(C) — is a corporation in which the parent owns more than 50% of the combined voting power of all classes of voting stock or more than 50% in value of all outstanding stock. Under Section 1202(e)(5)(A), the parent is treated as owning a ratable share of the subsidiary's assets and conducting a ratable share of its activities.
- **Maximum real estate holdings — Section 1202(e)(7):** the corporation fails the active-business requirement for any period during which more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business. For this purpose, the ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business.
- **Working capital — Section 1202(e)(6):** assets are treated as used in the active conduct of a qualified trade or business if they are (A) held as part of the reasonably required working capital needs of a qualified trade or business, or (B) held for investment and reasonably expected to be used within 2 years to finance research and experimentation in, or increases in working capital needs of, a qualified trade or business.
  - After the corporation has been in existence for at least 2 years, in no event may more than 50% of the corporation's assets (on a FMV basis) qualify as so used by reason of this paragraph.

PROHIBITED REDEMPTIONS

Stock will not qualify as QSBS if the issuing corporation has made certain redemptions near the issuance date. See Section 1202(c)(3).

1. Related Party Redemption (Treas. Reg. § 1.1202-2(a))
Stock is not QSBS if, in one or more purchases during the 4-year period beginning on the date 2 years before issuance, the issuing corporation purchases (directly or indirectly) more than a de minimis amount of its stock from the taxpayer or a related person (within the meaning of Section 267(b) or Section 707(b)).

- **De minimis:** exceeded only if aggregate amount paid exceeds $10,000 and more than 2% of the stock held by the taxpayer and related persons is acquired.

2. Significant Redemption (Treas. Reg. § 1.1202-2(b))
Stock is not QSBS if, in one or more purchases during the 2-year period beginning on the date 1 year before issuance, the issuing corporation purchases more than a de minimis amount of its stock and the purchased stock has an aggregate value (at the time of the purchases) exceeding 5% of the aggregate value of all of the corporation's stock as of the beginning of that 2-year period.

- **De minimis:** exceeded only if aggregate amount paid exceeds $10,000 and more than 2% of all outstanding stock is purchased.

PROHIBITED REDEMPTIONS (CONT'D)

Certain Redemptions Disregarded By Regulation

- **Treas. Reg. § 1.1202-2(c) — Service-provider transfers:** a transfer of stock by a shareholder to an employee or independent contractor (or to a beneficiary of either) is not treated as a purchase of the stock by the issuing corporation — even if the stock is deemed first transferred to the corporation under Treas. Reg. § 1.83-6(d)(1).
- **Treas. Reg. § 1.1202-2(d) — Termination, death, disability, divorce:** a stock purchase is disregarded if acquired incident to (1) the seller's retirement or other bona fide termination of services as an employee, director, or independent contractor; (2) death; (3) disability or mental incompetency; or (4) divorce.

SECTION 351 TRANSACTIONS & SECTION 368 REORGANIZATIONS

Transferors of otherwise eligible QSBS in a Section 351 contribution or Section 368 reorganization may continue the QSBS exclusion.

TYPE OF TRANSACTION	QSBS LIMITATION?	CITE
E or F Reorganization under Section 368(a)(1)(E)/(F)	New stock continues to be treated as QSBS.	Section 1202(h)(3); Treas. Reg. § 1.1244(d)-3(c)/(d)
Section 368 Reorganizations	Eligible gain is "frozen" at the time of the reorganization if the stock received is not itself QSBS (e.g., the acquiring corporation fails the $50M / $75M aggregate gross asset test or other Section 1202(c) requirements). This is sometimes called the "Gain Limitation Rule".	Section 1202(h)(4)(A)/(B)
Section 351 Contribution to a Controlled Corporation	Same rules as "Any other Section 368 Reorganization" — pre-exchange eligible gain is frozen under the Gain Limitation Rule unless the transferee corporation independently satisfies Section 1202 at the time of issuance of the new stock.	Section 1202(h)(4)(A)/(B)

THE ANTI-ABUSE RULE

Section 1202(k) — The Anti-Abuse Hook

"The Secretary shall prescribe regulations…to prevent the avoidance of the purposes of this section through split-ups, shell corporations, partnerships, or otherwise."

