

QSBS Requirements and Estate Planning Opportunities

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In this article, Everist and Mauner examine opportunities for income and estate tax efficiencies before a sale of qualified small business stock that may be eligible for the income tax exclusion in section 1202 or income tax gain deferral in section 1045.

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I. Introduction

Navigating the complexities of the income and estate tax landscape requires both technical expertise and strategic foresight, particularly for individual taxpayers seeking to plan for after-tax wealth among generations. Recent developments under the One Big Beautiful Bill Act (P.L. 119-21) and other long-standing provisions in the code present significant planning opportunities for those who hold or are considering investments in closely held businesses.

This article explores opportunities available for integrating the exclusion of gain on qualified small business stock (QSBS) under section 1202, using tax-deferred rollovers under section 1045, and trusts commonly used in comprehensive estate tax planning. By understanding and coordinating these provisions, taxpayers and their advisers might be able to unlock substantial tax savings, enhance liquidity, and achieve long-term wealth transfer objectives.

II. Qualified Small Business Stock

First, let's outline the rules for QSBS as defined in section 1202 and as applicable for both section

1202 exclusion and section 1045 rollover purposes. The requirements for QSBS can be categorized as those tested at issuance versus those tested over substantially all of a shareholder's holding period. Testing may be bifurcated between corporate-level versus shareholder-level requirements. Additional requirements apply if the direct shareholder is a passthrough entity (PTE), as explained later in this article.

Table 1. Shareholder-Level and Corporate-Level QSBS Requirements

Shareholder-Level	Corporate-Level
• Noncorporate taxpayer • Acquisition after August 10, 1993 • Original issuance • Hold period • Redemption transactions	• Domestic C corporation • Qualified trade or business • Active conduct of qualified trade or business • Qualified small business/aggregate gross assets

A. Shareholder-Level Requirements

1. Noncorporate taxpayer.

While the stock issued must be C corporation stock, C corporations are not eligible shareholders of QSBS.¹ Non-grantor type trusts can usually claim an exclusion on the gain recognized on the sale or exchange of stock. Some PTEs that recognize a gain on the sale of QSBS can avail owners an exclusion if additional requirements are met applicable to PTEs and their owners. For QSBS purposes, a PTE is defined as any partnership, S corporation, regulated investment company, or common trust fund.²

¹ Section 1202(a)(1).

² Section 1202(g)(4)(A)-(D).

2. Original issuance after August 10, 1993, and holding period.

To qualify as QSBS, the taxpayer needs to have received the stock as original issuance from the corporation. The original issuance requirement is also met if the stock was obtained by the taxpayer through gift or bequest when the donor obtained the stock at original issuance, retaining the donor's acquisition date for the exclusion percent and tacking their holding period to the beneficiary's.³ This allows for tax planning opportunities because a new three- to five-year holding period isn't required.

QSBS also includes a taxpayer's ownership in a PTE that received original issuance QSBS and held the stock for more than three to five years, depending on the issuance date.⁴ PTE owners may receive QSBS treatment for their share of the QSBS disposed of if they owned an interest in the PTE at the time the entity acquired the QSBS and at all times afterward until the disposition of QSBS by the entity.⁵ The stock will also qualify if the partnership distributes QSBS to the partner and the partner later sells the QSBS.⁶

Original issuance may include stock issued in exchange for money or property or in exchange for services if vested or included in gross income under section 83(b).⁷ Exclusions may be allowed for stock consideration received in exchange for property (other than stock of another corporation) in a nonrecognition exchange governed by section 351. There is also a special elective gain deferral available for the sale of QSBS when the proceeds are used to acquire new QSBS within a 60-day period codified under code section 1045 (rollover of QSBS) that will tack the holding period from the originally held QSBS.

