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Keep the good tax planning rolling: Section 1045 rollover of QSBS

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The benefits of Section 1202 are a popular topic, but the companion tax benefit under Section 1045 is often overlooked. Read more on the requirements of Section 1045 and how the benefits be magnified in combination with Section 1202.

The ability to exclude gain on qualified small business stock (QSBS) under **Section 1202 is becoming a more popular topic**. However, the companion tax benefit under Section 1045 is much less well known. Section 1045 allows taxpayers to defer gain from QSBS held for at least six months by rolling the gain into another QSBS — essentially a like-kind exchange of QSBS. While Section 1202 is limited to $10 million or 10x basis, the Section 1045 gain deferral doesn't have a cap. When combined with Section 1202, you may be able to get gain deferral on the sale of qualified stock today and the potential for a complete exclusion of the deferred gain in the future. There is a very quick timeline required to execute on investing in replacement stock under Section 1045. To make the most of this tax-planning opportunity, it's important to begin planning for the reinvestment of proceeds as early as possible.

What are the requirements for Section 1045, and how is it different from Section 1202?

There are several requirements to take advantage of Section 1045. First, the deferral only applies to QSBS, which is generally defined similar to Section 1202. (**The specific requirements of QSBS under Section 1202** are discussed in our previous article.) The one key difference from Section 1202 is that the stock only has to be held for six months rather than five years. Once the six-month holding period on QSBS is met, then a shareholder recognizing gain on the QSBS must reinvest the proceeds from that sale in other QSBS (replacement stock) within 60 days and make a proper election on their timely filed tax return for the year of the reinvestment.

How does Section 1045 work?

Shareholders reinvesting proceeds from QSBS into qualified replacement stock can reduce or eliminate the gain on the sale of the QSBS. At its core, Section 1045 is a gain deferral provision — a shareholder is choosing to pay taxes in the future rather than in the year of the original sale. To accomplish this deferral, the basis of the replacement stock is reduced by the deferred gain, increasing the gain that will be recognized on sale of the new stock in the future. Since the replacement stock may be held for years into the future, the gain deferral may be very long term.

Magnifying the power of Section 1045 by combining it with Section 1202

While Section 1045 is primarily a gain deferral provision, careful planning into Section 1202 could allow that deferral to translate to a permanent exclusion. In a perfect world, the replacement stock would continue to meet Section 1202 requirements through the future sale of the stock. The replacement stock retains the holding period of the original stock, so it only needs to be held for the remainder of the five years required for Section 1202 in order to eventually qualify for the 100% gain exclusion.

Partnerships and Section 1045

A partnership that sells QSBS may also be able to make a Section 1045 deferral election if it reinvests in other QSBS within 60 days of its sale, but there are additional requirements in that scenario. Alternatively, a partner in that partnership could also reinvest into other QSBS directly, but they still need to do it within 60 days of the partnership's sale of its original QSBS. In addition, it's possible for a partner in a partnership that sells QSBS to make an investment in new QSBS through a separate partnership owned by that partner. Ultimately, there's a lot of flexibility under these rules with respect to partners and partnerships, but the devil is in the details. The strict 60-day deadline requires a lot of communication between the partnership and its partners, as well as coordination on the timing of cash distributions to ensure that actions are taken in a timely manner.

Planning for reinvestment

The 60-day reinvestment requirement is often the biggest impediment for taxpayers to maximize the benefit of Section 1045. Unless ripe investment opportunities already exist when the initial sale occurs, it's often difficult to identify and close a new investment in 60 days. Planning ahead can make a meaningful difference. For example, if the taxpayer is struggling to find replacement QSBS, the taxpayer can create a new corporation and invest the QSBS proceeds into that new entity. However, new stock only qualifies as replacement stock if the QSBS requirements are met for substantially all of the first six months following investment. Taxpayers that are considering forming a corporation should be prepared to begin active business operations quickly and deploy the invested capital or risk losing qualified small business status. Simply forming a corporation with a cash investment and holding onto that cash isn't a good strategy. The key is that any actions taken regarding Section 1045 typically need to be arranged long before the 60-day reinvestment window even begins.

What to do now

Despite some of the limitations, Section 1045 can benefit taxpayers who initially planned to qualify for **Section 1202** but end up not meeting the five-year holding period. Taxpayers may also be able to utilize Section 1045 in combination with Section 1202 to achieve robust tax-planning solutions when there are multiple investment tranches or where the total gain exceeds Section 1202 limitations. If you're interested in the nuanced calculations of Section 1045, continue reading on.

We can help you navigate the different provisions

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Getting into details: Gain deferral amount

If a shareholder reinvests all of its proceeds on the sale of QSBS, the determination of deferred gain under Section 1045 is intuitive — the entire amount is deferred. The shareholder will also take a modified basis in the replacement stock by reducing basis in the replacement stock dollar-for-dollar for the deferred gain.

