Qualified Small Business Stock- An Expansion?

Take-Away: The benefits of a Qualified Small Business Stock (QSBS) exclusion from capital gains taxes may soon get even better.

Background: The Senate just released its version of the One Big Beautiful Bill. The bill includes proposed changes to the benefits of IRC 1202, which is provides capital gain exclusion for the owners of qualified small business stock, or QSBS. Prior missives have summarized the benefits of QSBS stock and why IRC 1202 is included in the Tax Code as a tax incentive for entrepreneurs. If enacted, the Senate's proposed bill will expand the QSBS tax exemption.

Short History: IRC 1202 was added to the Tax Code back in 1993. That section was then enhanced in 2010 to create conditions for a shareholder to claim a 100% capital gain exclusion if the sale of the stock occurred after September 27, 2010 (the *Effective Date*) and the stock was held for at least 5 years. This exclusion from capital gain recognition is limited to the *greater* of ten (10) times the shareholder's adjusted basis in the QSBS or $10.0 million. [Note, if the shareholder is married but filing separately, the dollar threshold is reduced to $5.0 million.] Also excluded from gain recognition on the sale of QSBS is that the sales proceeds are exempt from the alternative minimum tax (AMT) and the net investment income tax (NIIT.) Moreover, the investor who sells his/her QSBS can defer any gains by reinvesting the sales proceeds in new QSBS within 60 days. Finally, any gain in the QSBS will receive an income tax basis adjustment on the investor's death. [IRC 1014.]

Proposed Changes: A summary of the Senate's proposed changes to the existing law and conditions regarding QSBS follow:

Phase-in: Under current IRC 1202 the gain from the sale of QSBS after September 27,2010 is eligible for the 100% exclusion from U.S. capital gains if the QSBS is held for more than 5 years. This is a 'cliff' regarding the ability to claim the gain exclusion. If the QSBS is held for 5 years or less, then the shareholder in unable to claim the exclusion.

- **Change:** The proposed bill would provide that if the QSBS was held for exactly 5 years (not just more than 5 years) then the IRC 1202 exclusion would be available for the stock sold. The proposed bill replaces the strict 5-year holding cliff with phase-ins. Some of the benefits of IRC 1202 occur if the QSBS is held for at least 3 years, which then makes the stock eligible for a 50% gain exclusion. If the QSBS is held for at least 4 years, then the exclusion of gain would be up to 75%. Since QSBS stock is subject to a 28% capital gain tax rate, the phase-in of the exclusion amounts would result in respective effective tax rates of 14% (held for 3+ years) or 7% (held for 4+ years.)

Increase in Exemption: Under the current IRC 1202, the aggregate amount of '*eligible gain*' is subject to a per issuer-cap. The shareholder can exclude from capital gain the *greater* of (i) $10 million, or (ii) ten (10) times the shareholder's adjusted basis of the QSBS disposed of by the shareholder. If married, but filing separately, the dollar threshold amount is reduced to $5.0 million.

- **Change:** The dollar threshold amount of excluded gain is increased to $15 million, or $10 million for shareholder who is married and files separately. This dollar threshold amount will be annually indexed for inflation, starting in 2026.

Asset Limitation: To become eligible as QSBS, the small business's aggregate gross assets from inception to immediately after the issuance of such stock (including proceeds received in exchange for such stock) cannot at any time exceed $50,000,000.

- **Change:** The business's asset threshold would be increased to $75,000,000, starting in 2026 and be indexed for inflation.

Caution: For QSBS purposes, stock is treated as issued on the date that the holding period begins, as determined under IRC 1223, even if the stock has not actually been issued. Consequently, if the stock is treated as issued and acquired prior to the *Effective Date* (because, for example it was issued for property in a tax-free exchange) the proposed changes under the bill will not apply even if such stock is issued after the *Effective Date*.

Conclusion: As noted, this is only a proposal in the Senate's version of the budget reconciliation bill, not the House's version, so it remains to be seen if these QSBS proposals will ever make their way into amendments to the Tax Code. Perhaps they will be viewed as just one more tax break for the wealthy. Who knows?

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