QUALIFIED SMALL BUSINESS STOCK:

A Tax Home Run (and Possibly a Grand Slam) for Qualifying Taxpayers That Gets Even Better Under the New Tax Bill

by STEVEN B. HILTON

In the world of baseball, few moments are as electrifying as a home run—one of the most challenging and celebrated feats in all of sports. In a single swing, a batter can change the course of a game, sending the ball soaring over the fence and igniting the crowd. For the home team, a home run often means more than just runs on the scoreboard; it's a moment of pure celebration, sometimes punctuated by a dazzling fireworks display.

While the tax code rarely offers such moments of pure thrill, there are a few tax strategies that are undeniably a home run for clients who qualify. Perhaps foremost among those is the capital gain exclusion for Qualified Small Business Stock (QSBS) under Internal Revenue Code Section 1202 (Section 1202). For the right client, Section 1202 provides the following trifecta of typically elusive tax benefits: (1) complete avoidance of federal taxes on the sale of business holdings; (2) unlimited flexibility in the use of sale proceeds; and (3) a purchase cost basis for reinvested capital.

For QSBS acquired on or before July 4, 2025, Section 1202 provides that taxpayers who sell QSBS held for more than five years can potentially exclude from federal capital gains the greater of (1) $10 million or (2) ten times the taxpayer's aggregate adjusted basis in the QSBS (the Gain Exclusion Limit). In many cases, this means that a taxpayer will be able to completely exclude their entire capital gain from federal taxes.

Further, for taxpayers who are issued QSBS after July 4, 2025, the $10 million floor to the Gain Exclusion Limit is increased to $15 million under the recently passed Public Law 119-21 (called One Big Beautiful Bill, or BBB). The BBB also expands Section 1202 to provide partial gain exclusion for certain taxpayers who hold QSBS for less than five years (discussed further below).

For example, suppose athlete-entrepreneur George Herman Ruth sells shares in a business to Mickey Mantle for $20 million. Suppose that these shares qualify as QSBS and have been held by George for more than five years. Further, suppose that George has an aggregate adjusted basis in the QSBS of $2M. Under Section 1202, George has a Gain Exclusion Limit of $20 million ($2 million aggregated adjusted basis x 10 = $20 million) and can potentially exclude the entire gain from federal income taxes on the sale of the shares.

If George lives in a state with no state income tax (or that conforms to federal treatment under Section 1202), George now has virtually $20 million of cash in hand (ignoring transaction expenses) that he can spend or invest however he wishes. If he invests the funds in depreciable property (e.g., real estate), he will obtain a purchase cost basis in the property equal to fair market value and can recognize enhanced annual depreciation deductions.

Compare this to popular tax-deferral strategies such as like-kind exchanges of real estate under Internal Revenue Code Section 1031. Such strategies avoid taxes on a sale but require the funds be rolled over into replacement property within a tight timeframe. They also require the taxpayer to take a transferred basis in the replacement property (e.g., lower depreciation deductions).

It would be hard to dispute that George has hit a home run on the sale of his shares. And just as every home run in baseball is the result of intangible natural talent mixed with preparation and performance, a QSBS home run is also the result of a mix of certain intangibles along with preparation, and performance.

QSBS Intangibles

The main QSBS intangible is that the company must be engaged in the active conduct of one or more "qualified trade or business" (QTOB) with respect to at least 80% (by value) of its assets. Not every baseball player is a home-run hitter and not every company is engaged in a QTOB. That term is defined by exclusion and generally excludes most professional service businesses and related business types. This includes businesses in the fields of law, accounting, financial services, consulting, and banking among others. However, every business is unique, and a thorough analysis is often necessary to qualify or disqualify a business under Section 1202. Prototypical QTOBs are high-growth technology companies, though many other business sectors qualify.

A second QSBS intangible relates to the date the taxpayer acquired the shares. To be eligible for QSBS gain exclusion, the taxpayer must have acquired the shares from the company after August 10, 1993. Additionally, to be eligible for 100% gain exclusion, the taxpayer must have acquired the shares from the company after September 27, 2010. Shares acquired between those two dates are only eligible for partial gain exclusion (between 50-75% depending on the date of acquisition), and the taxpayer is subject to a heightened 28% federal tax rate on the remaining portion of the gain.

For example, suppose Tim Salmon realizes $10 million of gain selling QSBS shares to Mike Trout that qualify for 50% gain exclusion. $5 million of gain will be excluded from federal income tax; however, the remaining $5 million of gain is subject to a 28% federal tax rate (compared to the highest capital gains tax rate of 20%) that cuts against the Section 1202 gain exclusion.

Additionally, for taxpayers looking to take advantage of partial exclusion for shorter holding periods under the BBB, the taxpayer must have acquired the shares after July 4, 2025.

