taxnotes® federal

Volume 193, Number 6 ■ November 9, 2026

© 2026 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

QSBS Considerations for Independent Sponsors

by Felix J. Kushnir, John G. Hodnette, Joshua Geller, and Savannah Rankich

Reprinted from *Tax Notes Federal*, November 9, 2026, p. 1065

© 2026 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

QSBS Considerations for Independent Sponsors

by Felix J. Kushnir, John G. Hodnette, Joshua Geller, and Savannah Rankich


Felix J. Kushnir


John G. Hodnette


Joshua Geller


Savannah Rankich

Felix J. Kushnir is a corporate partner in the Washington office of Fox Rothschild; John G. Hodnette is a partner and tax and wealth planning attorney in the Charlotte, North Carolina, office; Joshua Geller is a corporate attorney in the West Palm Beach, Florida, office; and Savannah Rankich is a taxation and wealth planning attorney in the San Francisco office.

In this article, the authors explore the qualified small business stock qualification under section 1202 and changes introduced by the One Big Beautiful Bill Act.

This article is for informational purposes only and does not constitute legal or tax advice. Independent sponsors and their advisers should consult with qualified tax counsel to evaluate the application of section 1202 to their specific facts and circumstances.

I. Introduction

Few provisions of the IRC offer the enormous tax savings potential of section 1202, which allows taxpayers to exclude gain from the sale of qualified small business stock (QSBS). While QSBS is often associated with startup businesses, acquirers of qualified trades or businesses in the lower-middle market can take advantage of the same significant benefits. With careful planning and structuring, an independent sponsor, its investors, and even rollover equity holders can (subject to important restrictions and limitations) also enjoy the dramatic tax savings afforded by section 1202. This article examines the benefits of QSBS, its eligibility requirements, the changes introduced by the One Big Beautiful Bill Act, and considerations for independent sponsors regarding their organizational and deal structures.

II. QSBS Benefits — As Modified by the OBBBA

The ultimate (and substantial) benefit afforded by section 1202 is straightforward: A noncorporate taxpayer may exclude from federal taxable income a portion — or, in many cases, all — of the gain[1] recognized upon the sale or exchange of QSBS (that is, stock meeting the requirements detailed below).[2] For stock issued

[1] Section 1202(b)(2) defines "eligible gain" as gain from the sale or exchange of QSBS held for three or more years in the case of QSBS acquired after July 4, 2025, and QSBS held for five years or more for QSBS acquired on or before July 4, 2025.

[2] Section 1202(a)(1).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

before the enactment of the OBBBA, the minimum holding period to receive any benefit under section 1202 is five years, and the gain exclusion percentages vary from 50 percent to 100 percent based on the date of issuance. For stock issued on or after July 4, 2025, the OBBBA provides different percentages of gain eligible for exclusion depending on how long the taxpayer held the stock: 50 percent for stock held for three years, 75 percent for stock held for four years, and 100 percent for stock held for five years or more.[3]

In addition to the percentage-based exclusion, there is a cap on the total amount of gain that may be excluded. Under the OBBBA, for QSBS acquired after July 4, 2025, this cap is the greater of $15 million or 10 times the taxpayer's adjusted basis in the stock sold.[4] For QSBS acquired on or before that date, the pre-OBBBA $10 million cap applies, even if the stock is sold after the OBBBA's effective date.[5] The $15 million cap (but not the $10 million cap) is indexed for inflation beginning in 2027.[6] While a single qualifying transaction can shield a taxpayer from millions of dollars of capital gain from federal taxation, the gain exclusion mechanism operates on a per-taxpayer, per-issuer basis, creating even greater potential under section 1202 to maximize aggregate tax savings.

First, certain tax-free transfers of QSBS are permitted under section 1202 (for example, by gift).[7] Each qualifying taxpayer, therefore, can exclude from taxable income the amount of eligible gain (subject to the applicable cap). Thus, the aggregate gain that may be excluded across all qualifying taxpayers may vastly exceed the cap applicable to a single taxpayer. For example, assume an individual invested $100,000 in a corporation three years ago that is now worth $15 million. If the individual gifts 50 percent of the QSBS to each of their two children, each child now owns $7.5 million in stock with a three-year holding period and a basis of $50,000. Two years later, the corporation doubles in value, and each child's stock is worth $15 million. Each child can sell the stock and exclude the entire $14.95 million gain. Without the gifts, the individual would have been limited to a single $15 million exclusion; by transferring the QSBS, the aggregate exclusion increases to nearly $30 million.