3. Redemption transactions.

Because of the opportunity for tax avoidance, there are two major anti-evasion rules in place for other redemptions, with a limited exception for de minimis transactions. The anti-evasion rules look

at corporate redemptions from the taxpayer or related party (defined in sections 267(b) and 707(b)), even indirectly, two years before and two years after stock is issued; or other redemptions aggregating 5 percent or more of stock value one year before and one year after stock is issued.⁸ The de minimis exception for redemptions is, in the aggregate, \$10,000 or 2 percent of outstanding stock held by the taxpayer and related persons.⁹

Redemptions for some business purposes generally side-step these redemption rules, including repurchases following termination of services if stock was acquired in connection with the performance of services, death if purchased within three years and nine months after death, disability or mental incapacity, or divorce.¹⁰ This provides significant flexibility for common business purposes to redeem a shareholder's stock while not preventing other shareholders from potential QSBS benefits. Care must be taken to meet these requirements if QSBS treatment is desired.

Finally, special attribution and constructive ownership rules apply in determining related party status and the scope of redemptions, including rules for redemptions under section 304(a) involving control of multiple corporations.

B. Corporate-Level Requirements

1. Domestic C corporation.

In general, a domestic corporation is one "created or organized in the United States or under the law of the United States or of any State."¹¹ Although there may be opportunities for a domestic C corporation to hold controlled foreign corporation stock and meet the QSBS requirements, that is beyond the scope of this article.

PTEs have become very popular over the past few decades, but they do not qualify as QSBS. When the QSBS provisions were first enacted, C corporations were a more common type of business entity structure than passthrough options. However, there could be another uptick

³ Section 1202(h)(1).

⁴ Section 1202(b)(2)(A).

⁵ Section 1202(g)(2).

⁶ Section 1202(h)(2)(C).

⁷ H.R. Rep. No. 103-111 (P.L. 103-66) (1993).

⁸ Section 1202(c)(3)(A)-(B).

⁹ Reg. section 1.1202-2(a)(2); (b)(2).

¹⁰ Reg. section 1.1202-2(d).

¹¹ Section 7701(a)(4).

in C corporations thanks to both the passage of the Tax Cuts and Jobs Act, which permanently reduced the C corporation tax rate to 21 percent, and the increased section 1202 benefits through the OBBBA. Industry, potential future sale, type of business income, and anticipated owner distributions also play a significant role in entity choice.

2. Active conduct.

Generally, the active business test has an 80 percent threshold based on asset value used in the active conduct of one or more qualified trades or businesses. This includes goodwill, concern value, and other intangible assets of the business that may not have a carry value on the book basis financial statements. The 80 percent asset value includes working capital or assets anticipated to be used within the first two years of the corporation for qualifying research and experimentation. After the first two years, the threshold is limited to 50 percent of total asset value.¹² Further, the active conduct requirement restricts the amount to 10 percent or less of the value of the business assets exceeding liabilities composed of stock or securities in other corporations that are not subsidiaries.¹³ To qualify as a subsidiary, the parent must own more than 50 percent of the voting power of all voting classes of stock or more than 50 percent of the value of all outstanding classes of stock. Accordingly, restricting minority position investments is usually prudent. The parent and all subsidiaries meeting the 50 percent vote or value threshold are treated as one corporation for the purpose of QSBS testing. The active conduct requirement also states that no more than 10 percent of the business assets can be made up of real estate not actively used in the corporation's qualified trades or businesses. For these purposes, the ownership of, dealing in, or renting of real property is not treated as the active conduct of a qualified trade or business.¹⁴ This active conduct requirement must be met "during substantially all of the taxpayer's holding period for such stock," without this requirement being further defined,

unless the business meets the definition of a specialized small business investment company.¹⁵ It is generally accepted that active conduct refers to the activities of the corporation's employees and not independent contractors or outsourced labor.¹⁶ Depending on the assets and operations of the business during the taxpayer's holding period, review of activities is prudent to help ensure QSBS status.