A final intangible is that the company must not have exceeded certain gross asset thresholds at the time the shares were issued. The BBB increases this threshold to $75 million for shares issued after July 4, 2025. For shares issued on or prior to that date, the threshold is $50 million. Additionally, the corporation's assets must not have exceeded $50 million at any time before the shares were issued but after August 10, 1993.

QSBS Home Run Preparation

Assuming the intangibles are in place, there are three main "preparatory steps" to hitting a QSBS home run.

First, the taxpayer must acquire the shares directly from the corporation. This is referred to as an "original issuance." Shares acquired in any other manner (e.g., by purchase from another shareholder) do not qualify.

Second, the business must be organized as a C corporation. S corporations and tax partnerships do not qualify. However, for some companies that otherwise qualify, including meeting the aggregate gross assets test at the time of conversion, non-C-corporation status is a fixable problem. In such cases, the entity can convert to a C corporation ahead of a liquidation event. If structured properly, the conversion will be considered an "original issuance" of the shares.

Third, the taxpayer must hold the shares for the minimum holding period under Section 1202. For stock issued on or prior to July 4, 2025, the minimum holding period is five years. For stock issued after that date, a taxpayer still needs to hold the shares for at least five years to obtain 100% gain exclusion, but can still obtain 50% exclusion if the shares are held at least three years and 75% exclusion if the shares are held at least four years. This makes a C corporation conversion more attractive for companies that are less than five years out but more than three years out from a liquidation event.

In addition to these rules, there are numerous traps for the unwary in Section 1202 that might be akin to an outfielder reaching over the wall and snagging what otherwise would have been a trot around the bases. These are beyond the scope of this article, but an example is the transfer of otherwise qualifying shares to a tax partnership, which negates the shares' QSBS status. Certain redemption transactions close in proximity to an issuance of shares must also be closely scrutinized, as must any reorganization of the business.

Attorneys and tax professionals are encouraged to thoroughly review Section 1202 and the associated regulations, cases, and IRS rulings when making a Section 1202 determination.

Performing at the Plate

The last piece is performance. Just as the batter must put together a swing that is both powerful and accurate enough to hit the ball over the fence, a taxpayer must negotiate the proper structure in order to qualify a sale for QSBS treatment. This essentially requires that the seller negotiate a stock sale, rather than an asset sale (or stock sale taxed as an asset sale under Internal Revenue Code Section 338(h)(10)).

Buyers will typically prefer an asset sale both for liability and tax (depreciation) purposes. Sellers may need to accept a lower purchase price to compensate for the lost depreciation benefits to the buyer and may need to provide indemnifications to compensate for the liability exposure to the buyer.

When intangibles, preparation, and performance all come together, taxpayers can hit a QSBS home run that completely (or at least substantially) eliminates federal income taxes on a liquidation event.

Hitting a Grand Slam

But what if the proverbial "bases" are loaded? In baseball, the greatest reward for a home run comes when there is a runner on every base. In that case, a home run scores the batter and all three runners and is called a "grand slam."

For example, suppose in the initial example that Mr. Ruth has zero basis in his QSBS shares. Assume the shares were issued after July 4, 2025, in which case he qualifies for a $15 million Gain Exclusion Limit. Further assume that Mr. Ruth is able to negotiate a higher total sale price of $60 million for his shares. On the sale of the shares, he will be able to exclude $15 million of gain but will be subject to federal capital gains tax on the remaining $45 million.

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That is, unless he can "load the bases" prior to the sale.

Tax and estate planning professionals can help clients "load the bases" through a process commonly referred to as "QSBS Stacking." QSBS Stacking involves multiplying or "stacking" the Gain Exclusion Limit by gifting shares to other taxpayers who qualify for their own separate Gain Exclusion Limit. Section 1202(h)(2)(A) treats a taxpayer who receives QSBS shares by gift as acquiring the shares in the same manner as the transferor and as assuming the transferor's holding period.

For example, suppose Mr. Ruth has three children. Subject to estate and gift tax considerations, he can gift $15 million of stock to each child prior to the sale, and each child will be treated as having acquired the stock in the same manner as Mr. Ruth. Upon the sale of the shares to Mr. Mantle, Mr. Ruth and each child will have a $15 million gain exclusion limit and can exclude the entirety of their respective $15 million shares of gain from the sale. Assuming the gifts do not negatively impact his lifestyle, Mr. Ruth hits a grand slam by loading the bases with his children and multiplying his $15 million Gain Exclusion Limit four-fold.

As alluded to above, Mr. Ruth will need to evaluate the gift and estate tax implications of making these gifts. For 2025, Mr. Ruth would have a $15 million exemption from federal gift and estate taxes. If he is married, then he and his spouse can gift approximately $30 million combined without incurring gift and estate taxes. This gets him close to the $45 million ($15 million x 3 children) in value that he needs to transfer to his children, and if he plans far enough ahead, he can take advantage of minority interest discounts.