Phantom Regulations Post-Loper Bright

After Loper Bright Enters. v. Raimondo, 603 U.S. 369 (2024) (overturning Chevron deference). Courts should no longer defer to agency interpretations of ambiguous statutes. See also Phillip Gall, Phantom Tax Regulations: The Curse of Spurned Delegations, 56 Tax Law. 413 (2003).

Section III

SHAREHOLDER REQUIREMENTS & EXCLUSION MECHANICS

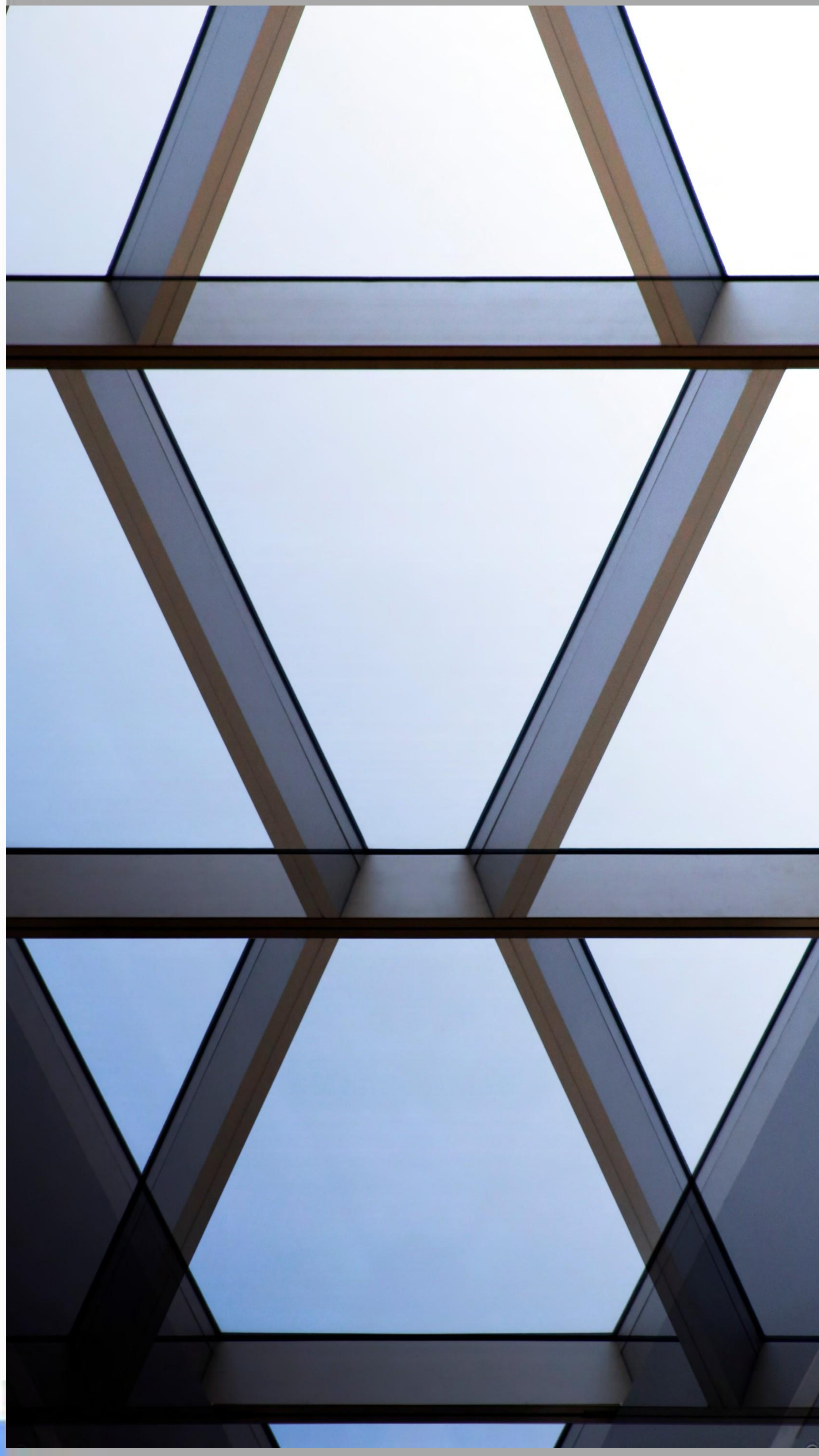
Shareholder Considerations

SUBSTANTIALLY ALL OF THE TAXPAYER'S HOLDING PERIOD

- **Statutory text.** Stock is not QSBS unless, **"during substantially all of the taxpayer's holding period** for such stock, such corporation meets the **active business requirements of subsection (e)** and such corporation is a **C corporation.**"

- **Measurement period.** These tests are measured during the **shareholder's holding period** for the stock — not the life of the corporation. Pre-issuance and post-sale activity is outside the window with respect to a shareholder's qualification.