Further, a taxpayer that has QSBS from multiple issuing corporations can exclude the gain recognized (up to the applicable cap) in each instance. In the independent sponsor context, a sponsor that consummates multiple acquisitions, each involving a separate issuing corporation, can claim a section 1202 exclusion for each qualifying issuer, creating the potential for stacked, compounding tax savings across a portfolio of investments. For example, if an independent sponsor acquires three separate businesses through three distinct C corporations, and each investment appreciates by $15 million, the sponsor may exclude up to $45 million in aggregate gain, that is, $15 million per issuer.

III. QSBS Qualification — As Modified by the OBBBA

The benefits of QSBS can hardly be overstated. There are, however, several requirements and other restrictions that both the taxpayer and the issuing corporation must meet to obtain (and maintain) QSBS eligibility.

1. *Tax Status of the Holder.* To be eligible for QSBS treatment, the taxpayer must be a noncorporate taxpayer, that is, an individual who directly holds QSBS or indirectly holds QSBS through a passthrough entity.[8]

2. *The Issuing Entity Must Be a C Corporation.* The issuing entity must be a domestic corporation classified as a C corporation for U.S. federal income tax purposes at the time of issuance and during substantially all of the taxpayer's holding period.[9]

[3] Section 1202(a)(1)(B) and (a)(5)-(6).

[4] Section 1202(b)(1) and (4)(B).

[5] Section 1202(b)(4)(A).

[6] Section 1202(b)(5).

[7] The transferee is treated as having acquired QSBS in the same manner and with the same holding period as the transferor. Section 1202(h).

[8] Section 1202(a)(1) and (g). Partnerships, S corporations, regulated investment companies, and common trust funds are considered PTEs.

[9] Section 1202(c). However, certain entities cannot issue QSBS even if they are C corporations: a current or former domestic international sales corporation, RIC, real estate investment trust, real estate mortgage investment conduit, or cooperative. Section 1202(e)(4). The corporation must also agree to submit reports to the IRS as the secretary may require, which has never been required. Section 1202(d)(1).

For more Tax Notes® Federal content, please visit www.taxnotes.com.

© 2026 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

3. *The Stock Must Be Originally Issued by the Corporation.* The taxpayer must acquire the stock at its original issuance, for example, not from another shareholder. Stock meets the original issuance requirement if it is issued after August 10, 1993, directly from the corporation or through an underwriter (and not in a secondary sale), whether in exchange for money, other property (but not other stock), or as compensation for services provided to the corporation.[10] There are, however, exceptions that permit some transfers or exchanges to preserve QSBS status, such as gifts, tax-free exchanges under section 351, or reorganizations under section 368.[11]

4. *No Substantial Redemption Transactions.* The issuing corporation cannot redeem stock from the taxpayer (or a related person[12]) within two years before or after the issuance of the stock. Further, the issuing corporation cannot repurchase more than 5 percent of the aggregate value of the corporation's stock within one year before or after issuance to the taxpayer.[13]

5. *No Offsetting Short Positions.* The taxpayer must not have taken hedging or offsetting short positions regarding the QSBS during the holding period.[14]

6. *Qualified Trade or Business.* During substantially all of the taxpayer's holding period,[15] at least 80 percent (by value) of the issuing C corporation's assets must be used in the active conduct of a qualified trade or business.[16] A qualified trade or business is any trade or business other than service businesses in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services,[17] as well as businesses in banking, insurance, financing, leasing, investing, or similar activities.[18] Businesses in manufacturing, technology, and distribution are generally eligible.

