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by Herman Spence III

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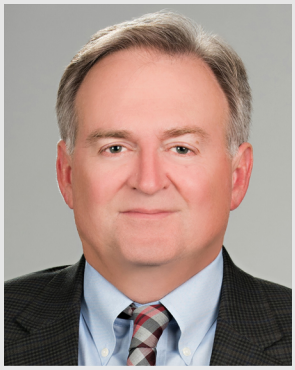

Herman Spence III

Herman Spence III is an attorney with Robinson, Bradshaw & Hinson PA in Charlotte, North Carolina.

In this article, Spence explains that because of conflicting provisions in section 1202, the availability of some qualified small business stock benefits is uncertain.

Using C corporations to operate businesses has become more common as the advantages of qualified small business stock (QSBS) have expanded. The section 1202 exclusion percentage was increased to 100 percent in 2010. The tax rate for C corporations was reduced to 21 percent in 2017. The One Big Beautiful Bill Act (P.L. 119-21) enhanced section 1202 in several respects. The base exclusion limit was increased from $10 million to $15 million for QSBS issued after July 4, 2025, adjusted for inflation. The aggregate gross asset limit was increased from $50 million to $75 million, adjusted for inflation. There is a phase-in of gain exclusion for QSBS issued after July 4, 2025: 50 percent of gain may be excluded after a holding period of three years, 75 percent after four years, and 100 percent after five years.

Business owners may incorporate their businesses to take advantage of the enhanced QSBS benefits. An incorporator will expect the following to apply: (1) 100 percent exclusion as to appreciation after the date of contribution, (2) the phase-in of the exclusion from three to five years, (3) the $15 million base exclusion limit, and (4) the $75 million gross asset limit. The availability of those benefits is uncertain, however, because of conflicting provisions in section 1202.

## Contribution of Property for QSBS

When a taxpayer contributes property (other than money or stock) to a corporation in exchange for its stock, the stock is treated as having been acquired by the taxpayer on the date of the exchange, and the basis of the stock is no less than the value of the property contributed.[1]

One consequence of those rules is that the built-in gain on the date of the contribution can never be excluded under section 1202. Although the holder's eventual gain may generally be excluded under section 1202, the built-in gain will be taxable. Another consequence is that the eligible gain that is excludable under section 1202 may be increased because of the contributed property's being treated as having a basis equal to its fair market value on the date of contribution. That will be the case if the 10 times basis component of section 1202(b)(1) is greater than $15 million adjusted for inflation (or $10 million for stock issued on or before July 4, 2025).

## Unclear Acquisition Date and Holding Period

Taxpayers will generally expect section 1202(i) to apply literally, with the date the stock is issued treated as the acquisition date for purposes of section 1202. The provisions in section 1202 regarding acquisition date and holding period, however, are unclear. Section 1202(a)(3) and (4) provides (and provided before the OBBBA) that "the acquisition date for purposes of this subsection shall be the first day on which such stock was held by the taxpayer determined after

[1] *See* section 1202(i).

the application of section 1223." After the OBBBA, new section 1202(a)(6) states, "In the case of any stock which would (but for this paragraph) be treated as having been acquired before, on, or after the applicable date, whichever is applicable, the acquisition date for purposes of this section shall be the first day on which such stock was held by the taxpayer determined after the application of Section 1223." Section 1223 provides for the tacking of holding periods in numerous situations, including property contributions for stock governed by section 351.

Section 1202(i) states that stock issued for property (other than money or stock) is treated as having been acquired by the taxpayer on the date the property is contributed for stock. It makes no mention of section 1223. It implies that the date of the contribution and stock issuance is the acquisition date for purposes of section 1202. Under that approach, the holding period for the five-year requirement (or three-to-five-year phase-in) begins on the actual date of issuance. Also under that approach, the eligibility for 100 percent exclusion is based on the actual date of the stock issuance rather than the holding periods of the contributed assets. Similarly, the eligibility for the $15 million base exclusion limit depends on the actual issuance date.

Commentators have concluded that section 1202(i) should be applied literally without tacking under section 1223.[2] Practitioners, in my experience, generally take the same position.

The relevant portion of section 1202(a)(3) was added in 2012. The legislative history indicates that the provision addresses section 1045 rollovers. The Joint Committee on Taxation stated: "The provision is not intended to change the acquisition date determined under Section 1202(i)(1)(A) for certain stock exchanged for property."[3] Section 1202(i) was not revised when the relevant provision was added to section 1202(a).

New section 1202(a)(6) repeats the language in section 1202(a)(3) and (4) about the application of section 1223. However, it states that tacking applies for purposes of the section, as contrasted with the other provisions' stating that it applies for purposes of the subsection.

Section 1223(13) provides for the tacking of holding periods for section 1045 rollover QSBS. Section 1202(a) refers to the entirety of section 1223, including tacking for section 351 contributions, rather than referencing only section 1223(13). Section 1223(13) states that tacking for QSBS does not apply for purposes of section 1202(a)(2) regarding empowerment zone businesses and section 1202(c)(2)(A) regarding the active business requirement.

### Acquisition Date for Purposes of the Holding Requirement

To qualify for gain exclusion, stock must be held for more than five years, or if acquired after July 4, 2025, at least three years with the applicable percentage being 50 percent after three years, 75 percent after four years, and 100 percent after five years. Section 1202(a)(6)(B) states that "the acquisition date for purposes of this section shall be the first day on which such stock was held by the taxpayer determined after the application of Section 1223." If a taxpayer contributes property for stock, should the three-to-five-year holding requirement be applied by considering the holding periods of the contributed assets? Although section 1202(a)(6)(B) states that for purposes of the section, the acquisition date is determined after the application of section 1223, is "held for more than five years" and "held for at least three years" based on the actual issuance date?

