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GUIDE 5

How Business Owners *Accidentally* Lose QSBS

The Decisions That Can Put a Future §1202 Exclusion at Risk

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QSBS CAN BE LOST YEARS BEFORE YOU ARE READY TO SELL



A business may start with stock that appears positioned for QSBS treatment.
Then the company grows.
New investors come in.
Ownership changes.
The business model evolves.
Shares are transferred.
Stock is redeemed.
And years later, when a buyer finally arrives, the owner discovers that one of those earlier decisions created a problem.

OFFICIAL RULE

IRC §1202 does not look only at the date stock is issued. For stock to remain qualified, the issuing corporation generally must continue to be a C corporation and satisfy the statutory active-business requirements during substantially all of the taxpayer's holding period.

COMMON POINTS WHERE PROBLEMS CAN BEGIN

STOCK ISSUANCE
Was the stock issued correctly?

CAPITAL RAISE
Did the new block independently qualify?

COMPANY GROWTH
Was the applicable gross-asset test satisfied when new shares were issued?

BUSINESS PIVOT
Is the company still conducting a qualifying business?

OWNERSHIP CHANGE
Did a transfer or entity election change who is treated as the shareholder?

REDEMPTION
Did buying back stock create an anti-churning problem?

WHAT THIS MEANS FOR YOU

QSBS should not be treated as a tax question you ask only when a letter of intent arrives.

THE BEST TIME TO FIND A QSBS PROBLEM IS BEFORE THE TRANSACTION THAT CREATES IT.

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MISTAKE 1:

ASSUMING EVERY SHARE OF STOCK IN THE COMPANY HAS THE SAME QSBS HISTORY



Two people can own stock in the same company and have completely different QSBS outcomes.

Even one shareholder can own different blocks of stock with different histories.

THE ORIGINAL-ISSUANCE RULE

Federal law generally requires QSBS to be stock in a C corporation that was originally issued after August 10, 1993 and acquired by the taxpayer at original issuance, directly or through an underwriter, in exchange for money, qualifying property or services. Buying shares from another shareholder generally does not satisfy this original-issuance requirement.

Source: IRC §1202(a)(1), (d)(2)(A) (U.S. Code, current through 2026).

EXAMPLE: DIFFERENT ROUNDS, DIFFERENT RESULTS

ROUND 1

Stock issued correctly at original issuance in exchange for money, property or services.

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POTENTIALLY QUALIFYING BLOCK

ROUND 2

Stock issued through the wrong vehicle or under different facts (e.g., secondary purchase or nonqualifying consideration).

POTENTIALLY NONQUALIFYING BLOCK

ROUND 3

Requirements independently satisfied again at a later issuance.

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POTENTIALLY QUALIFYING BLOCK

ONE COMPANY CAN HAVE MULTIPLE STOCK BLOCKS WITH DIFFERENT QSBS RESULTS.

POTENTIAL BENEFIT

Reviewing every issuance separately can preserve the qualifying treatment of blocks that were properly issued.

POTENTIAL CONSEQUENCE

Treating the entire cap table as "QSBS" without tracing individual issuances can produce an unpleasant surprise at exit.

WHAT THIS MEANS FOR YOU

Do not keep only one note that says: "Company qualifies for QSBS."
Keep records showing:

WHICH SHARES WERE ISSUED, WHEN, TO WHOM, AND UNDER WHAT FACTS?

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MISTAKE 2:

ISSUING NEW STOCK AFTER THE COMPANY HAS CROSSED THE APPLICABLE ASSET LIMIT



The gross-asset test is tied to the issuance of stock. Current federal rules use different thresholds depending on when the stock was issued.

STOCK ISSUED ON OR BEFORE JULY 4, 2025

$50 MILLION

Aggregate gross assets generally must not exceed $50 million.

STOCK ISSUED AFTER JULY 4, 2025

$75 MILLION

Aggregate gross assets generally must not exceed $75 million, subject to statutory inflation adjustments for taxable years beginning after 2026.

AN IMPORTANT DETAIL THAT IS EASY TO MISS

The federal gross-asset test applies at all relevant times after August 9, 1993 and before the issuance of the stock, and immediately after the issuance, including the amount received in the issuance. It is not just a snapshot on the day before the stock is issued.

Source: IRC §1202(d)(1)(A) (U.S. Code, current through 2026).

HOW TIMING AFFECTS DIFFERENT STOCK BLOCKS

EARLIER QUALIFYING STOCK

Company satisfies the test.