- **"Substantially all" is undefined.** Neither Section 1202 nor any Treasury regulation defines the term for this purpose.



ORIGINAL ISSUANCE REQUIREMENT

- **Statistical text.**

"[E]xcept as provided in subsections (f) and (h), such stock is acquired by the taxpayer at its original issue (directly or through an underwriter)…" Section 1202(c)(1)(B).

- **Permitted consideration:**

(i) "in exchange for money or other property (not including stock)," or
(ii) "as compensation for services provided to such corporation (other than services performed as an underwriter of such stock)."

- **Transfers/exchanges that preserve original-issuance status:**

  - **Section 1202(f)** — stock acquired solely through the conversion of other QSBS is itself treated as QSBS in the hands of the taxpayer, with the original holding period tacked;

  - **Section 1202(h)(1)–(2)** — transferee "treated as… having acquired such stock in the same manner as the transferor" (with tacked holding period) for transfers (A) by gift, (B) at death, or (C) from a partnership to a partner (subject to conditions similar to Section 1202(g));

  - **Section 1202(h)(3)** — rules similar to Section 1244(d)(2) preserve QSBS status across recapitalizations (Section 368(a)(1)(E)), changes in identity, form, or place of organization (Section 368(a)(1)(F)), and some other carryover-basis transactions including nontaxable stock dividends and stock splits. See Treas. Reg. § 1.1244(d)-3;

  - **Section 1202(h)(4)** — certain Section 351 transactions and Section 368 reorganizations (subject to the Gain Limitation Rule).

PER-ISSUER LIMITATION

- **The Rule.** If the taxpayer has eligible gain for the taxable year from one or more dispositions of stock issued by any corporation, the aggregate gain from that corporation taken into account under Section 1202(a) for the year **shall not exceed the greater of:**

  (A) **Cumulative Exclusion Cap** — the applicable dollar amount, reduced by the aggregate amount of eligible gain taken into account by the taxpayer under Section 1202(a) for prior taxable years and attributable to dispositions of stock issued by such corporation; or

  (B) **10× Basis Cap** — 10 times the aggregate adjusted bases of QSBS issued by such corporation and disposed of by the taxpayer during the taxable year (adjusted basis determined without regard to additions to basis after original issuance).

- **Applicable Dollar Amount:**

  - **Pre-OBBBA.** For stock issued **on or before July 4, 2025: $10M**; <u>not</u> indexed for inflation.

  - **Post-OBBBA.** For stock issued **after July 4, 2025: $15M,** indexed annually for inflation for tax years beginning after 2026.

- **Per Issuer, Per Taxpayer.** The cap applies separately to each issuing corporation and to each taxpayer — gain from different issuers is not aggregated, and the cap is not shared by separate shareholders.

SECTION 1202 EXCLUSION PERCENTAGES

50% exclusion	70% exclusion	100% exclusion	Post-OBBBA tiered (see below)
8/10/1993	2/18/2009	9/28/2010	7/4/2025 → Today

Post-OBBBA (stock issued after 7/4/2025) — Tiered Holding-Period Exclusion
For QSBS acquired after 7/4/2025, the five-year cliff is replaced by a tiered schedule: **≥ 3 yrs →50%** • **≥ 4 yrs →75%** • **≥ 5 yrs →100%.** Per-issuer cap raised to $15M (indexed); $50M gross-asset test raised to $75M (indexed).

Pre-OBBBA stock (issued on or before 7/4/2025) exclusion percentage remains under prior rules.