7. *Minimum Holding Period.* Before the OBBBA, the taxpayer had to hold the stock for at least five years to qualify for any gain exclusion. While the five-year holding period requirement still applies to QSBS acquired before the OBBBA (that is, before July 4, 2025), stock acquired after that date has a new tiered holding period requirement, which applies as shown in the table.[19]

Holding Period	Percentage of Eligible Gain Excluded
Less than three years	0%
Three years	50%
Four years	75%
Five years	100%

Importantly, while QSBS status carries over in tax-free exchanges under sections 351 or 368, the OBBBA introduces a critical limitation.[20] The acquisition date for determining whether pre-OBBBA or post-OBBBA rules apply is based on the general holding period tacking rules.[21] As a result, a taxpayer who exchanges pre-OBBBA QSBS for new stock in a tax-free reorganization will retain the original acquisition date for purposes of determining the applicable exclusion percentage, gain cap, and holding period requirements. Those taxpayers remain subject to

[10] Section 1202(c)(1).

[11] Section 1202(c)(1)(B), (f), and (h). However, in the case of a tax-free exchange under section 351 or a reorganization under section 368, the amount of gain that may be excluded is limited to the amount of gain that would have been recognized at the time of the transfer, had it not been for the application of section 351 or section 368, unless the QSBS was exchanged for stock in a qualified small business that meets the active business and gross assets requirements of section 1202. Section 1202(h)(4).

[12] See sections 267(b) and 707(b) for the detailed related-party rules. Generally, a related person includes family members and partnerships and corporations that the individual owns more than 50 percent of.

[13] Section 1202(c)(3).

[14] Section 1202(j).

[15] While "substantially all" is not defined in this context in the IRC or released guidance, in other sections of the code, "substantially all" has been interpreted by the IRS and courts as 80 percent to 95 percent. *See Arctic Ice Machine Co. v. Commissioner*, 23 B.T.A. 1223 (1931) (68 percent insufficient); reg. section 1.41-4(a)(6) (80 percent sufficient); *Commissioner v. First National Bank of Altoona*, 104 F.2d 865 (3d Cir. 1939) (86 percent sufficient); Rev. Proc. 77-37, 1977-2 C.B. 586 (70 percent of gross assets or 90 percent of net assets sufficient); reg. section 1.448-1T(e)(5)(i) (95 percent sufficient).

[16] Section 1202(c)(2) and (e).

[17] Or any trade or business in which the principal asset is the reputation or skill of one or more of its employees.

[18] Section 1202(e)(3). Farming, hotels, and production or extraction (for example, oil, gas, and minerals) are also excluded.

[19] Section 1202(a)(1)(B) and (a)(5).

[20] Section 1202(h)(4).

[21] Section 1202(a)(6)(B).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2026 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the pre-OBBBA rules (that is, the five-year holding period, 100 percent exclusion, and $10 million cap). They cannot access the OBBBA's tiered exclusion schedule or the increased $15 million cap.[22]

8. *Active Business Requirements and Limitation on Passive Assets.* There are various requirements that the corporation must meet to qualify as having an active business. The value of the corporation's net assets cannot consist of more than 10 percent of stock or securities in other nonsubsidiary[23] corporations.[24] No more than 10 percent of the corporation's assets can consist of real property not used in the active conduct of a qualified trade or business.[25] After the first two years of the corporation's existence, no more than 50 percent of its assets used in the active conduct of its trade or business may consist of working capital.[26]

9. *Aggregate Gross Assets Threshold.* At the time of and immediately after issuance, the corporation's aggregate gross assets must not exceed $50 million (for stock issued on or before July 4, 2025) or $75 million (for stock issued after that date).[27] Importantly, gross assets, for the purposes of this test, equal the sum of cash plus aggregate adjusted tax bases (as opposed to fair market value) of other property held by the corporation.[28] For property that was contributed to the corporation (or any other property with a carryover basis), the adjusted basis is the FMV of the property at the time of the contribution.[29]

IV. Structural Considerations for Independent Sponsors

Whether a sponsor decides to pursue QSBS treatment — necessitating a C corporation structure — or a traditional flow-through entity structure depends on several factors. Most critically, to reap the benefits of QSBS, an exit must involve a sale of C corporation stock (rather than an asset sale). Other factors include the sponsor's intent to make distributions, the projected holding period, and after-tax projections of proceeds under each structure.

