The "New" Qualified Small Business Stock Exclusion

Take-Away: As new businesses are formed, more attention needs to initially be given to forming the business as a C corporation, despite the double taxation of a C corporation before the adoption of either an S corporation or an LLC.

Background: The One Big Beautiful Bill Act of 2025 (OB3) greatly expanded the benefits of a qualified small business stock (QSBS) exclusion under IRC 1202. It is available for C stock issued by a domestic corporation. Under the OB3, a sale of QSBS stock issued on or after July 5, 2025, by an eligible QSBS shareholder may exclude from income the **greater** of (i) $15 million of gain ($7.5 million for married taxpayers filing separately), which amount is adjusted to inflation starting in 2027, or (ii) the amount of gain equal to 10 times the shareholder's basis in the QSB shares. 100% of the gain recognized on the sale can be excluded if the QSBS is held for at least 5 years. The OB3 also phased-in shorter holder periods for the QSBS- 50% exclusion of gain if the shares are held for at least 3 years, and a 75% exclusion for shares that are held at least 4 years.

Eye-Opener: How effective is this exclusion? Between 2012 and 2022, 217,000 individual QSBS shareholders and 25,000 trusts claimed the QSBS exclusion. The total amount of exclusions for these shareholders from gain recognition was over $140 **billion**. [*Source*, Zahrah Abdulrauf, et. al., "Quantifying the 100% Exclusion of Capital Gains on Small Business Stock," Office of Tax Analysis, Working Paper 127 (2025.)]

QSBS Requirements: Two sets of requirements need to be met to qualify for the QSBS exclusion.

Shareholder: To qualify as QSBS, the shareholder must acquire his/her stock at original issuance in exchange for money or compensation for services rendered. The QSBS shareholder may be an individual, a trust, an estate, S corporation, or a partnership, but not a C corporation.

Corporation: The C corporation must satisfy specific requirements at the time the QSBS stock was issued as well as continuing requirements during substantially all of the

shareholder's holding period. The OB3 requires that stock that is issued after July 5, 2025, the gross assets of the corporation and any predecessor entity (if applicable) cannot have ever exceeded $75 million (which amount is adjusted for inflation starting in 2027) both before and after the issuance of the stock. In addition, the corporation must also use at least 80% of its assets (determined by value) in the conduct of a 'qualifying trade or business' or in its start-up activities to establish the 'qualifying trade or business.'

Excluded Businesses: Not all businesses can even qualify for the QSBS exclusion despite meeting all of the other QSBS requirements. IRC 1202 excludes the following businesses: (i) hotels, motels, restaurants, or comparable businesses; (ii) farming; (iii) banking, insurance, real estate investing or leasing; (iv) a business that involves the production or extraction of minerals (and some other products too numerous to describe;) (v) any business in which the principal asset is the reputation or skill of one or more employees; and (vi) any business that involves the performance of services in the fields of law, health, engineering, architecture, accounting, performing arts, consulting, athletics, finance, brokerage, or actuarial sciences.

However, there are a couple of private letter rulings that suggest that peripheral prohibited activities, if minimal, might not cause a corporation to lose its status as a qualified small business. [PLR 202114002, January 13, 2021; PLR 201717010, January 23, 2017.]

Anti-Churning: The corporation must satisfy all of the above requirements at the time the QSBS stock is issued, and it must meet the requirement to conduct a qualifying trade or business during the shareholder's entire holding period, e.g., 5 years. In addition, the IRC 1202 Regulations contain anti-churning rules when it comes to some stock redemptions within specific time periods tied to when the QSBS stock was initially issued.

Convert to C Corporation: An existing S corporation or an LLC might consider converting to a C corporation to take advantage of the QSBS exclusion, despite the 21% C corporation federal income tax rate. Such a conversion from a passthrough entity might, though, trigger the 10 times basis limitation for the exclusion. Consider an LLC that converts to a C corporation. The stock received by the LLC member in the conversion may have significant basis for purposes of the 10 times basis limitation. That is because the C corporation conversion would involve an actual or deemed contribution of the LLC or its assets to the

new corporation in exchange for shares of the corporation's stock. For purposes of the '10 times basis' rule, the former LLC member (now shareholder) would take a basis in those shares equal to the fair market value of the contributed LLC interests (or LLC assets.)

Example: Bert and Ernie own an LLC, Birdco, as 50%-50% members. Birdco elected to be taxed as a partnership. Bert and Ernie decide to convert Birdco to a C corporation. At the time of the conversion, Birdco is worth $8 million. Consequently, with the conversion of Birdco to a C corporation, each of Bert and Ernie have a $4 million basis in their new shares in Birdco [50% of $8 million = $ 4 million.] Ten times basis for each of Bert and Ernie means that each of them have a fixed exclusion of gain from the sale of their stock in Birdco of $40 million (not the optional $15 million provided by the QB3.) That means that Bert or Ernie could sell their stock in Birdco and exclude $40 million of gain when they finally sell their shares of stock.

Note, that each of Bert and Ernie, while having a $4 million basis in their shares for purposes of the '10 times basis' exclusion rule, might have a normal income tax basis in those shares much lower, maybe even close to zero, if they started their Birdco business from scratch. That is because each owner would take a carryover basis in their shares for normal tax purposes, not the 'fair market value basis' they can use for purposes of the QSBS '10 times basis' rule. If that were the case, e.g., a near zero basis in their interests, their corporate shares would be near zero for normal tax purposes. Accordingly, nearly all of their first $4 million of gains on a later sale of their shares (representing nearly $4 million of appreciation that occurred before the C corporation conversion) would not be eligible for any QSBS exclusion.

Asset Sales: Many business sales are set up as asset sales, not stock sales. If the business sale is structured as a sale of C corporation assets, followed by a liquidation of the C corporation, there would be a corporate-level tax on the asset sale, which would not be eligible for the QSBS exclusion. The subsequent liquidation of the corporation would then cause a shareholder-level taxable gain. If the shares are QSBS and the holding period is met, the QSBS exclusion should apply to the shareholder-level gain on liquidation, meaning that the QSBS exclusion *should* nonetheless remain available in an asset sale, but the additional tax paid at the corporate level will no doubt reduce the after-tax return when compared to a QSBS sale.

States: A word of caution. Not all states follow the federal QSBS exclusion, California and Pennsylvania being the most noteworthy. Each state applies its own rules for the sale of QSBS, either to follow the federal rule, disregard the federal rule, or allow only a partial QSBS exclusion. Michigan follows the federal QSBS exclusion. [MCL 206.30(1); MCL 206.471(6.)]

Conclusion: The rules surrounding the QSBS exclusion are highly complex. Clearly, a misstep could cause C stock to lose QSBS status, which could not be recovered later on. If it is a family business that is to be created and ultimately expected to be run by succeeding family generations, it may not make much sense to set up the business as a C corporation to begin with (using an LLC or S corporation passthrough entity to save taxes.) Businesses that will someday in the future be sold by its owners should probably look more closely a forming it as a C corporation before an S corporation or an LLC is explored.

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