- **Example 1 (no stock basis)**: Sarah sells QSBS that she's held for two years in 2025, with no basis for $500,000. Without Section 1045, Sarah would recognize $500,000 of gain in 2025. However, Sarah's team at Plante Moran advises her that she may be able to defer a portion of her gain under Section 1045 if she reinvests in new QSBS within 60 days after the sale. So, 45 days after the sale of the original QSBS, Sarah buys replacement QSBS for $500,000. Sarah will defer the entire $500,000 of gain if she makes a Section 1045 election on her 2025 tax return. Her basis in the replacement stock will be $0 ($500,000 reinvestment less $500,000 of deferred gain).

However, if the shareholder doesn't reinvest all of the proceeds from the sale, then they will still have to recognize gain in the year of the sale up to the amount of proceeds not reinvested.

- **Example 2 (no stock basis)**: Same facts as Example 1 except that Sarah only reinvests $400,000 in new QSBS, retaining $100,000 of the proceeds. Sarah will defer $400,000 in gain if she makes a Section 1045 election on her 2025 tax return. Her basis in the replacement stock will be $0 ($400,000 reinvestment less $400,000 of deferred gain). Since her stock doesn't qualify for the Section 1202 exclusion, she must recognize the remaining $100,000 of gain that wasn't rolled into the replacement stock on her 2025 tax return regardless of whether she makes a Section 1045 election.
- **Example 3 (some stock basis)**: Same facts as Example 2 except that Sarah has $200,000 of basis in her stock. Without Section 1045, Sarah would recognize $300,000 of gain in 2025 ($500,000 of proceeds less $200,000 of basis). Since Sarah didn't reinvest $100,000 of the proceeds, she will still be required to recognize that amount of gain. Therefore, Sarah will recognize $100,000 of gain and defer the remaining $200,000 of gain if she makes a Section 1045 election on her 2025 tax return. Her basis in the replacement stock will be $200,000 ($400,000 reinvestment less $200,000 of deferred gain).

As illustrated in the examples, it's not enough for a shareholder to make a reinvestment of just their gain on QSBS because Section 1045 only begins to kick in after a shareholder reinvests an amount in excess of their original investment. This requirement isn't a substantial burden for taxpayers that have little to no basis in the original stock. However, if a shareholder has significant basis in the existing QSBS, this may force them to make a much larger reinvestment than desired and may not give them enough cash from the sale to meet their other cashflow needs. In situations where tax basis and Section 1202 basis differ due to property contributions, taxpayers should be even more attentive to the mechanics of gain recognition.

Impact of gain deferral

The fact that gain deferral is accomplished through a reduction in the basis of the replacement QSBS means that the shareholder will essentially recognize the deferred gain as well as any future appreciation on the replacement stock in the year of a future sale. The table below illustrates Sarah's tax result if she sells her replacement stock in 2026.

	New stock purchased without Section 1045	EXAMPLE 1: No basis, $500,000 rolled into replacement stock	EXAMPLE 2: No basis, $400,000 rolled into replacement stock	EXAMPLE 3: $200,000 basis, $400,000 rolled into replacement stock
Proceeds on Sale 1	$500,000	$500,000	$500,000	$500,000
Less: Basis	($0)	($0)	($0)	($200,000)
Less: Section 1045 deferral	($0)	($500,000)	($400,000)	($200,000)
Gain recognized in 2025	$500,000	$0	$100,000	$100,000
Proceeds on Sale 2	$800,000	$800,000	$700,000	$700,000
Less: Basis in replacement stock	($500,000)	($0)	($0)	($200,000)
Gain recognized in 2026	$300,000	$800,000	$700,000	$500,000
Cash retained in Sale 1	$0	$0	$100,000	$100,000
Cash from Sale 2	$800,000	$800,000	$700,000	$700,000
Less: Basis in original investment	($0)	($0)	($0)	($200,000)
Total gain recognized	$800,000	$800,000	$800,000	$600,000

Pairing Section 1045 with Section 1202

We've talked about the tax deferral Section 1045 can offer; however, the example below highlights the true value of Section 1045 — using it as a bridge so a taxpayer can eventually meet the full requirements of Section 1202. While a tax deferral is great, tax exclusions are even better!

- **Example 4 (combination with Section 1202)**: The facts are the same as Example 1. When Sarah rolls her $500,000 basis into the replacement stock, her replacement stock is treated as though Sarah purchased it in 2023 (when she purchased the original stock), and it has $0 basis. As noted in the table above, if Sarah sells the replacement stock in 2026, she will have to recognize the full $800,000 of gain. However, if Sarah waits to sell her stock until 2029 (after the five-year holding period is met), she may qualify for gain exclusion under Section 1202 if the stock has maintained QSBS status through the date of the sale. If so, Sarah can exclude the entire $800,000 from income.

How we can help

Taking advantage of a tax-deferred rollover under Section 1045 can provide significant tax savings, particularly if your qualified stock hasn't reached the five-year mark or the gain surpasses your Section 1202 exclusion. If you believe you have an upcoming exit of QSBS, please let us know so we can help you determine potential planning opportunities under Section 1045.

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