Stock issued → Company later grows beyond the threshold → Earlier properly issued stock may still preserve its position if the other requirements continue to be satisfied.

LATER STOCK

Company has already crossed the applicable threshold.

New stock is issued after crossing the threshold → That later stock may fail the gross-asset requirement even if earlier stock qualified.

POTENTIAL BENEFIT

Growing past the threshold later does not automatically destroy every earlier properly issued share, as long as the other requirements continue to be satisfied.

POTENTIAL CONSEQUENCE

Waiting until after substantial growth to issue additional stock may produce a very different QSBS result for the new block.

WHAT THIS MEANS FOR YOU

Before a financing, option exercise, founder issuance or restructuring, ask:

"DOES THIS NEW STOCK STILL SATISFY THE GROSS-ASSET TEST?"

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MISTAKE 3:

ASSUMING THE BUSINESS ONLY HAS TO QUALIFY WHEN THE STOCK IS ISSUED



QSBS is not only a formation-date test. During substantially all of the relevant holding period, at least 80% of the value of the corporation's assets generally must be used in the active conduct of one or more qualified trades or businesses.

QUALIFYING BUSINESS → COMPANY CHANGES DIRECTION → BUSINESS DRIFTS INTO AN EXCLUDED ACTIVITY OR NON-BUSINESS ASSETS ACCUMULATE

QSBS STATUS MAY BE AT RISK

A company can begin in a qualifying activity and later create a problem if its business activities or asset mix no longer satisfy the requirements.

QUALIFYING BUSINESS EXAMPLES

- Manufacturing
- Software and technology
- Product distribution and retail
- Certain service businesses that are not in an excluded category
- Other active operating businesses

FEDERALLY EXCLUDED BUSINESS CATEGORIES INCLUDE:

- Health, law, engineering, architecture, accounting and actuarial services
- Performing arts, consulting and athletics
- Financial and brokerage services
- Businesses whose principal asset is the reputation or skill of employees
- Banking, insurance, financing, leasing and investing businesses
- Farming
- Certain extraction businesses
- Hotels, motels, restaurants and similar businesses

ADDITIONAL OFFICIAL GUARDRAILS

A corporation can also fail the active-business requirement during a period in which:

- More than 10% of the value of its assets, net of liabilities, consists of stock or securities in non-subsidiary corporations, subject to exceptions.
- More than 10% of total asset value consists of real property not used in the active business.

POTENTIAL BENEFIT

Monitoring the company's business-activities and asset mix can identify a problem before the company has substantially changed direction.

POTENTIAL CONSEQUENCE

A pivot or investment decision that makes perfect commercial sense may create an unintended QSBS issue.

WHAT THIS MEANS FOR YOU

Before a major pivot, acquisition or change in how corporate assets are being used, ask:

"DOES THIS CHANGE AFFECT OUR ACTIVE-BUSINESS TEST?"

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MISTAKE 4:

STRUCTURE CHANGES THAT CAN JEOPARDIZE QSBS ELIGIBILITY



Certain transactions and structural changes can cause a company to lose QSBS status, even if it originally qualified.
These changes can affect the active-business test, the original-issuance requirement or both.

TRANSACTIONS THAT CAN CREATE PROBLEMS

MERGERS AND ACQUISITIONS

Can result in a loss of QSBS status depending on how the transaction is structured.

REORGANIZATIONS

Certain reorganizations may be treated as a new issuance of stock.

CHANGES IN OWNERSHIP

Transfers to new shareholders or changes in control can jeopardize eligibility.

CONVERSIONS

Converting to an S corporation, LLC or other entity can terminate QSBS status.

REDEMPTIONS

Significant redemptions may affect the active-business test or be treated as a disqualifying event.

POTENTIAL SAFE APPROACHES

- Evaluate QSBS implications before any merger, acquisition or major restructuring.
- Consider structures that preserve the original issuance and active-business requirements.
- Model the tax and non-tax consequences with legal and tax advisors.
- Keep detailed documentation of the facts and business purpose for the transaction.

POTENTIAL CONSEQUENCES

- Loss of QSBS eligibility for some or all shares.
- Unexpected taxable gain on a future sale.
- More complex and costly transaction structures.
- Disputes with the IRS over whether the requirements continued to be satisfied.

WHAT THIS MEANS FOR YOU

Before any major transaction or change to your company's structure, ask:

"WILL THIS AFFECT OUR QSBS STATUS?"