3. Qualifying trade or business test.

Qualifying trade or business requirements for QSBS is an exclusionary list, defined as:

any trade or business other than —

- (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;
- (B) any banking, insurance, financing, leasing, investing, or similar business;
- (C) any farming business (including the business of raising or harvesting trees);
- (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A; and
- (E) any business of operating a hotel, motel, restaurant, or similar business (code section 1202(e)(3)).¹⁷

There are nuances within each subsection of this list. For subparagraph (A), services are referenced for the fields of health, law, etc., but under the principal asset portion of the trade or business is the reputation or skill of one or more of its employees, not limited to the named service

¹² Section 1202(e)(1)(A) and (e)(6).

¹³ Section 1202(e)(5).

¹⁴ Section 1202(e)(7).

¹⁵ Section 1202(c)(2)(A) and (B).

¹⁶ See reg. section 1.355-3(b)(2)(iii) in the absence of a definition under section 1202.

¹⁷ Section 1202(e)(3).

industries. Principal asset of reputation or skill is not defined here or elsewhere. Some informal guidance is available from private letter rulings. These rulings primarily focus on intellectual property as the basis of value — not employee skills specifically learned and used for the employer that would exclude the business from QSBS status.¹⁸

For subparagraph (C), a broad definition of farming is found in section 263A, which references farming businesses, including nurseries, sod farms, and tree farms (for crop-bearing and ornamental trees, except evergreens over six years old when severed from the roots). The business of farming is defined as when one “cultivates, operates, or manages a farm for gain or profit, either as owner or tenant,” and notably excludes forestry from the definition.¹⁹ We get a clearer answer for the depletion exceptions because they specifically incorporate sections 613 and 613A by reference. All of those businesses may be related to an excluded service field and still qualify if the professional services themselves are not primary to the business. If there are multiple components of business operations that may or may not be QSBS, planning may be done to separate the different types of work applicable to distinct entities because QSBS does not follow the controlled business group rules.

4. Qualified small business/aggregate gross assets.

The qualified small business test, also referred to as the aggregate gross asset test, is vital to qualifying for QSBS tax treatment. Because section 1202 was enacted August 10, 1993, that is the earliest date the aggregate gross asset test may be applied. If a business was incorporated after that date, then the aggregate gross asset test looks at date of incorporation through the date of QSBS issuance, as well as the aggregate gross assets immediately after issuance. The OBBBA increased the allowable gross assets for QSBS purposes for the first time since the section’s original enactment. For all stock issued July 4, 2025, and before, the allowable gross assets limit remains at \$50 million, and for stock issued after July 4, 2025,

the gross assets may be up to \$75 million, with future built-in annual inflation adjustments beginning in 2027.

One of the most important factors of the aggregate gross asset test is that it is based on the “amount of cash and the aggregate adjusted bases of other property held by the corporation.”²⁰ For contributed property, this test looks at the fair market value of the property on the date contributed.²¹ Depending on the type of business, there could be a significant difference between the FMV of the assets or business and the basis of the assets. Because of the limited value of assets that a corporation may have at stock issuance, QSBS generally can be great for startup entities and other smaller businesses that are not in an excluded industry.

III. QSBS Benefit: The Gain Exclusion

Since the QSBS gain exclusion was first enacted, the exclusion percentage has increased from 50 percent to 100 percent.²² For stock issued during the period from August 10, 1993, to February 17, 2009, the exclusion percentage is 50 percent; from February 18, 2009, to September 27, 2010, 75 percent; and from September 28, 2010, to July 4, 2025, 100 percent. The OBBBA created another set of exclusionary periods for stock issued after July 4, 2025: 50 percent if held for more than three years, 75 percent if held for more than four years, and 100 percent if held for more than five years. Any eligible gain that is not excluded from income tax is taxed at the top capital gains rate of 28 percent²³ (there is a special 60 percent exclusion for qualified empowerment zone businesses on pre-2019 attributable gain, as well as for stock acquired before February 19, 2009, under section 1202(a)(2)). Eligible gain is limited to the greater of (A) \$10 million per taxpayer, per issuer, or \$15 million if issued after July 4, 2025 (annually adjusted for inflation beginning 2027); or (B) 10 times the aggregate

¹⁸ LTR 202319013; LTR 201717010; LTR 202125004; LTR 201436001.

