ARTICLES

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Qualified Small Business Stock after the OBBBA

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Founders, early-stage investors, and other shareholders of certain small businesses and growth companies must consider the powerful tax benefit—**potentially up to a 100% exclusion from tax upon the disposition of stock**—available under the "qualified small business stock" (QSBS) rules.[1] It is critical that QSBS tax considerations are an integral component of investors' and shareholders' long-term growth and expansion planning.

Section[2] 1202 exempts from taxation all or a portion of a noncorporate shareholder's gain realized upon the sale or disposition of stock in certain small business corporations. As discussed in more detail below, some of the general requirements to qualify for QSBS tax benefits include:

An entity taxed as a corporation (C-corporation) must issue stock to a noncorporate shareholder for cash, property or services;[3]

The C-corporation's gross asset value cannot exceed a certain threshold at the time of issuance;

The C-corporation must be engaged in a qualifying active trade or business during the shareholder's holding period; and

The shareholder must satisfy the requisite holding period prior to disposition of such stock.

The recently enacted One Big Beautiful Bill Act (OBBBA) includes taxpayer-favorable changes that magnify the QSBS tax benefits for stock issued *after* the OBBBA enactment date (*i.e.*, increasing the gross asset value threshold, increasing the eligible gain exclusion amount, and providing a new partial gain exclusion in the case of a holding period of at least three years and less than five years).

This article will discuss and analyze the application of the revised QSBS rules under the OBBBA, important traps for founders, investors and other shareholders to navigate, and various tax planning techniques that can be utilized to maximize the tax savings upon the disposition of QSBS. The intended audience of this series includes:

Founders and investors that hold (or are unsure if they hold) QSBS issued before or after the enactment of the OBBBA;

Investors that are contemplating forming or investing in a corporation and desire to qualify for QSBS benefits; and

Investors considering converting entities not taxed as corporations (i.e., partnerships, LLCs, and S-corporations) to meet the QSBS requirements.

For purposes of this article, QSBS issued on or prior to July 4, 2025, will be referred to as "Pre-OBBBA QSBS" and QSBS issued on or after July 5, 2025, will be referred to as "Post-OBBBA QSBS."

Gain Exclusion

For Pre-OBBBA QSBS, a noncorporate shareholder is generally entitled to exclude from income 100% of the gain realized on the sale of QSBS held for more than five years (50% in the case of stock issued on or before 2/17/2009 and 75% in the case of stock issued between 2/18/2009 and 9/27/2010). This exclusion is subject to a cap that equals the greater of:

$10 million[4] (less any gain previously excluded from income with respect to QSBS in the same corporation); and

10 times the "aggregate adjusted bases" of the QSBS disposed of during the tax year.

For Post-OBBBA Stock, a noncorporate shareholder is generally entitled to exclude from income 100% of the gain realized on the sale of QSBS held for at least five years (75% if such QSBS is held for at least four years, and 50% if such QSBS is held for at least three years), subject to a cap that equals the greater of:

$15 million, adjusted annually for inflation[5] (less any gain previously excluded from income with respect to QSBS in the same corporation); and

10 times the "aggregate adjusted bases" of the QSBS disposed of during the tax year.

Adjusted Basis of Stock

For purposes of determining the amount of gain that is eligible for exclusion from income under the Section 1202, the adjusted basis of QSBS equals the amount of money paid to acquire such stock. However, if a shareholder receives QSBS in exchange for built-in-gain property, the adjusted basis of such stock equals the fair market value of the contributed property. In other words, only future appreciation in the stock issued in exchange for property would be eligible for exclusion from income under Section 1202. Example 2 (below) illustrates the application of the QSBS rules when appreciated property is contributed to a corporation in exchange for QSBS.

Holding Period Exception—Rollover Election

One exception to the holding period rules described above allows a taxpayer to defer taxable gain from the sale of QSBS held for at least six months if the taxpayer reinvests the proceeds from such sale into replacement QSBS within 60 days.[6] This rollover election is beyond the scope of this article and will be discussed in a future article.