Assume a taxpayer contributes property she has held for five years. She receives stock that appreciates significantly. She sells the stock after one year. Can she exclude the gain attributable to appreciation after the contribution of the property because section 1202(a)(6)(B) states that for purposes of the section, the acquisition date is determined after the application of the section 1223 tacking rules? Congress almost certainly did not intend that. Nevertheless, many courts

[2] *See* Janet Andolina and Kelsey Lemaster, "Candy Land or Sorry: Thoughts on Qualified Small Business Stock," *Tax Notes*, Jan. 8, 2018, p. 205, at 222; Paul S. Lee et al., "Qualified Small Business Stock: Quest for Quantum Exclusions, Part 2," *Tax Notes Federal*, July 13, 2020, p. 217, at 233; and Anthony Polito, "Small Business Corporation Stock: Special Tax Incentives (Portfolio 760)," at Part VII(C).

[3] JCT, "General Explanation of Tax Legislation Enacted in the 112th Congress," JCS-2-13, at 185 (Feb. 25, 2013).

embrace literalism and the plain meaning of statutes. Similar to the holding in *Gitlitz*,[4] a court might be unconcerned with a result that is contrary to likely congressional intent and probably the result of poor drafting. On the other hand, a court could interpret "held" independently of the definition of the acquisition date, especially since section 1202(i) states that when property (other than money or stock) is contributed for stock, the stock is treated as having been acquired by the taxpayer on the date of the exchange.

### Acquisition Date for Purposes of the 100 Percent Exclusion

Section 1202(a)(4) states that for QSBS acquired after the enactment of the 2010 tax act, the exclusion percentage is 100 percent. Section 1202(a)(1)(B) provides that the applicable percentage (50-100 percent) applies to gain from the sale of QSBS acquired after July 4, 2025. Section 1202(a)(1)(A) provides that the exclusion percentage is 50 percent for stock acquired before the applicable date (other than certain stock acquired from 2009 to July 4, 2025). Since section 1202(a)(6)(B) states that for purposes of the section, the first day on which stock is held by the taxpayer is determined after the application of the section 1223 tacking rules, is the exclusion percentage determined by the holding period of property contributed for QSBS?

For example, assume a taxpayer operates a business through a disregarded LLC. The business was started in 2005. All of the LLC's real estate and equipment were acquired in 2005. The LLC has operated only one business, which apparently means its goodwill and similar assets have a holding period that began in 2005. Given the enhanced benefits for QSBS, the taxpayer incorporates the business in late 2025 by making a check-the-box election. The owner is treated as contributing assets to a newly formed corporation for QSBS. The owner holds the stock for more than five years. It appreciates significantly. The owner then sells the stock, expecting 100 percent of the appreciation after the date of contribution to be excluded under section 1202. Should most of the owner's gain be limited to a 50 percent exclusion because the principal assets contributed for the stock had a holding period that began in 2005?

Section 1202(i)(1)(A) and section 1202(a)(6)(B) are inconsistent. The former states that when a taxpayer transfers property (other than stock) to a corporation for its stock, the stock is treated as having been acquired on the date of such exchange. The latter states that for purposes of the section, the acquisition date is the first day on which the stock is held by the taxpayer, determined after the section 1223 tacking rules. Arguably, the actual acquisition date provided in section 1202(i)(1)(A) should control because it is more specific than section 1202(a)(6)(B). As described above, the JCT stated in 2013 that the portion of section 1202(a)(3) regarding acquisition date was not intended to change the acquisition date determined under section 1202(i)(1)(A) for stock exchanged for property. Congress probably did not intend to deny the 100 percent exclusion based on the holding period of property contributed for QSBS.

### Acquisition Date for Purposes of the Base Exclusion Limit

Section 1202(b) generally provides that gain from dispositions of stock issued by a corporation that may be taken into account under section 1202(a) may not exceed the greater of (1) the applicable dollar limit for the year or (2) 10 times the aggregate adjusted basis of QSBS issued by the corporation and disposed of by the taxpayer during the year. If the taxpayer acquired the stock on or before July 4, 2025, the applicable dollar limit is $10 million reduced by the amount of gain previously taken into account by the taxpayer in prior years and attributable to dispositions of stock issued by the corporation. If the stock is acquired by the taxpayer after July 4, 2025, the applicable dollar limit is $15 million, subject to similar rules.

In the above example, in which a business begun in 2005 is incorporated after July 4, 2025, should the $15 million limit generally not apply because the principal assets contributed for the stock had a holding period that began in 2005? As described above, the statements about acquisition dates in section 1202(a)(6)(B) and 1202(i)(1)(A)

[4] *Gitlitz v. Commissioner*, 531 U.S. 206 (2001).

conflict. Arguably, section 1202(i)(1)(A) should govern. Congress probably did not intend the availability of the $15 million limit to depend on the holding period of assets contributed for QSBS.

### Conclusion

Congress should clarify the acquisition date and holding period provisions of section 1202. It is probably consistent with congressional intent for (1) the three-to-five-year holding requirement, (2) the 50 percent, 75 percent, or 100 percent exclusion, and (3) the $15 million exclusion limit to be based on the actual acquisition date without tacking for the holding periods of contributed assets. In that case, the references in section 1202(a) to section 1223 could be changed to 1223(13), which addresses section 1045 rollovers.

Taxpayers who contribute property for QSBS should be aware of the risk of the contributed assets' holding periods jeopardizing their qualification for the 100 percent exclusion and the $15 million base exclusion limit. Given the conflicting provisions in section 1202, a taxpayer may have a reasonable position that the three-to-five-year holding requirement may be applied taking into account the holding periods of contributed assets, even though that was not Congress's intent. ■