¹⁹ Reg. sections 1.175-3 and 1.182-2.

²⁰ Section 1202(d)(2).

²¹ Section 1202(d)(2)(B).

²² Section 1202(a).

²³ Section 1202(a)(1) and 1(h)(4)(A)(ii).

Table 2. Gain Exclusions for Sale of QSBS

Stock Issued		Gross Assets Limit	Eligible Gain Exclusion	Greater of 10x Basis or	Required Holding Period (Years)
On or Before	After				
2/17/2009	8/10/1993	\$50M	50%	\$10M	5
9/27/2010	2/17/2009	\$50M	75%	\$10M	5
7/4/2025	9/27/2010	\$50M	100%	\$10M	5
	7/4/2025*	\$75M	50%	\$15M	3
	7/4/2025*	\$75M	75%	\$15M	4
	7/4/2025*	\$75M	100%	\$15M	5

Note: The OBBBA \$75 million gross asset test and \$15 million eligible exclusion are adjusted annually for inflation beginning in 2027.

adjusted basis of stock sold during the tax year for each qualifying corporation.²⁴ For taxpayers applying a 50 percent or 75 percent exclusion, the amount of eligible gain not excluded is also subject to the net investment income tax (section 1411). For QSBS acquired on or before September 27, 2010, gain excluded is a 7 percent alternative minimum tax preference item; any QSBS acquired after that date is not an alternative minimum tax preference item.

The exclusion is per taxpayer, although “taxpayer” is not clearly defined within section 1202, especially for married taxpayers. Generally, married taxpayers are considered one taxpayer and get only one exclusion, or split one exclusion if filing separately.²⁵ However, this position has in some cases been successfully rebutted when each taxpayer owns interests in the business or they have legal ownership through applicable community property rules. Married individuals claiming the exclusion or wanting to make QSBS gifts to their spouses should discuss the tax consequences and proper reporting of those gifts with their estate and tax advisers. Additionally, those concerned about the uncertainty could consider making an *inter vivos* gift to a spousal lifetime access non-grantor trust.²⁶

Because there is a higher capital gains rate for the amount of gains that are not excludable, when

the stock was issued and how long it was held are both very important. The effective tax savings for a sale that qualifies for a 50 percent exclusion is 7.9 percent (50 percent of 28 percent capital gains plus 50 percent of 3.8 percent net investment income tax). While this may be significant depending on the amount of the gain, stock that qualifies for the full exclusion has a tax savings of 23.8 percent. Because most states conform with QSBS gain exclusion, the amount of exclusion affects the level of state income tax as well. There are some states that do not conform or only partially conform; notably, California, New Jersey, and Massachusetts.

Many shareholders have nominal basis in their shares compared with anticipated gain, so it’s common for the per-taxpayer exclusion of \$10 million or \$15 million to provide the more beneficial result from a sale. The gain exclusion analysis is performed annually, so it’s possible to first use the \$10 million or \$15 million exclusion — that is, an aggregate amount per taxpayer per issuing corporation — and then have sales in future years qualify for the 10 times basis rule. For example, suppose a shareholder has 1,000 shares in a corporation that are QSBS and were issued in 2015 with a basis of \$1,000 each and a FMV of \$20,000 per share. There’s an unrecognized gain of \$19,000 per share. Selling 525 shares will create a gain of \$9.975 million using most of the \$10 million exclusion because that is greater than 10 times the basis of those shares, which would exclude only \$5.25 million of gain. However, in future years, the taxpayer would still have

²⁴ Section 1202(b)(1).

²⁵ Section 1202(b)(3).

²⁶ See also Section V, “Estate Planning,” *infra*.

\$475,000 in basis or an opportunity for another \$4.75 million exclusion in accordance with the 10 times basis calculation because the \$10 million has essentially been used.

