

34th Annual Tax Symposium

QUALIFIED SMALL BUSINESS STOCK

By: David B. Deutsch, Esq. and David H. Freedman, Esq.

I. BACKGROUND

A. Introduction

1. Qualified Small Business Stock (“QSBS”) is a tax incentive to drive the investment and establishment of small businesses in the United States.
2. The QSBS rules are governed under §1202 of the Internal Revenue Code of 1986, as amended (“Code”).
3. Per the legislative history, QSBS was intended to encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing.
4. Under §1202 of the Code, non-corporate shareholders who sell eligible stock may be able to exclude a significant portion of their capital gains from federal income taxes, provided specific criteria are met by both the shareholder and the issuing company. Such criteria include the acquisition date of the QSBS and length of holding period.

B. History

1. §1202 of the Code was initially enacted as part of the Omnibus Revenue Reconciliation Act of 1993 to bolster investment in qualifying small businesses, specifically those in leading, albeit risky, industries, such as technology, microelectronics, biotechnology, advanced materials, or environmental engineering.
2. As originally enacted, §1202 provided for a 50% exclusion of gain recognized on the sale or disposition of QSBS. In response to the 2008

34th Annual Tax Symposium

recession, Congress expanded the gain exclusion to 75%. Less than two years later, in the Small Business Jobs Act of 2010, Congress temporarily provided for a 100% gain exclusion. In a series of statutes enacted between 2010 and 2014, Congress extended the temporary 100 percent gain exclusion to subsequent tax years. It was not until the Protecting Americans From Tax Hikes Act of 2015 that Congress made permanent the 100% gain exclusion.

3. The 100% gain exclusion has continued since 2015; however, the condition for obtaining the gain exclusion was that investors had to tie up their capital for at least 5 years. For many investors, the 5-year investment period was not acceptable.
4. The One Big Beautiful Bill Act alleviates some of this pressure by introducing a tiered gain exclusion that kicks in from year 3, assuming all other requirements under the statute are satisfied. For QSBS acquired after July 4, 2025, up to 50% of the gain may be excluded where the QSBS has been held for 3 years, 75% of the gain may be excluded after 4 years, and 100% of the gain may be excluded after 5 years.

II. REQUIREMENTS FOR QSBS QUALIFICATION

A. Qualified Small Business Stock - §1202(c) of the Code

1. The term “qualified small business stock” means any stock in a C corporation which is originally issued after the date of the enactment of the Revenue Reconciliation Act of 1993 (August 10, 1993), if: (a) as of the date of issuance, such corporation is a “qualified small business”, and (b) such stock is acquired by the taxpayer at its “original issue”.
2. The original issue can be acquired directly or through an underwriter in exchange for money or other property (not including stock), or as compensation for services provided to such corporation (other than

34th Annual Tax Symposium

services performed as an underwriter of such stock).

B. Qualified Small Business - §1202(d) of the Code

1. The term “qualified small business” means any domestic corporation which is a C corporation whose aggregate gross assets (treating all members of the same parent-subsidary controlled group as one corporation): (a) at all times before and immediately after the stock is issued (i) do not exceed \$50,000,000 (for stock issued after August 10, 1993), and (ii) do not exceed \$75,000,000 (for stock issued after July 4, 2025 as indexed for inflation after 2026); and (b) such corporation agrees to submit such reports to the Secretary of the Treasury and to shareholders as the Secretary of the Treasury may require to carry out the purposes.
2. The term “aggregate gross assets” means the amount of cash and the aggregate adjusted bases of other property held by the corporation.
3. In regards to contributed property, the adjusted basis of any property contributed to the corporation shall be determined as if the basis of the property contributed to the corporation was equal to its fair market value as of the time of such contribution.
4. The IRS has yet to issue either any reporting requirements described in §1202(d) of the Code or any guidance as to the manner in which a corporation is to agree to meet these requirements. Until the IRS provides guidance as to the manner in which a corporation is to agree, a corporation can issue QSBS without the necessity for the corporation to file any sort of agreement that it will comply with any reporting requirements, if and when issued. Presumably, if the IRS ever does require reporting, it will prescribe procedures at that time for making the agreement called for in the Code.