NOTE: *The portion of Section 1202 gain not excluded because of the exclusion percentage is taxed at a maximum 28% rate. See Sections 1(h)(4)(A)(ii), (h)(7). Excluded gains are also not subject to the net investment income tax under Section 1411.*

Sources: Section 1202(a); One Big Beautiful Bill Act, Pub. L. No. 119–21 (July 4, 2025); Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114–113, div. Q, § 126 (Dec. 18, 2015) (making 100% exclusion permanent); Small Business Jobs Act of 2010, Pub. L. No. 111–240 (Sept. 27, 2010); American Recovery and Reinvestment Act of 2009, Pub. L. No. 111–5 (Feb. 17, 2009); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103–66 (Aug. 10, 1993).

PASS-THRU ENTITY OWNERSHIP

- Gain from sale of a partnership interest or S corp stock of an entity that owns QSBS is **not** eligible for the QSBS exclusion.

- Under **Section 1202(g),** a partner's allocable share of gain from a pass-thru entity's sale of QSBS qualifies as Section 1202(a) gain if both prongs of **(g)(2)** are met: (1) Gain is attributable to the entity's sale of stock that is QSBS in the entity's hands (treating the entity as an individual) and held by the entity for the applicable holding period; and (2) taxpayer held the interest in the entity on the date the entity acquired the QSBS and continuously thereafter through disposition. A "pass-thru entity" is defined as a partnership, S Corporation, RIC, or common trust fund.

  - **Section 1202(g)(3)** caps the excludable amount by reference to the taxpayer's percentage interest in the entity on the date the QSBS was acquired — later increases in the taxpayer's share do not enlarge the exclusion.

OFFSETTING SHORT POSITIONS

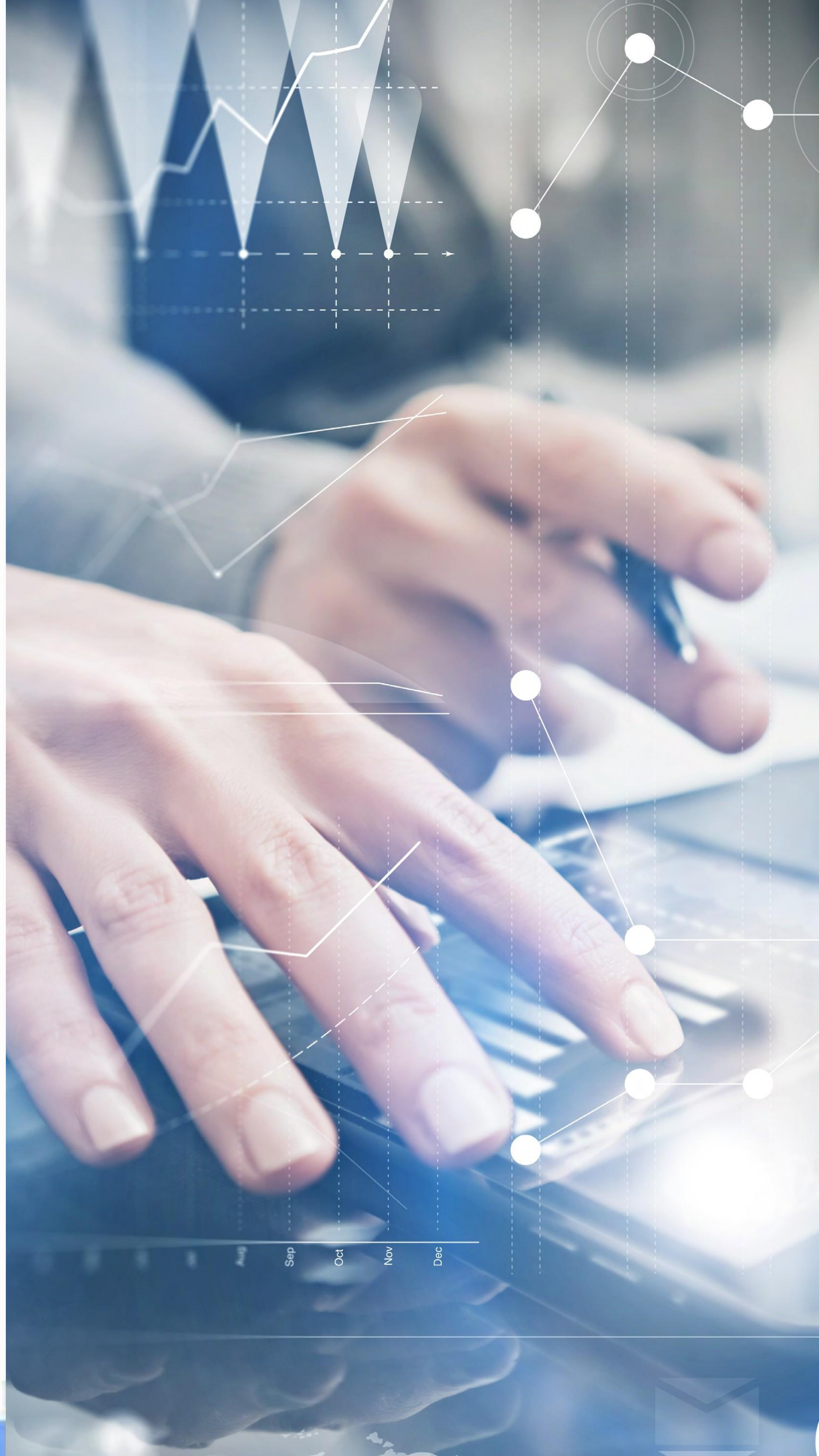
- **The Rule.** Under Section 1202(j)(1), if the taxpayer has an **offsetting short position** with respect to QSBS, the Section 1202(a) exclusion shall not apply to gain on the sale or exchange of that stock unless **both:**

