

The OBBBA and Qualified Small Business Stock

Take-Away: The One Big Beautiful Bill Act (OB3) makes three significant changes to the gain avoidance rules associated with Qualified Small Business stock, adding to the incredible benefits associated with such stock.

Background: *Qualified Small Business Stock* (QSBS) is described in IRC 1202. To be QSBS the stock must have been issued after August 10, 1993. The stock must be issued by a **C** corporation. However, an LLC a partnership or even an S corporation can do a tax-free reorganization to become a C corporation to take advantage of the rules under IRC 1202 to avoid gain recognition on the sale of QSBS.

QSBS Requirements: Besides only applying to a C corporation stock, there are some other requirements that must be met to be QSBS.

Qualified Trade or Business: In general, **80% of the assets** have to be used in an active *qualified trade or business*. Mostly the rules identify what is *not* a qualified trade or business, excluding health, law, accounting, performing arts, consulting, athletics, financial services, hotels, restaurants, etc. from the benefits of QSBS.

Original Issuance: This requirement is that the shareholder must have **acquired the stock directly from the issuing corporation**. Restated, the QSBS cannot have been purchased from another existing shareholder. The QSBS must have been received in exchange for money or property, but not stock. However, the QSBS can be acquired as compensation for services to the corporation or as restricted stock as part of an employee's compensation.

Gift or Inheritance: One important exception to the prior rule is that the stock is still QSBS if the QSBS is received via a gift or as an inheritance. Accordingly, if the owner of QSBS gives some of his/her stock to a child, the stock will continue to be treated as QSBS.

OB3 Changes: Three major changes were made to the QSBS rules making this stock even more attractive.

- 1. Gross Asset Limit:** Previously, in order to be classified as a *small business* the corporation's gross assets could not exceed \$50 million through the time when the QSBS was issued. That \$50 million amount was not a fair market value 'test;' it was cash plus the adjusted basis of assets but does not include self-created intangibles like goodwill. In short, the corporation might be worth more than \$50 million, but the gross asset 'test' could still be satisfied. After OB3, for stock **issued after July 4, 2025**, the new gross asset limit is **\$75 million** for the issuing corporation. In addition, this gross asset limit is adjusted for inflation after 2026. Accordingly, more C corporations might qualify as a small business by meeting the increased gross asset limit.

Example: On June 30, 2025, ABC corporation had gross assets of \$60 million and thus it was unable to issue any new QSBS stock. Yet now, with the increase up to \$75 million of gross assets, that is an additional \$15 million of QSBS that ABC corporation can issue and still stay under the new \$75 million limit.

Example: On June 30, 2025, ABC corporation had gross assets of \$80 million. After July 4, 2025, ABC spends \$15 million on research and development during the balance of 2025, thus taking its gross assets down to \$65 million. ABC can now issue another \$10 million of QSBS.

- 2. Increased Gain Exclusion:** Yet another significant change to the QSBS rules made by OB3 is how much the shareholder is allowed to exclude when QSBS is sold. Prior to OB3 the shareholder was allowed to exclude \$10 million, i.e., the *greater* of \$10 million or the ten times the shareholder's basis in the QSBS. Under OB3, that \$10 million limit is increased to **\$15 million**. In addition, like the gross asset limit, this \$15 million amount is indexed to inflation after 2026. However, this is only **for QSBS issued after July 4, 2025**. This is one dollar figure limit, not two.

Example: Ned has owned QSBS in ABC corporation for several years now. Ned's ABC stock is now worth \$10 million. Ned is considering selling his ABC stock. Ned will probably want to sell his \$10 million of ABC stock that he acquired before the July 5, 2025, cut-off date; he

should sell that QSBS first, and then if continues to receive ABC stock as part of his continued ABC employment, Ned can get an extra \$5.0 million of QSBS that was acquired *after* July 4, 2025.

- 3. New Percentage Exclusions:** The question is whether the owner of QSBS stock gets to exclude 100% of the gain or whether it is the greater of \$10 million- or 10-times basis, or the greater of \$15 million- or 10-times basis? The third OB3 change to QSBS deals with the percentage limit limitations.