As with most tax strategies, if multiple sale transactions are anticipated, be sure each is independent to prevent potential step-transaction doctrine implications. Also, while this option may be an important component of careful tax planning, buyer preferences mean it's not always possible, and this plan is still subject to the risk that the value of the stock could go down between sales and net less to the taxpayer. The value of shares in multiple transactions may also be lower because of reduced buyer control and the lack of marketability for the seller's retained shares.

Generally, sellers prefer installment method tax treatment to spread out the tax due each year and help match cash flow because many sales have a multiyear payment structure. As noted, the amount of potential gain recognition, exclusion, or deferral at the federal and state levels may affect a decision to use the installment method or elect out of this treatment, and whether the sale is subject to section 453A deferred interest charge.

IV. Section 1045 Gain Deferral

Gain deferral under section 1045 might be a good option if the QSBS doesn't qualify for section 1202 exclusion because of the required holding and active business periods or for the exceeding-eligible-exclusion gain. Section 1045 gain deferral requires only a six-month holding and active business period — substantially less than section 1202 general requirements. Upon sale of valid QSBS, long-term capital gain may be deferred in accordance with section 1045 to the extent that proceeds are reinvested into other QSBS within 60 days following the date of sale. The deferred gain not recognized is a downward adjustment to the tax basis of purchased QSBS in the rollover.

Qualifying for section 1045 treatment is similar to meeting section 1202 requirements. Along with the business needing to qualify as QSBS under section 1202(a), section 1045 incorporates by reference section 1202 subsections (f)-(k). These provisions generally include the rules for: stock acquired on conversion of other stock, specific tax-free and other transfers, stock

owned by PTEs, basis rules, and issued section 1202 regulations.

For example, suppose an individual taxpayer sells QSBS for \$2 million, realizing a \$1.5 million gain, after holding the stock for eight months. The taxpayer does not qualify for the section 1202 exclusion because the stock was not held for three to five years. Within 60 days of the sale, the taxpayer reinvests the entire \$2 million in newly issued QSBS of another eligible corporation, and:

- the taxpayer elects code section 1045 gain deferral on its tax return;
- the \$1.5 million gain is not recognized in the year of sale;
- the basis in the new QSBS is reduced by the deferred gain, so the basis in the replacement stock is \$500,000 (\$2 million purchase price minus \$1.5 million deferred gain); and
- if the taxpayer sells the replacement QSBS, the deferred and any additional gain will be recognized unless the proceeds qualify for exclusion or are reinvested into stock that also qualifies for further deferral.

QSBS provides multiple taxpayer-favorable opportunities for effective income and estate tax planning. Taxpayers and advisers should work together to determine the taxpayer's priorities and tailor a plan for their specific circumstances and goals.

V. Estate Planning

Estate planning with QSBS assets often involves transferring QSBS to family members or trusts for their benefit. Under section 1202(h), a gift or bequest of QSBS does not violate the original issuance requirement; the recipient steps into the donor's shoes for both the holding period and acquisition date. This means the donee or trust beneficiary can potentially benefit from the QSBS exclusion, provided all other requirements are met. Outright gifts of QSBS and transfers to non-grantor trusts are generally effective ways to multiply the QSBS exclusion because each unmarried individual and non-grantor trust is treated as a separate taxpayer.

Incorporating potential section 1202 gain exclusion and section 1045 gain deferral into an estate and gift tax plan may provide significant

tax savings. This planning should incorporate several considerations, including:

- the value of the section 1202 stock;
- the shareholder's basis in the section 1202 stock;
- the shareholder's family structure and dynamics;
- the shareholder's charitable intent;
- the shareholder's preference to use non-grantor trusts, grantor trusts, or gifting outright;
- the shareholder's applicable section 1202 gain exclusion percentage;
- the shareholder's overall estate and other assets; and
- the shareholder's health.

