

## Lower Middle Market Monthly – January 2026

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### You can sell your business tax-free, but know the rules and these important changes to the tax code.

Owners, buyers, and investors in middle-market deals now have a much more powerful—but more complex—tool in Section 1202 planning, especially after the recent changes effective for stock issued on or after July 5, 2025.

### Why QSBS Just Became a Bigger M&A Issue

Section 1202 lets sellers of qualified small business stock (QSBS) exclude a significant portion—often all—of the gain on exit, subject to strict rules around the issuer, the shareholder, and the holding period. For M&A, that can shift after-tax proceeds by eight figures in a single transaction, change buyer–seller pricing dynamics, and influence whether a deal is structured as stock vs. asset. The OBBBA changes increase potential benefits for new QSBS while tightening the need for proactive structuring throughout the company's life cycle.

### Key 1202 Changes Deal Teams Must Track

For stock issued on or after July 5, 2025, several headline changes matter directly in transactions:

- The per-taxpayer, per-issuer exclusion cap increases to 15 million for new stock (legacy stock retains the 10 million or 10× basis cap).
- The aggregate gross assets test at issuance rises to 75 million, but must still be satisfied “before and immediately after” issuance.
- A new holding-period ladder applies: a 3-year hold yields a 50 percent exclusion, 4 years 75 percent, and 5 years 100 percent, with the remaining gain taxed at the collectibles rate (28 percent) for non-excluded QSBS gain.
- The statute now explicitly halves the cap for married filing separately taxpayers.

What did not change is just as important for M&A: original-issuance is still required, service businesses in excluded fields remain ineligible, the 80 percent active-business test and redemption “taint windows” still apply, and old stock that already qualifies continues to use the 10 million / 10× basis framework with a 5-year hold for full exclusion.

### Structuring Pass-Through to C-Corp Conversions

As more sponsors and founders move LLCs and S corporations into C-corporation form to access QSBS, M&A and growth capital transactions need careful design.

- LLC/partnership to C-corp: Incorporation or a check-the-box election can create deemed original-issue stock and start the QSBS clock, but only post-conversion appreciation is eligible; pre-incorporation built-in gain will be taxed on exit. Gross assets for the 75 million test are measured at fair market value of contributed assets, not tax basis.
- S corporation to C-corp: Simply terminating S status or merging an S corporation into a C corporation does not create original-issue stock, as illustrated in Leto; only new issuances after conversion can qualify if the issuer meets all 1202 requirements.
- Partnership/S-corp ownership: If a partnership or S corporation acquires QSBS at original issuance and holds it for the requisite 3–5+ years, qualifying partners/shareholders can claim the 1202 exclusion on their share of the gain, provided they are owners from acquisition through sale. Later-granted profits interests generally do not pick up 1202 benefits on pre-existing QSBS, and carried interests are not eligible for 1045 rollover.

For buyers rolling existing businesses into C-corps, the Wayne Enterprises case study shows the stakes: in a conversion where assets with 15 million fair value and zero tax basis are incorporated and later sold

for 100 million, only the post-conversion appreciation is eligible, yet the shareholder still excluded 37.5 million under 1202 and saved approximately 5.9 million in federal tax.

## Right-Sizing to the 75 Million Cap in Buyouts

Private equity and strategic buyers frequently form new C-corps to acquire operating businesses; if gross business assets exceed 75 million, those shares will not qualify as QSBS.

M&A teams can “right-size” the target and deal structure by:

- Distributing or spinning off unwanted assets (accounts receivable, real estate, ancillary operations) to sellers before the C-corp acquisition, where feasible.
- Reassessing working capital and financing so that equity and debt proceeds do not push the business above the 75 million threshold, remembering that both equity and debt financing count toward gross assets and that 351 contributions are measured at fair market value.
- Using separate acquisition vehicles for different business lines when one combined entity would otherwise trip the cap.

These decisions often sit at the intersection of purchase price mechanics, tax modeling, and long-term exit strategy.

## Equity-Linked Instruments and Installment Sales in Deals

Common M&A tools—options, RSUs, warrants, convertibles, and earn-outs—interact in specific ways with QSBS.

- Equity-linked instruments: Options, warrants, and convertible debt do not create QSBS until they are exercised or converted into actual stock of a C-corp, and the QSBS holding period starts on that exercise or conversion date. Restricted stock generally starts the clock at vesting, unless a Section 83(b) election is made, in which case the election date starts both QSBS and capital-gain holding periods. Preferred-to-common conversions tack the holding period, and many SAFEs need careful review to confirm they are treated as equity, not debt-like instruments.
- Installment sales: When QSBS is sold for installment payments, deal teams must decide whether to apply Section 1202 to the gain reported each year under the installment method or to apply the exclusion pro-rata to total gain, a choice that can materially shift timing of tax benefits. IRS guidance leans toward a pro-rata approach, but both models should be run, and in some situations it may be better to elect out of the installment method and recognize all gain in the year of sale.

These rules influence how earn-outs, seller notes, and management incentive equity are structured in negotiated documents.

## Common QSBS Myths That Derail M&A Planning

These are several recurring misconceptions that surface in transactions.

- Converting from a pass-through to a C-corp does not shelter pre-conversion appreciation; that gain is always taxable on exit, even if the QSBS holding period is satisfied.
- Options and restricted stock do not qualify immediately; they only qualify once exercised or vested (or at 83(b) election), and pre-exercise periods do not count toward the QSBS holding period.
- 1202 exclusion does not override net operating loss usage, does not apply to asset sales, and any non-excluded QSBS gain is taxed at the 28 percent collectibles rate, not the standard 20 percent capital gains rate.
- Terminating an S election alone is not an issuance of stock, and 1045 rollovers do not benefit carried interests or amounts rolled below basis.
- The active-trade-or-business and gross-assets tests are ongoing—companies cannot “resurrect” QSBS status after falling out of compliance.

For M&A professionals, debunking these myths early avoids mispricing deals or overpromising tax outcomes to sellers.

## Documentation and Action Items for Deal Readiness

Recent litigation in *Ju v. United States* underscores that even technically qualifying QSBS can lose in court if documentation is weak.

For companies likely to transact, and for their investors and buyers, a practical checklist includes:

- Maintaining a dedicated QSBS file: stock certificates, cap tables, board minutes, formation documents, and evidence of original issuance and holding periods by block.

- Tracking gross assets and the 80 percent active-business test at and around each issuance, including redemption history and transaction costs.
- For equity compensation, considering early exercises with 83(b) elections where appropriate to start the QSBS clock sooner for key employees.
- Modeling Section 1045 rollovers and installment-sale treatments when exits occur before a full 5-year holding period or use contingent consideration.
- In partnership structures, admitting key service partners before QSBS acquisitions and monitoring ownership shifts so that partners' allocable QSBS gains do not erode unintentionally.

Incorporating these steps into M&A playbooks allows buyers, sellers, and their advisors to surface QSBS opportunities early, quantify the potential tax savings, and reflect them thoughtfully in valuation, structure, and negotiation.

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Schedule a meeting

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