An independent sponsor pursuing a QSBS strategy may form the holding company as a limited liability company taxed as a partnership, and underneath the LLC, the sponsor may form a wholly owned C corporation to acquire the target business and act as the operating company. When QSBS is held through an LLC as the holding company, the PTE itself must receive the stock at original issuance, and the individual partners claim the exclusion on the gain that is passed through to them when the partnership sells the stock.[30]

Alternatively, the sponsor may form the holding company as a C corporation with a subsidiary LLC, taxed as a disregarded entity, as the acquirer and operating company. Each structure has different implications for investor eligibility, additional capital contributions in exchange for more equity, add-on acquisitions, and the treatment of rollover equity. Because the more common approach is to have an LLC as the holding company rather than a C corporation, this article addresses the tax implications of the former structure rather than the latter.

V. LLC Holding Company Structure Considerations

A. Investor Considerations

Because section 1202's gain exclusion flows through PTEs, each investor may claim its own per-issuer exclusion (up to $15 million or 10 times the basis) when the QSBS is sold, provided certain requirements are met. This creates the potential for multiple stacked exclusions across the investor base — family offices, high-net-worth individuals, and trusts can each benefit independently, dramatically increasing the aggregate tax savings available to the group.

However, a critical timing issue applies: The individual equity holder must have held an

[22] Section 1202(a)(1) and (4)-(5).

[23] A corporation is a subsidiary if the parent owns more than 50 percent of the stock by vote or value. Section 1202(e)(5)(C).

[24] Section 1202(e)(5)(B).

[25] Section 1202(e)(7).

[26] Section 1202(e)(6).

[27] Section 1202(d)(1).

[28] Section 1202(d)(2)(A).

[29] Section 1202(d)(2)(B).

[30] Section 1202(g).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2026 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

interest in the PTE on the date the PTE acquired the QSBS and must have continued to own the interest without interruption through the sale of the QSBS.[31] Increases in an investor's ownership percentage after that date do not increase the exclusion.[32]

Add-on acquisitions, however, present an opportunity to issue additional interests eligible for gain exclusion. When additional capital contributions are made to the LLC holding company to support new acquisitions, the LLC holding company makes a contribution to its subsidiary C corporation in exchange for additional QSBS. This strategy requires meticulous tracking of each investor's ownership percentage at the time of each successive QSBS issuance. Each tranche of QSBS starts its own holding period, so new QSBS issued for add-on acquisitions must independently satisfy the applicable holding period requirement.

B. Rollover Equity for Sellers

Many independent sponsor acquisitions involve sellers of the target business receiving rollover equity in the purchasing holding company, allowing them to participate in the go-forward economics of the combined enterprise. A key question is whether the rollover seller can qualify for QSBS treatment on the equity received in connection with the rollover.

The answer depends on meeting the original issuance requirement discussed above. To qualify as an original issuance, the seller should first contribute equity interests or assets to the purchasing holding company in exchange for equity in that company. Later, the purchasing holding company should contribute the interests or assets acquired from the seller to its C corporation subsidiary in exchange for stock.

Conversely, if the seller first contributes its equity interests or assets directly to the C corporation and then transfers those shares to the purchasing holding company, the shares fail the original issuance requirement and do not qualify as QSBS. This is an important point because a fund will often require an exchange with the C corporation first, followed by an exchange with the fund, to avoid potential effectively connected income concerns when the fund has nonresident alien owners.

Two important points to note. First, as discussed above, to qualify as QSBS, the stock must be received in exchange for services, money, or other property — not including stock. Thus, if the target is a corporation (rather than an LLC), the rollover structure must be carefully analyzed to ensure the original issuance requirement can be satisfied. Second, under section 1202(i), when QSBS is received in exchange for property other than money or stock (such as the contribution of target LLC interests), the holding period for section 1202 purposes begins on the date of the exchange — not the date the taxpayer originally acquired the contributed property.[33] Moreover, the basis of the QSBS received equals the FMV of the property exchanged.[34] Therefore, only the post-rollover appreciation in the QSBS will be eligible for the section 1202 exclusion; the pre-rollover gain is still subject to tax (which can usually be allocated to the rollover sellers under section 704(c)).