For example, suppose that Mr. Ruth and his spouse transfer shares to their children before the company is marketed to buyers. Because each child will be taking a minority interest in the company, he should be able to apply a minority interest discount to the valuation of the gifted shares. For example, assume the shares qualify for a 35% minority interest discount. Mr. Ruth and his spouse can transfer $15 million of shares to each child while only using $9.75 million ($15 million discounted by 35%) of their combined lifetime exemption per child. This results in their using only $29.25 million (3 x $9.75 million) of their combined $30 million exemption.

Inheritance, Loss Protection, and Multi-Generational Tax Considerations

Mr. Ruth may wish to multiply his Gain Exclusion Limit, but may not want to gift substantial amounts of stock to his children outright. He can instead gift the shares to one or more irrevocable non-grantor trusts for his children. These trusts will allow him to place restrictions on a child's access to the trust assets as well as to protect the trust assets from loss to third parties like a divorcing spouse, predators, and creditors.

	PRE-BBB (Shares Issued on or before July 4, 2025)	POST-BBB (Shares Issued after July 4, 2025)
GAIN EXCLUSION LIMIT	Greater of $10 million or 10x aggregate basis	Greater of $15 million or 10x aggregate basis
GROSS ASSET THRESHOLD	$50 million	$75 million
HOLDING PERIOD FOR 100% EXCLUSION	5 years	5 years
PARTIAL EXCLUSION (Shorter Holding Periods)	Not available (must hold 5 years for exclusion)	50% exclusion at 3 years; 75% exclusion at 4 years

Table 1

Multi-generational irrevocable trusts can also provide gift, estate, and generation-skipping transfer tax savings.

When transferring shares to more than one trust, the transferor should be aware of Internal Revenue Code Section 643(f) and Treas. Reg. Section 1.643(f)-1(a), which allow the IRS to aggregate multiple trusts into one single trust (i.e., one single Gain Exclusion Limit) if all of the following factors are present: (1) the trusts have substantially the same grantor or grantors; (2) the trusts have substantially the same primary beneficiary or beneficiaries; and (3) a primary purpose for establishing such trusts or for contributing additional cash or other property to such trusts is the avoidance of federal income tax. In the context of Section 1202, these rules operate to prevent a taxpayer from creating multiple irrevocable trusts to multiply the Gain Exclusion Limit for the same beneficiary. For example, these rules prevent a taxpayer with one child from creating five separate irrevocable trusts for the benefit of that child to obtain five additional Gain Exclusion Limits (i.e., a $75,000,000 aggregate Gain Exclusion Limit).

Trusts with distinguishable beneficiaries (i.e., a separate trust for each child) should avoid aggregation since the trusts would not accomplish a result that could not have been obtained without them (i.e., the client could have obtained the same benefit by gifting the shares to the children outright).

Alternate Rollover of Gain

Taxpayers who do not qualify for gain exclusion under Section 1202 may still be able to avoid taxes on a sale of QSBS by rolling the gain into shares of a new QSBS investment under IRC Section 1045. Among other things, IRC Section 1045 has a shorter holding period requirement (six months vs. three to five years for Section 1202).

State Taxation of QSBS

California and many other states do not provide an exclusion for the sale of QSBS. Some states only allow a partial exclusion, even where QSBS qualifies for a 100% exclusion under federal law.

For example, suppose that Mr. Ruth resides in Orange County, California. He can exclude gain from the sale of QSBS from his federal taxes but will be subject to California income tax rates of up to 13.3% on the sale. Though beyond the scope of this article, he may be able to mitigate or defer state taxes by gifting shares to one or more irrevocable Nevada trusts.

In conclusion, Section 1202 provides complete exclusion of gain (for federal purposes), unlimited access to cash proceeds, and the ability to take a purchase cost basis in new investments. This is a home run for clients who qualify, and potentially a grand slam if a client can stack multiple Section 1202 exclusions by gifting shares to trusts for their beneficiaries. Further, Congress has made the playing field even more hitter-friendly by beefing up the tax benefits and easing the holding period and aggregate gross asset requirements for stock issued after July 4, 2025. Table 1 summarizes these changes.

Founders and investors in high-growth industries should seriously consider C corporation status to set themselves up for future QSBS gain exclusion.

Additionally, for clients with non-corporate entity types engaged in a QTOB that are three or more years away from a sale or liquidation event, practitioners should explore whether a C corporation conversion can set the client up to qualify for QSBS treatment down the road. This may include a second look for clients with aggregate gross assets of more than $50,000,000 but less than $75,000,000 or a liquidation horizon of less than five years but more than three years.

Lastly, sell-side transactional attorneys representing clients selling a business organized as a C corporation should explore whether the corporation is engaged in a QTOB and whether the shareholders qualify for gain exclusion under Section 1202.

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