

QUALIFIED SMALL BUSINESS STOCK

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SECTION 1202: QUALIFIED SMALL BUSINESS STOCK

Entrepreneurs who start a business have many up-front decisions around choosing the form of entity the business is organized under and the form of tax the business uses. For many years, the easy button has been to select taxation as a flow-through entity where the business taxable income flows through to the owners' individual tax return and thus avoiding any double taxation upon ultimate disposition. However, recent tax law changes make the easy button not so easy anymore.

The One Big Beautiful Bill Act signed by President Trump in July brought significant benefits to owners of Qualified Small Business Stock (QSBS) under IRC code Section 1202. While the code section has been around for many years, the changes greatly expanded the potential benefits. The new rules are effective for QSBS shares issued after July 4, 2025, and are not retroactive. Let's take a look at the law as it stands today.

First, what defines an eligible owner and eligible QSBS entity?

- The owner shareholder must be a noncorporate taxpayer, i.e. an individual or qualifying trust
- The shares must be common or preferred stock in a qualified domestic trade or business taxed as a C corporation
- The corporation cannot have had aggregate gross assets in excess of \$75 million (with annual inflation adjustments) at any time after August 10, 1993 through the issuance of the QSBS shares
- The shares must be originally issued in exchange for nonstock property or as compensation for services
- Certain professional service businesses do not qualify as a QSBS entity, i.e. accounting, engineering, law, consulting, healthcare, leasing, etc.

Next, what are the tax benefits?

IRS Code section 1202 allows a qualifying owner who disposes of their shares in a QSBS to exclude from taxable capital gain income certain amounts based on the length of time the owner held the QSBS shares.

- The amount of gain excluded is the greater of \$15 million or 10 times the owners' original cost basis
- The owner must have held the shares for at least 3 years to receive any benefit
- If the holding period is between 3 and 4 years, 50% of the gain is eligible (vs 100%)
- If the holding period is between 4 and 5 years, 75% of the gain is eligible (vs 100%)
- If the holding period is at least 5 years, 100% of the gain is eligible
- All prior sales from the same QSBS entity must be aggregated for computation purposes

Examples:

An entrepreneur starts a business which qualifies as a QSBS entity by investing \$150,000 and sells his interest more than 5 years later for \$20 million.

- The first \$15 million of capital gain is 100% excluded from his taxable income

An investor invests in a business which qualifies as a QSBS entity by contributing \$3,000,000 and sells his interest more than 5 years later for \$33 million.

- All \$30 million (\$33 million sales proceeds less \$3 million cost basis) of capital gain is 100% excluded from his taxable income (greater of \$15 million or 10 times his \$3 million original cost basis).

Summary:

Entrepreneurs starting a business should at least consider the merits of a QSBS when determining the form of business an entity chooses.

At JVL Wealth Strategies we help business owners make the right decisions for their specific circumstances. We work with the business owners tax preparer and attorney to discuss the pros and cons of each option to ensure they make the best decision for them.

REFERENCES & DISCLOSURES

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