C. Receiving Rollover Equity on Exit

When the holding company is eventually sold, independent sponsors and existing QSBS holders may receive rollover equity in the acquiring company as part of the exit consideration. If QSBS is exchanged for stock in an acquiring corporation in a transaction qualifying under section 351 or section 368 (a tax-free reorganization), the stock received can be treated as QSBS acquired as of the date the exchanged QSBS was originally acquired — thereby preserving the holding period and the gain exclusion potential.[35] However, the potential QSBS benefit is limited to the amount of gain that would have been recognized if the tax-free exchange provisions had not applied, unless the acquiring corporation's stock independently qualifies as QSBS.[36]

[31] Section 1202(g)(2)(B).

[32] Section 1202(g)(3).

[33] Section 1202(i)(1).

[34] Section 1202(i)(2).

[35] Section 1202(h)(4)(A).

[36] Section 1202(h)(4)(B).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2026 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The OBBBA requires that carryover holding periods be taken into account when determining the acquisition date for purposes of section 1202. This limitation applies in the rollover context as well. Pre-OBBBA QSBS exchanged for new stock after July 4, 2025, will retain its original acquisition date and remain subject to the pre-OBBBA rules (the five-year holding period, 100 percent exclusion, and $10 million cap). That stock will not be eligible for the OBBBA's tiered exclusion schedule or the increased $15 million cap.

Section 1045 provides a mechanism that permits taxpayers to defer gain on the sale of QSBS by reinvesting the proceeds into new QSBS within 60 days, provided the original QSBS was held for more than six months.[37] This rollover election can be a valuable tool for sponsors who have not yet met the applicable holding period requirements and wish to redeploy capital while preserving QSBS tax benefits.

D. Carried Interest

As a deal fee, independent sponsors often receive carried interest or a "promote" in the form of profits interests. Whether and to what extent the sponsor's promote can qualify for the section 1202 gain exclusion is one of the most significant — and ambiguous — open questions in QSBS tax planning.

Section 1202(g)(2), which provides that the gain exclusion applies to an equity holder in a PTE "by reason of the holding of an interest" in the PTE, does not distinguish between capital interests and profits interests.

Although no authority under section 1202 expressly limits the exclusion to capital interests, the section 1045 regulations, which govern tax-deferred rollover transactions involving QSBS, create uncertainty. Under these regulations, gain eligible for rollover treatment is limited to the portion attributable to a partner's capital interest, excluding gain attributable to a profits interest.[38] While the section 1045 regulations do not govern section 1202 directly, they may signal how the IRS and Treasury would interpret the language in section 1202(g)(2). If the IRS were to apply the same capital-interest-only approach to section 1202, sponsors holding only profits interests would be ineligible for the gain exclusion.

Without definitive guidance, the prevailing view among many tax professionals is that the broader reading — encompassing profits interests — is the better interpretation of the statute. However, the IRS's position under the section 1045 regulations should be treated as a meaningful risk factor. Independent sponsors should discuss this issue thoroughly with their legal and tax advisers and consider whether the promote structure can be designed to mitigate risk — for example, by ensuring that the sponsor also holds a capital interest in the holding company as of the date the QSBS is acquired.

VI. Conclusion

Section 1202 has long represented one of the most powerful tax planning tools available to founders and investors in qualifying small businesses. The OBBBA's expansion of the QSBS regime — with a higher gross asset threshold ($75 million); an increased gain exclusion cap ($15 million); and a new tiered holding period of three, four, or five years — significantly broadens the universe of transactions and investors that can benefit from the exclusion. For independent sponsors, who operate at the intersection of deal sourcing, structuring, and investor management, early and deliberate QSBS planning can create substantial after-tax value for the sponsor, its investors, and its management teams. Issues such as entity choice, capital structure, equity compensation design, rollover mechanics, and add-on transaction planning should all be evaluated through the lens of QSBS qualification — ideally at the outset of every new transaction. ■

[37] Section 1045(a).

[38] Reg. section 1.1045-1(d).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2026 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.