34th Annual Tax Symposium

C. Active Business and Qualified Trade or Business - §1202(e) of the Code

1. The company must be an “active business” that is incorporated as a U.S. C corporation.
2. To qualify as an “active business,” at least 80% (by value) of the assets of the corporation are used by such corporation in the active conduct of 1 or more “qualified trades or businesses” and such corporation is an eligible corporation (any eligible corporation with certain exceptions).
3. A “qualified trade or business” means any trade or business other than: (a) a trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees, (b) banking, insurance, financing, leasing, investing, or similar business, (c) farming business (including the business of raising or harvesting trees), (d) produce products, such as fossil fuels, for which percentage depletion (a type of tax deduction) can be claimed, or (e) a business of operating a hotel, motel, restaurant, or similar business.

D. Qualified Holders of Stock - §1202(g) of the Code

1. The shareholder must be an individual, trust, estate, or pass-through entity.
2. A partnership, limited liability company (taxed as a partnership), or S corporation can pass through benefit to partners, members or shareholders, respectively.
3. Such amount is attributable to gain on the sale or exchange by the pass-thru entity of stock which is qualified small business stock in the hands of

34th Annual Tax Symposium

such entity (determined by treating such entity as an individual) and which was held by such entity for at least 3 years (more than 5 years in the case of stock acquired on or before the applicable date), and such amount is includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-thru entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-thru entity.

E. Holding Period and Exclusion Amount- §1202(a) of the Code

Summary of changes	Prior law (stock acquired on or before July 4, 2025 but after August 10, 1993)	Modernized under OBBBA (stock acquired after July 4, 2025) by raising outdated thresholds and allowing investors to tap into §1202(A) in as little as 3 years
Holding Period	More than 5 Years	At least 3 Years
Tiered Gain Exclusion Percentages	• 100% for stock acquired after September 27, 2010 • 75% for stock acquired after February 17, 2009, and before September 28, 2010 • 50% for stock acquired before February 18, 2009 but after August 10, 1993	• 50% for stock held for 3 years • 75% for stock held for 4 years • 100% for stock held for 5 years or more
Cap on Gain Exclusion	Greater of: (i) \$10 million; or (ii) 10 times the taxpayer's tax basis in the QSBS	Higher Asset Threshold and Bigger Exclusion Cap. Now it is the greater of: (i) \$15 million (adjusted annually for inflation beginning after 2026); or (ii) 10 times the taxpayer's tax basis in the QSBS

Note: The portion of gain that remains taxable under the QSBS rules is subject to a 28% tax rate, rather than the standard 20% long-term capital gains rate. As a result, the effective tax rate is 14% for a 50% gain exclusion and 7% for a 75% gain exclusion, respectively (without considering the 3.8% net investment income tax).

34th Annual Tax Symposium

III. ROLLOVER ELECTION FOR GAIN FROM SALE OF QSBS

A. Rollover Election - §1045 of the Code

1. Under §1045, shareholders (other than corporations) can elect to roll over (defer) capital gain from the sale of QSBS held for more than 6 months.
2. This rollover election is most valuable for taxpayers who want to delay capital gains tax but have not yet met the relevant holding period for the full gain exclusion.
3. The gain is recognized only to the extent that the amount realized exceeds the cost of QSBS bought during the 60-day period beginning on the sale date, reduced by any part of the cost previously considered.
4. The amount of the deferred gain reduces the basis in the new stock. Thus, the potential gain will be recognized when the replacement QSBS is eventually sold.
5. Rules similar to those under §1202(g) (for determining which holders of interests in pass-through entities are eligible for the 50% exclusion of gain from the sale of QSBS) apply to the rollover of gain from the sale of QSBS by a pass-through entity.
6. The holding period of the original QSBS is “tacked” onto the holding period of the replacement stock. This allows the taxpayer to more quickly satisfy the five-year requirement for the potential tax-free gain exclusion under §1202.
7. Original QSBS: (a) the stock sold must qualify as QSBS under §1202 at the time of sale; and (b) the stock must have been held for more than 6 months.

34th Annual Tax Symposium

8. Replacement QSBS: (a) the replacement stock must be newly issued stock from a qualifying domestic C corporation, not stock purchased on a secondary market; (b) the purchase of the new QSBS must occur within a 60-day window following the sale of the original stock; and (c) the issuer of the new stock must meet the §1202 active business requirement for at least 6 months following the replacement stock's issuance.