Examples

Example 1: S, an individual, contributed $1.5 million to a corporation for 100 shares of stock on January 1, 2021. The stock qualifies as QSBS. On January 2, 2026, S sold 50 shares (aggregate adjusted basis of $750,000) for $5 million and realizes taxable gain of $4.25 million. The maximum amount of gain that can be excluded from taxable income under Section 1202 is the greater of (i) $10 million (the lifetime exclusion per issuer) and (ii) $7.5 million (10 times the $750,000 adjusted basis). Therefore, all $4.25 million of realized gain would be exempt from federal income tax. On January 1, 2027, S sells the remaining 50 shares for $8 million and realizes taxable gain of $7.25 million. The maximum amount of gain realized in the second sale that can be excluded from taxable income is the greater of (i) $5.75 million ($10 million per issuer lifetime exclusion, less $4.25 million previously excluded), and (ii) $7.5 million (10 times $750,000). Accordingly, all $7.25 million of gain realized on the second sale would also be exempt from federal income tax. In total, $11.5 million of total gain was realized on the two sales, and all $11.5 million was exempt from federal income tax.

Example 2: Same as example 1, except S contributed property with a basis of $0 and a fair market value of $1.5 million to the corporation. The first sale would result in $5 million of total taxable gain realized ($5 million less $0 basis in the disposed shares). The first $750,000 of gain would not be within the scope of the QSBS rules and would be subject to federal income tax. However, the remaining $4.25 million of gain would be exempt from federal income tax (see example 1, above). The second sale would result in $8 million of gain realized ($8 million less $0 basis). Similar to the first sale, $750,000 of gain realized on the second sale would not be within the scope of the QSBS rules and would be subject to federal income tax. The remaining $7.25 million of gain would be exempt from federal income tax (see example 1, above). In total, $13 million of total gain was realized on the two sales, and $11.5 million was exempt from tax under the QSBS rules.

The table below summarizes the tax considerations[7] for the different types of QSBS.

	Pre-OBBBA QSBS			Post-OBBBA QSBS		
Issue Date	8/11/1993 through 2/17/2009	2/18/2009 through 9/27/2010	9/28/2010 through 7/4/2025	After 7/4/2025		
Holding Period	More than 5 years			At least 5 years	At least 4 years	At least 3 years
Percentage of Gain that is Eligible for Exclusion from Taxable Income ("Eligible Gain Exclusion")	50%	75%	100%	100%	75%	50%
Limitation on Eligible Gain Exclusion	Greater of (a) $10 million lifetime exclusion or (b) 10x adjusted bases of disposed shares			Greater of (a) $15 million (adjusted for inflation) or (b) 10x adjusted bases of disposed shares		
Taxation of Gain Not Eligible for Exclusion	28% Capital Gain		n/a	n/a	28% Capital Gain	

QSBS Requirements

The gain exclusion rules described above only apply to stock that qualifies as QSBS. To qualify as QSBS, the following requirements must be met:

The shareholder must be a noncorporate taxpayer;

The stock must have been originally issued on or after August 11, 1993, by a C-corporation;

The issuing corporation must be a C-corporation during substantially all of the shareholder's holding period;

The corporation must satisfy the "qualified small business" requirement at the time of the stock issuance;

The taxpayer-shareholder must acquire the stock at original issuance (subject to certain exceptions) in exchange for cash, certain property, or as compensation for services;

During substantially all of the taxpayer-shareholder's holding period, the corporation must be engaged in a trade or business, which does not include certain specified service businesses (the "active business requirement"); and

The corporation must not have redeemed its stock from certain shareholders within specified time periods straddling the issuance date (except for certain de minimis redemptions).

Each of these requirements are described in more detail below.

Noncorporate Taxpayer

Only a noncorporate taxpayer (e.g., individuals) can qualify for the taxable gain exemption under Section 1202. A noncorporate taxpayer can hold QSBS through an entity treated as a partnership (including an LLC that has not elected to be treated as a corporation) or S-corporation for federal income tax purposes.