Prudent estate planning with business interests is performed independently and ahead of any business sale. Estate planning transfers are documented on grantor gift tax returns that require adequate disclosure with qualified business valuations. Having proper documentation, autonomy in transactions, and adequate disclosure on a timely filed return can start the statute of limitations and potentially contribute to a positive audit outcome and estate plan.²⁷

A. QSBS and Family Investment Entities

Many estate planning strategies use family investment entities — such as family limited partnerships or limited liability companies — to manage family assets and investments, potentially provide a layer of creditor protection, and possibly receive marketability and minority discounts on gifts of interests. This is done by carefully abiding by legal formalities and not retaining a level of control high enough to trigger section 2036 and bring the assets back into the grantor's estate. However, the gifting of family investment entity interests to family members generally prevents the recipient from qualifying for QSBS benefits if the QSBS is transferred into a family investment entity after original issuance. Even so, QSBS purchased by and held in the family investment entity may be deemed original issuance. QSBS treatment may be possible for the

entity owners based on ownership from when QSBS was originally issued until it is sold. This means that the entity would need to be set up and funded with other assets to facilitate the purchase of QSBS by the entity itself to provide the benefit to the flow-through owners at the time the QSBS was issued and until it is sold.²⁸ If the family investment entity ownership changes during the QSBS holding period, that will affect QSBS status for the entity owners. If the entity was not previously established, a transfer of QSBS to a partnership will result in the loss of QSBS status, so care should be taken before transferring any QSBS.

Again, if the taxpayer would like to use an investment entity in conjunction with QSBS, the entity needs to be the recipient of the originally issued QSBS.²⁹ Otherwise, it is usually best for the shares that qualify for gain exclusion to be retained in the shareholder's name until the sale is completed, or to be gifted outright or to a non-grantor trust before and independently of the sale transaction, as explained below, without the additional entity layer.

B. Trusts

Estate planning with trusts is common for QSBS assets because it may remove appreciation from the estate and, depending on trust type and beneficiaries, may create an additional QSBS taxpayer for gain exclusion. Incorporating the use of trusts in succession planning may provide additional tax efficiencies while allowing assets and income to pass, consistent with the grantor's intent, through beneficiary distribution provisions.

When establishing trusts with significant assets, trust situs should be carefully considered because trust law varies greatly among states. While state income taxes may be a significant factor, other factors for state situs selection to consider in long-term planning include allowed trust duration, flexibility with available trust modification and decanting statutes, and creditor protection.

²⁷ Reg. section 301.6501(c)-1.

²⁸ Section 1202(g)(3).

²⁹ Section 1202(g).

There are a couple of primary trust types we will examine that incorporate overlapping benefits with QSBS gain exclusion or deferral. The first is an irrevocable non-grantor trust, which is primarily used to obtain additional section 1202 taxpayer gain exclusions because it is deemed a separate taxpayer from the grantor. The second is a common estate planning trust type: the irrevocable defective grantor trust (IDGT). However, this type is significantly less prevalent with QSBS stock because it is not considered a separate taxpayer for income tax purposes and therefore doesn't receive an additional QSBS taxpayer gain exclusion.

1. Irrevocable non-grantor trusts.

When QSBS is a significant asset of a grantor, and there is a contemplated future sale, irrevocable non-grantor trusts are a beneficial tax strategy because they may qualify for an additional taxpayer QSBS gain exclusion. The value of this has further increased with the OBBBA adjusting the per-taxpayer exclusion from \$10 million to \$15 million for stock issued after July 4, 2025, indexed for inflation annually starting in 2027. Many grantors also like this type of trust because the trust is liable for the income tax for income earned by the trust assets. This reduces the liquidity needs for grantors to pay income taxes.

Gifts of QSBS to an irrevocable trust are generally treated as taxable gifts for federal gift tax purposes. As a result, donors typically seek to limit those gifts to the amount of their available lifetime gift tax exemption to avoid incurring a current gift tax liability. The 2026 federal estate and gift tax exemption is \$15 million per individual, and this amount will be adjusted for inflation starting in 2027. If the value of the QSBS being transferred exceeds the donor's remaining exemption, the donor may want to consider alternative or additional trust structures, such as incomplete gift non-grantor trusts.