IV. PRACTICAL CONSIDERATIONS

A. Criteria

Issue	Practical Considerations
C-Corporation Status	Only C corporations qualify. LLCs, S corporations, and partnerships do not. Conversion to C status starts a new QSBS holding period. Later conversion from C to S disqualifies the stock.
\$75M/\$50M Gross Assets Test	Must not exceed \$75M/\$50M in aggregate gross assets before and immediately after issuance. Ensure contemporaneous balance sheets are preserved. Valuing contributed IP or appreciated property can inadvertently breach the limit.
Active Business Requirement	80% (by value) of assets must be used in the active conduct of a qualified trade or business. Disqualified fields include services (law, health, accounting, etc.), finance, real estate, and hospitality. Business pivots can cause loss of qualification.

34th Annual Tax Symposium

B. Stock Issuance and Documentation

Issue	Practical Considerations
Original Issuance	Stock must be acquired directly from the corporation for money, property, or services. Secondary purchases or redemptions do not qualify. SAFE and note conversions start the holding period at conversion.
Redemptions	Redemptions by the company (or related parties) within two years before or after issuance can taint all stock issued in that window. Avoid buybacks near issuance events.
Stock Records	Maintain stock ledgers, purchase agreements, and board resolutions evidencing issuance and consideration paid.

C. Holding Period and Gain Exclusion

Issue	Practical Considerations
Relevant Holding Period (Pre and Post OBBBA)	The shareholder must hold the stock for more than five years for the full 100% exclusion. Convertible instruments start the period only upon conversion.
Differing Exclusion Amounts (Pre and Post OBBBA)	Basis documentation is often weak—keep clear records.
Multiple Shareholders / Trusts	Proper structuring can multiply exclusions, but must be planned early to avoid assignment-of-income concerns.

34th Annual Tax Symposium

D. Exit and Transaction Planning

Issue	Practical Considerations
Stock v. Asset Sale	QSBS benefits apply only to stock sales. Buyers often prefer asset deals; negotiation required to preserve QSBS benefits.
Reorganizations	§368 tax-free reorganizations can preserve QSBS if the new stock also qualifies and tacking rules are satisfied. Careful drafting required.
Partial Cash Consideration	Mixed consideration in a sale (cash plus stock) may partially qualify for QSBS exclusion if structured properly.

E. Recordkeeping and Audit Readiness

Issue	Practical Considerations
Entity Qualification	Articles of Incorporation showing C-Corp status (no S election); initial capitalization records
\$75M/\$50M Test	Balance sheet and valuation records at the time of issuance.
Active Business	Description of business activities; financial statements supporting 80% test.
Stock Issuance	Subscription agreements, board approvals, and proof of consideration.
Redemption History	Maintain records of all stock repurchases or redemptions within relevant timeframes.

34th Annual Tax Symposium

F. State and Federal Coordination

Issue	Practical Considerations
Non-Conforming States	Some states (e.g., California, Pennsylvania, Mississippi and Alabama) do not recognize the QSBS exclusion. New Jersey will recognize the DSBS exclusion starting in 2026. Consider state-level impact in modeling after-tax proceeds.
Rollover Planning (§1045)	If QSBS is sold before the relevant holding period, gains can be rolled over into new QSBS within 60 days. Strict timing and procedural rules apply.

V. COMMON PRACTICAL PITFALLS

- A. Founders receive stock for services but fail to document value or issuance properly.
- B. LLCs convert to C corporations too late, forfeiting earlier appreciation.
- C. Investors purchase stock from other shareholders, not directly from the corporation.
- D. Redemptions or reorganizations occur within the two-year “taint” window.
- E. Inadequate documentation of the \$75M/\$50M test or active business use.
- F. State tax conformity overlooked in transaction modeling.

VI. RECOMMENDED ACTIONS FOR COMPANIES AND ADVISORS

- A. Plan early: Establish QSBS compliance at incorporation or initial funding.
- B. Maintain contemporaneous records: Keep detailed documentation supporting every QSBS requirement.
- C. Monitor business activities: Ensure 80% of assets remain in qualified operations.

34th Annual Tax Symposium

- D. Review redemptions: Avoid repurchases that may disqualify outstanding stock.
- E. Coordinate with advisors: Engage tax counsel during any reorganization or M&A transaction.

VII. CONCLUSION

- A. The QSBS exclusion is one of the most powerful incentives available to founders and investors in growth companies, but it is *not self-executing*. Proper structuring, documentation, and ongoing compliance are essential to preserving the benefit and avoiding later disqualification.

VIII. CORPORATE TRANSPARENCY ACT UPDATE