Issuer—Domestic Corporation / Eligible Corporation

Only a C-corporation can issue QSBS and such QSBS must have been issued on or after August 11, 1993. A C-corporation includes an LLC that has an election in effect at the time of stock issuance to be treated as a corporation for income tax purposes but does not include a regulated investment company, S-corporation,[8] real estate investment trust, REMIC, cooperative, or DISC. Moreover, the corporation issuing the QSBS must be a C-corporation during substantially all of the shareholder's holding period.

Qualified Small Business Requirement

At all times between August 10, 1993, and the stock issuance date, the corporation's "aggregate gross assets" must not exceed a certain threshold value. The threshold for Post-OBBBA QSBS is $75 million (adjusted annually for inflation) and for Pre-OBBBA QSBS is $50 million. A corporation's aggregate gross assets consist of cash and the adjusted tax bases of all other property held by the corporation.

However, the adjusted basis of property contributed to the corporation (and property with a basis determined in whole or party by reference to the basis of contributed property) is deemed to be its fair market value at the time of the contribution.

Stock Issuance for Money, Property, or as Compensation

The corporation must originally issue the stock to the taxpayer in exchange for money, other property, or as compensation for services provided to the corporation.

Property does not include other stock. Accordingly, a taxpayer cannot contribute stock of a C-corporation (that does not qualify as QSBS) to a corporation in exchange for stock of the issuing corporation and treat such stock received in the exchange as QSBS.

Compensation for services excludes services performed as an underwriter of stock.

Active Business Requirement

At least 80% (by value) of the assets of the corporation must be used by such corporation in the active conduct of one or more "qualified trade or businesses" during substantially all of the taxpayer-shareholder's holding period.

For purposes of this determination, a corporation is deemed to own its ratable share of the assets of each "subsidiary"[9] and the debt and equity of such subsidiary is disregarded. Section 1202 contains special rules for assets used in certain startup and research activities, for assets held for working capital needs or for investment, and rights to computer software royalties.

A qualified trade or business means any trade or business, *except* for:

any 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;

any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;

any banking, insurance, financing, leasing, investing, or similar business;

any farming business;

certain businesses involved in the production or extraction of natural resources; and

any business of operating a hotel, motel, restaurant, or similar business.

Excessive holdings of portfolio stock or securities, or real estate, can result in a corporation failing to satisfy the active business requirement.

Disqualifying Redemptions

Two types of redemptions can disqualify stock held by a shareholder from QSBS status. The first type of prohibited redemption occurs where the issuing corporation purchases any of its stock from the taxpayer-shareholder or a related party within a four-year period, which commences two years prior to the original stock issuance date. The second type of prohibited redemption occurs when the issuing corporation engages in one or more purchases of its stock from any shareholder during the two-year period commencing one year prior to the original stock issuance date, provided such purchase or purchases in the aggregate exceed five percent of the aggregate value of all of the issuing corporations stock (as of the beginning of the two-year period). Finally, certain purchases by corporations related to the issuer corporation may be treated as a type of redemption described above that would disqualify QSBS treatment.

Conclusion

Section 1202 is a powerful tax provision for noncorporate shareholders that hold stock of small businesses. Furthermore, there are various planning techniques, including rollovers and gifting, that can protect and enhance the tax benefits arising under Section 1202. These planning techniques will be discussed in future articles.

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[1] The QSBS provision was introduced as part of the Revenue Reconciliation Act of 1993.

[2] All Section references provided herein are to the Internal Revenue Code of 1986, as amended.

[3] Subject to certain exceptions discussed later in this article.

[4] $5 million in the case of a married individual who files a separate return. Section 1202(b)(3).

[5] $7.5 million (adjusted annually for inflation) in the case of a married individual who files a separate return. Section 1202(b)(3).

[6] See Section 1045.

[7] The table excludes the impact of the NIIT and AMT.

[8] However, as discussed above, an S-corporation can hold stock in a C-corporation that qualifies as QSBS.

[9] To be considered a subsidiary, the parent corporation must own at least 50% of the combined voting power of stock entitled to vote or 50% of the value of all outstanding stock