Incomplete gift non-grantor trusts are designed so that the transfer to the trust is not treated as a completed gift for federal gift tax purposes, allowing the donor to avoid immediate gift tax even if the value of the assets transferred exceeds the exemption amount. These trusts are often established in states with favorable income tax laws and can provide additional planning

flexibility, but they may be limited in state income tax savings depending on the residence of the grantor (specifically New York and California).

Importantly, for QSBS planning purposes, each trust must have different beneficiaries to be treated as a separate taxpayer and qualify for its own QSBS exclusion. If multiple trusts have substantially identical beneficiaries, the IRS may treat them as a single taxpayer for exclusion purposes. Careful trust design and beneficiary selection are essential to increasing the benefits of QSBS and avoiding unintended tax consequences.

A spouse may be a beneficiary of a non-grantor trust (a spousal lifetime access non-grantor trust) if carefully structured. This helps reduce the uncertainty regarding the definition of taxpayer for married people but doesn't come without its own complexity. To have a spouse as a beneficiary of a non-grantor trust, other beneficiaries must be included to create adverse parties in charge of distributions to the spouse.

Transfers to non-grantor trusts by gift are generally allowed for section 1202 purposes as a separate taxpayer with a carryover basis and holding period tacking.³⁰ Grantor trusts have their own set of benefits, examined below, so an analysis may be done to compare the trust types, along with grantor preferences. Alternatively, a combination of both types of trusts may be possible and valuable in some situations.

2. Irrevocable defective grantor trusts.

IDGTs allow for a variety of flexibility and tax benefits. When structured properly, IDGTs and spousal lifetime access trusts are excluded from the grantor's estate for estate tax purposes, but the trust income is allocated to the grantor. The income tax paid by the grantor is not deemed a gift, so it reduces the grantor's taxable estate while allowing the trust to grow without the encumbrance of income tax. One of the common provisions used in trust drafting to create an IDGT is the grantor's retention of its ability to substitute personal assets with trust assets.³¹ This substitution power provides future income tax strategies because of the ability to substitute the grantor's high-basis assets with low-basis trust

³⁰ Section 1202(h).

³¹ Section 675.

assets. This results in income tax savings by increasing the overall basis step-up on assets in the grantor's estate when they pass.

Many IDGTs also include a provision — depending on the trust's situs and the applicable state law — that grants an independent party the ability to make discretionary tax reimbursements to the grantor for taxes associated with trust income. This allows the grantor the advantages of an IDGT without necessarily having to pay all the income tax on the trust assets every year. However, there should be no prearranged plan of income tax reimbursement to the grantor, and the distributions should vary depending on each year's circumstances.

Another method of providing a cash flow stream to the grantor is to have the grantor sell assets to the trust for a promissory note, usually at the applicable federal rate, without this being a tax recognition event. The note payments may provide resources to the grantor to pay the income tax on trust income. The IDGT should have adequate principal to support the leveraged transaction. Sales to IDGTs that are allocated the generation-skipping transfer tax exemption to all earlier gifts will further compound growth and protect future generations from additional layers of estate tax, gift tax, and GSTT. The GSTT is generally imposed at a flat 40 percent rate, similar, and in addition, to the federal estate tax for nonexempt assets distributed to beneficiaries who are more than one generation below the grantor; or on the value of trust assets when the only remaining beneficiaries are more than one generation below the grantor.³²

Because IDGTs are grantor trusts for income tax purposes, many sections treat the trusts as transparent to the grantor, and not as independent taxpayers for income limitation purposes. For example, IDGTs will not offer the ability to use an additional taxpayer gain exclusion under section 1202 while they are grantor trusts.

Using IDGTs may be beneficial if:

- there is less opportunity for section 1202 based on the anticipated exclusion and gain exclusion percentage, ranging from 50

percent to 100 percent depending on the year of the original issue stock and holding period if issued after July 4, 2025;

- deferred gain under section 1045 will not be extensively used;
- a significant sale transaction in addition to gifting may be advantageous based on the circumstances;
- the grantor is healthy, with considerable remaining life expectancy;
- substantial investments and growth are anticipated after the sale of QSBS; and
- the grantor has the resources to absorb significant amounts of income tax liability from the trust.