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MISTAKE 5:

REDEEMING STOCK IN A WAY THAT CREATES A DISQUALIFYING REDEMPTION



Some redemptions can cause a loss of QSBS eligibility, even if the company otherwise qualifies and the stock was properly issued. The rules focus on whether the redemption is treated as a "disqualifying redemption" under §1202.

WHAT IS A DISQUALIFYING REDEMPTION?

A redemption can be disqualifying if it is essentially equivalent to a taxable dividend with respect to the redeeming corporation. Disqualifying redemptions can cause the redeemed shares to lose their QSBS status.

Source: IRC §1202(c) (U.S. Code, current through 2026).

COMMON REDEMPTION SITUATIONS

REDEMPTIONS PRO RATA

Redemptions that are pro rata with respect to all shareholders are more likely to be disqualifying.

PARTIAL REDEMPTIONS OF A SHAREHOLDER

Certain partial redemptions may be treated as equivalent to a dividend depending on the facts.

REDEMPTIONS FROM EARNINGS AND PROFITS

Redemptions treated as distributions of earnings and profits can trigger disqualification.

REDEMPTIONS AROUND A LIQUIDITY EVENT

Redemptions shortly before a sale or other liquidity event can create unintended tax consequences.

POTENTIAL SAFE APPROACHES

- Evaluate the tax treatment of any redemption before it is implemented.
- Consider alternative structures, such as a sale, recapitalization or internal transfer.
- Review the company's earnings and profits and overall shareholder structure.
- Work with legal and tax advisors to model the potential impact on QSBS status.

POTENTIAL CONSEQUENCES

- Loss of QSBS treatment for the redeemed shares.
- Unexpected taxable dividends.
- Higher overall tax liability on a future exit.
- Disputes with the IRS over whether the redemption was disqualifying.

WHAT THIS MEANS FOR YOU

Before redeeming any stock, ask:

"COULD THIS REDEMPTION BE TREATED AS A DISQUALIFYING REDEMPTION?"

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HOW IT ALL CONNECTS:

KEY BUSINESS DECISIONS THAT CAN AFFECT QSBS ELIGIBILITY



QSBS does not exist in isolation. Many common business decisions can impact the active-business test, the original-issuance requirement or other qualification rules. Taking a coordinated approach across key planning areas can help reduce the risk of an unintended loss of QSBS status.

ASSET PROTECTION
Entity structure, ownership and asset transfers can affect QSBS eligibility.

BUSINESS OPERATIONS
Staying within qualifying active businesses is essential to maintain QSBS status.

ESTATE PLANNING
Transfers to family members, trusts or other entities can create QSBS issues.

BUSINESS OWNER

CAPITAL RAISES
The type of investment, investor rights and terms can impact eligibility.

OWNERSHIP CHANGES
Sales, redemptions or transfers of stock can create a disqualifying event.

EXIT PLANNING
Timing, structure and transaction details can determine whether the §1202 exclusion is available.

THE BIG PICTURE

Because QSBS touches so many areas of a business, decisions that seem unrelated (such as an estate planning transfer or a new investor) can have significant tax consequences. A coordinated strategy with legal and tax advisors can help you pursue growth, protect your assets and preserve potential QSBS benefits.

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NEXT STEPS:

PUTTING A PLAN IN PLACE FOR YOUR BUSINESS AND FAMILY



QSBS can provide a powerful tax benefit for qualified business owners, but the rules are complex and the stakes are high. A proactive plan can help you pursue the §1202 exclusion while also supporting your broader business, family and wealth goals.

A COORDINATED APPROACH CAN HELP YOU:

PURSUE GROWTH

Make business decisions with tax consequences in mind.

PROTECT YOUR ASSETS

Use entity structure and legal strategies to reduce risk.

PLAN FOR OWNERSHIP CHANGES

Evaluate the tax impact of potential transfers, sales or redemptions.

INTEGRATE YOUR ESTATE PLAN

Coordinate your business, estate and tax planning goals.

PRESERVE FLEXIBILITY

Keep your options open for future growth, investment or exit opportunities.

BOOK YOUR STRATEGY SESSION

Every business and family situation is different. A personalized strategy session can help you understand how QSBS may apply to your specific circumstances and what steps may make sense for your goals.

Scan the QR code or visit:
calendly.com/dahllawgroup-tyler/strategy-session



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