History: The original QSBS rules provided that out of that \$10 million or 10x basis exclusion, the QSBS shareholder could only exclude 50% of that amount and the 50% that was not excluded was subject to a 28% tax rate, effectively converting a federal capital gain rate to 14%. But then, there was the net investment income tax (NIIT) on top of the capital gains tax, and perhaps, too, the alternative minimum tax (AMT), to consider, because that part of the sales proceeds that is not excluded from QSBS will be subject to the AMT. In 2009, the percentage was increased, first to 75% and after 2010 it was increased again to 100%. Therefore, a shareholder was able to exclude 100% of his/her gain to the greater of \$10 million- or 10-times basis, if the QSBS stock was sold before July 4, 2025.

New Rule: Now, if the QSBS is sold after July 4, 2025, the 100% exclusion is the greater of \$10 million- or 10-times basis after that date, or smaller exclusions if the QSBS stock is held for less than 5 years. Under the old rule, the QSBS **had to be held for at least 5 years**.

Example: Donald, Huey, Dewey, and Louie, all investors, pool the funds and invest in ABC corporation. Their aggregate investment is \$74.9 million. ABC grows over the next 10 years. Those 4 investors decide to sell ABC. The investors can exclude 10 times their initial basis investment in ABC, which means that if they sell ABC years down the road, \$749 million all of the sales proceeds will be tax free.

Under OB3 the third big changes are that there are now **two new percentage limitations**. If the QSBS shareholder sells his/her company and he/she has not held the stock for 5 years, a **partial exclusion rule** will now apply. If the QSBS **is held for at least three years, the shareholder will be able to exclude 50% of his/her gain**. The non-excluded gain will still

be subject to a 28% tax rate (along with AMT and NIIT implications) but at least 50% of the gain will be excluded. If the QSBS is **held for at least four years, the shareholder will be able to exclude 75% of his/her gain.**

QSBS Planning: Assume that the QSBS shareholder wants to sell his/her stock, but he/she is unable to meet the 3- or 4-year holding period and he/she is unwilling to delay the sale until at least 5 years has passed. IRC 1045 allows yet another gain deferral. IRC 1045 allows the shareholder to roll over his/her QSBS into a new QSBS and that way continue to hold QSBS until 5 years passes. Alternatively, since investing in a new QSBS is a bit too risky for the QSBS shareholder, IRC 1045 also allows the QSBS shareholder to start a new company and roll over his/her gains into that new company, and then 'finish out' the 5-year holding period.

QSBS 'Stacking:' [We have covered this planning strategy in a missive several years back.] As noted earlier, a gift of QSBS enables the donee of the gifted stock to also be eligible for the QSBS exclusion.

Example: Donald forms ABC corporation on October 1, 2025, to develop AI software. Donald invests \$15 million in ABC. Donald plans to sell ABC when it is worth \$60 million. Anticipating that future success, Donald forms three non-grantor trusts for the benefit of his three sons, Huey, Dewey, and Louie. Donald gifts ABC stock to each of these non-grantor trusts. When Donald sells ABC, he will be able to shelter \$15 million in gain from the sale of his stock. Each of the three non-grantor trusts will also qualify as a QSBS owner, so each of the three non-grantor trusts will also be able to shelter \$15 million of gain. Consequently, if ABC is sold years down the road for \$60 million, neither Donald, nor the three non-grantor trusts, will pay any capital gain tax. No tax on \$60 million of sales proceeds. If Donald had not transferred ABC stock to the three non-grantor trusts, and he sold ABC for \$60 million, he would be able to shelter only \$15 million in gain (Donald's basis in the ABC stock) but the additional \$45 million in sales proceeds would be subject to the 28% capital gains tax.

Caveat: Not every state recognizes QSBS. If the 'stacking' planning strategy is pursued, it might make sense to establish the non-grantor trusts in a state like Delaware with no income taxes (or Nevada.)

Conclusion: Not every business will qualify for these gain exclusion rules. The corporation must be a C corporation, and not all C corporations will qualify. Notwithstanding those exclusions, many C corporations may qualify at small businesses that have issued Qualified Small Business Stock. As such, before a business pursues a liquidity event, such as its sale, it is important to determine if the business to be sold satisfies all of the QSBS rules.

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