Grantors may choose to release the powers that create grantor trust status if they no longer want to pay the income taxes for the IDGT, or if they want to use the trust for QSBS to create a separate taxpayer for income tax purposes. Releasing grantor powers should first be carefully reviewed for tax implications. For example, if there is life insurance on the grantor's life, that may prevent wholly turning off grantor status. If there is still an outstanding promissory note to the grantor, it may create a tax recognition event to the grantor from the sale of the assets to the trust.

While there are many benefits for non-grantor trusts with QSBS, planning opportunities with grantor trusts may still be available depending on the particular facts and grantor objectives. Using both trust types may be possible, especially if some irrevocable trusts have already been well established. For 2026, there is a \$15 million estate, gift, and GST exemption per person, annually adjusted for inflation. With section 1202 limit exclusions at \$10 million per taxpayer (or 10 times basis; \$15 million for stock issued after July 4, 2025, adjusted for inflation beginning 2027), a few non-grantor trusts may be established to use most of the gift exemption for married taxpayers with multiple beneficiaries. As with many strategies, because facts and preferences vary greatly, multiple sophisticated professionals should be involved and tax modeling should be completed to compare outcomes and help the grantor make an informed decision.

Table 3 shows the potential section 1202 QSBS gain exclusion available to different owner types.

³² Sections 2641 and 2612.

Table 3. Section 1202 Treatment for Various Entities

Entity Type	Section 1202 Treatment
Individual shareholder	Spouses together are normally considered one taxpayer; married spouses filing separately may use the greater of \$5 million (or half the applicable annual limit) or 10 times basis
Grantor trust	Is the same taxpayer as the grantor
Non-grantor trust	Each non-grantor trust is its own taxpayer with its own greater of \$10 million (or applicable annual limit) or 10 times basis exclusion
Flow-through business	A taxpayer may qualify if it is an owner in the entity at original issuance of the stock to the entity and maintains the same ownership through the date of the sale of the QSBS

C. Basis Step-Up

Most assets included in a decedent's gross estate receive a basis step-up for income tax purposes that affords another tax planning opportunity. Because assets transferred to the types of trusts mentioned above (created by the taxpayer during their lifetime) are not intended to be included in the taxpayer's estate, those trust assets will not receive a basis step-up at the death of the taxpayer. This is true even if the trust is a grantor trust for income tax purposes. A planning

opportunity for the sale of QSBS may be to have the taxpayer retain QSBS that deferred gain on an earlier sale of QSBS, in accordance with code section 1045, if it has low basis. Then the basis step-up is the value of the QSBS on the taxpayer's date of death. For example, if a taxpayer had a basis of \$100 per share of original QSBS, then rolled over the proceeds from the sale of QSBS when it was valued at \$1,000 into new QSBS, no gain is recognized if the rollover qualifies for section 1045 gain deferral, but the basis of the new QSBS is still \$100. If the value of the new QSBS is \$1,200 when the taxpayer dies, that is the new tax basis for the QSBS to the beneficiaries. This may result in significant income tax savings on the sale of the QSBS. Gain deferral under section 1045 is normally done for gain exceeding QSBS gain that qualifies for section 1202 exclusion.

VI. Conclusion

There has been increased interest in QSBS because of the potential for 100 percent gain exclusion, reduced C corporation income tax rate, and now the increased exclusion amount along with the potential benefits of shorter holding periods for QSBS issued after July 4, 2025. The income tax benefits of QSBS may be further leveraged with estate planning opportunities to obtain more taxpayer exclusions and asset growth out of a taxable estate. Qualifying for QSBS is very tax favorable but necessitates meeting many technical requirements, sometimes with limited guidance available. This makes working with professionals experienced in this area paramount to a path toward successful tax planning. ■