  (i) the QSBS was held by the taxpayer for **more than 5 years** as of the first day on which there was such short position, and
  (ii) the taxpayer elects to recognize gain as if the stock were sold on that first day for its **fair market value.**

- **Definition.** An offsetting short position is (A) **a short sale** of substantially identical property, (B) an **option to sell** substantially identical property at a fixed price, or (C) to the extent provided by regulations any other transaction which substantially reduces the risk of loss from holding such QSBS. See Section 1202(j)(2).

- **Related Persons.** A short position held by a person related to the taxpayer under Sections 267(b) or 707(b) is attributed to the taxpayer for purposes of Section 1202(j).

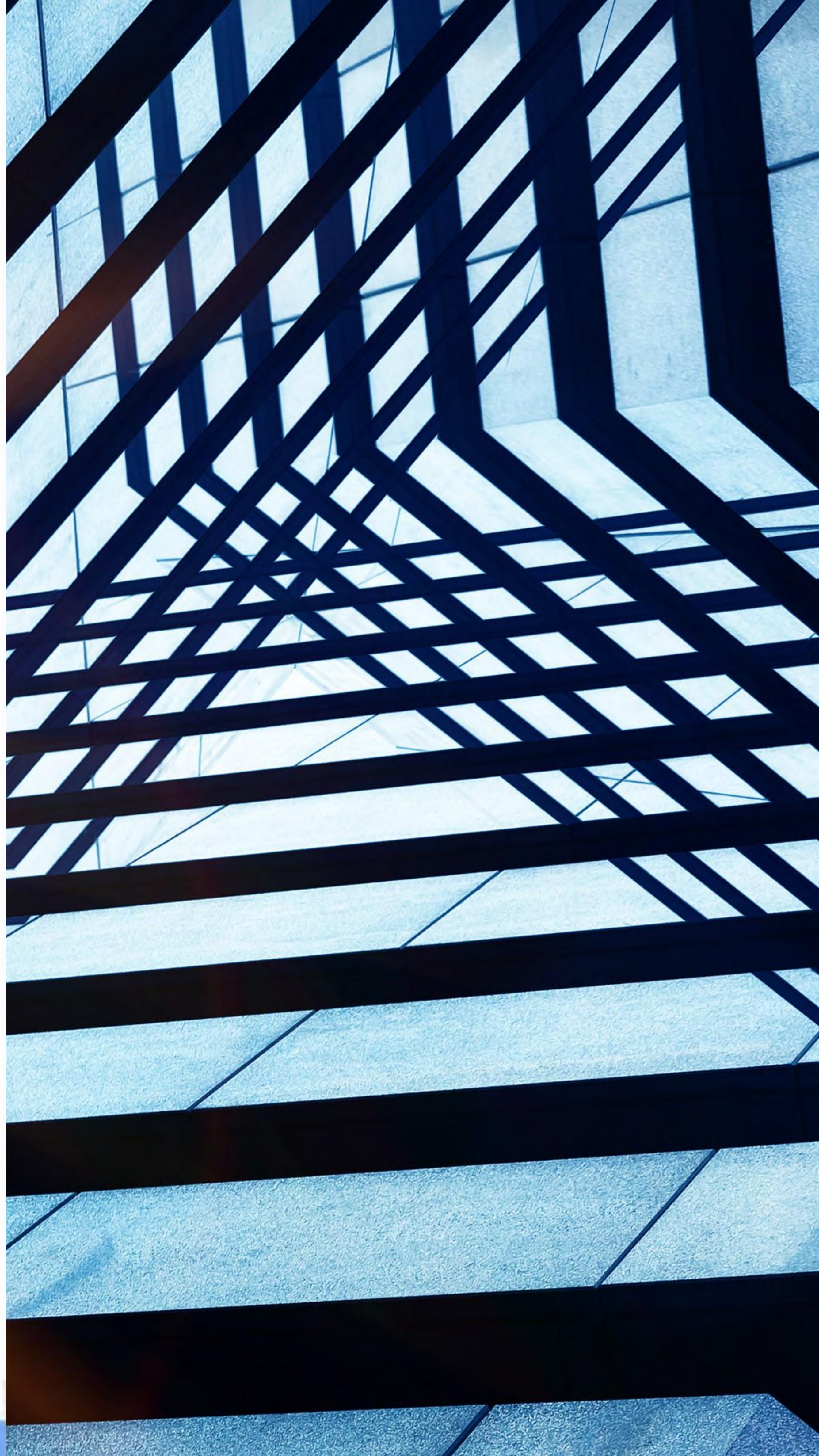
- **Legislative History.** The 1993 Conference Report (H.R. Conf. Rep. No. 103-213, at 599) explains that a short sale under (A) includes "writing a call option that the holder is more likely than not to exercise or selling the stock for future delivery."



OPTIONS, WARRANTS & CONVERTIBLE DEBT

- Stock acquired through exercise of options/warrants or conversion of convertible debt is treated as acquired at original issuance. H.R. Rep. No. 103-111, at 824 (1993) (Comm. on the Budget).

- Holding-period clock starts at **exercise / conversion** — not at grant or issuance of the debt. QSB and active-business tests measured at that date.



SAFES AND QSBS QUALIFICATION

- Simple Agreements for Future Equity (SAFEs) present an open QSBS-classification question — **stock** at issuance, or a **forward contract** that converts into stock.

  - Stock position. Y Combinator SAFE § 5(g) declares the instrument "intended to be characterized as stock … for purposes of Sections 304, 305, 306, 354, 368, 1036 and 1202."

  - Forward-contract position. A SAFE is a **variable prepaid forward contract** — Section 1259(d)(1) defines a forward contract as "a contract to deliver a substantially fixed amount of property … for a substantially fixed price"; see Rev. Rul. 2003-7, 2003-1 C.B. 363 (variable prepaid forward contract on stock).

REPORTING

Reporting Requirements

- **Taxpayer Reporting:** Sale reported on IRS Form 8949, Part II — Code "Q" on Column (f), with negative exclusion on Column (g).

- **IRS Form K-1 Reporting**

  - **Partnership Disclosures:** Gain flows through on Schedule K-1 (Form 1065), Box 11, Code O. Per the IRS Partner's Instructions, the partnership must furnish a statement giving (a) the name of the corporation that issued the QSB stock, (b) the partner's share of the partnership's adjusted basis and sales price of the QSB stock, and (c) the dates the QSB stock was acquired and sold. The partner then computes the exclusion and reports it on their own Form 8949.

  - **S Corporation Disclosures:** Gain flows through on Schedule K-1 (Form 1120-S), Box 10, Code O. Per the IRS Shareholder's Instructions, the S corporation must furnish a statement giving (a) the name of the corporation that issued the QSB stock, (b) the shareholder's share of the corporation's adjusted basis and sales price of the QSB stock, and (c) the dates the QSB stock was acquired and sold. The shareholder then computes the exclusion and reports it on their own Form 8949.

Remember

- Ju v. United States, 170 Fed. Cl. 266 (2024) — Taxpayer must have adequate records substantiating all QSBS requirements; recordkeeping failures can be fatal to the exclusion.
- Holmes v. Commissioner, T.C. Memo. 2012-251, aff'd 593 F. App'x 693 (9th Cir. 2015) — Taxpayer bears the burden of proving QSBS status.

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