

A photograph of two women in a modern office environment. The woman on the left, with dark wavy hair and wearing a grey patterned blazer over a black top, is smiling and pointing towards a laptop screen. The woman on the right, with long dark hair and wearing a white blouse with a black collar, is also smiling and looking at the laptop. They are seated at a light-colored wooden table. The background shows a glass-walled office space with a plant and some office equipment.

QUALIFIED SMALL BUSINESS STOCK

Planning for Founders and Early Investors

Many conversations about the qualified small business stock (QSBS) regime begin when a stock sale is already on the horizon. By then, the risk that key eligibility requirements may not have been met, tracked, or documented when it mattered most — at formation, during early rounds of capitalization, or when equity was issued to founders, employees, or investors — may be realized. That's why QSBS is often as much an entity choice and governance discussion as it is a transaction-planning topic.

One foundational requirement of the QSBS rules is that to qualify for QSBS treatment, the stock must be issued by a C corporation and remain C corporation stock for "substantially all" of the shareholder's holding period. For companies weighing entity structures, the possibility of qualifying for QSBS treatment is one factor that could make incorporation as a C corporation more attractive in certain growth profiles.

But simply being a C corporation isn't enough — QSBS treatment depends on how the stock was acquired, who owns it, what the company does, and whether financial limitations or restrictions were satisfied at the time of issuance and over "substantially all" of the shareholder's holding period.



What Stock Qualifies

In general, to qualify as QSBS, stock must have been issued after August 10, 1993, acquired at original issuance by a noncorporate shareholder (often an individual, pass-through entity, or certain trusts), and tied to the active conduct of a qualified trade or business. Moreover, an aggregate gross assets limitation must be satisfied at issuance. For original issuances between August 10, 1993, and July 4, 2025, the issuer's aggregate gross assets could not exceed \$50 million; for original issuances after July 4, 2025 - the date of enactment of the One Big Beautiful Bill Act (OBBBA) - that threshold increased to \$75 million (with inflation adjustments beginning in 2027).

Taxpayers are often surprised not by the existence of these requirements, but by the number of real-world events that can complicate them: capitalization history that is hard to reconstruct, equity that changed hands, contributions of property for stock, or uncertainty about whether the issuer's business activities meet the "qualified trade or business" standard. These issues may not feel urgent during growth stages, but they can become critical when the gain is about to be recognized.



How the Section 1202 Exclusion Works

When stock qualifies as QSBS, Section 1202 permits shareholders to exclude eligible gain on the sale or exchange of the stock, subject to holding period rules and limitation mechanics. Prior to the enactment of the OBBBA, the maximum benefit that could be excluded was the greater of \$10 million or 10 times the taxpayer's basis in the stock (with spouses typically treated as one taxpayer). Post-OBBBA enactment, the per-issuer gain limitation increased to \$15 million, still subject to the 10 times basis limitation.

Importantly, state conformity rules vary; some states do not follow the federal exclusion or do so only partially.

The applicable exclusion percentage and holding period depend largely on when the stock was issued, as summarized in the chart below:

Gain Exclusions for Sale of QSBS

Stock Issued		Exclusion of Eligible Gain	Greater of 10x Basis or	Required Holding Period (Years)
After	Before			
8/10/1993	2/18/2009	50%	\$10M	5
2/18/2009	9/27/2010	75%	\$10M	5
9/27/2010	7/4/2025	100%	\$10M	5
7/4/2025*		50%	\$15M	3
7/4/2025*		75%	\$15M	4
7/4/2025*		100%	\$15M	5

*One Big Beautiful Bill Act, passed on July 4, 2025

Even when the QSBS exclusion is available, it is important to understand what happens to any portion of the gain that remains taxable. For sales qualifying for a 50% or 75% exclusion regime, the taxable portion is subject to a 28% capital gains rate (often described as the collectibles rate) plus the 3.8% net investment income tax.



10x Basis Opportunity

The 10x basis limitation feature of Section 1202 can, in some situations, result in a larger potential exclusion than the fixed-dollar cap.

Because the aggregate gross assets threshold increased to \$75 million for qualifying issuances after July 4, 2025 (with inflation adjustments beginning in 2027), more companies may fall within the range where QSBS is part of the equity story. In that context, the 10x basis concept can be meaningful: with sufficient basis, the potential exclusion ceiling can scale quickly (for example, a \$75 million basis profile could, in theory, support up to a \$750 million ceiling under the 10x framework).

In addition to the other QSBS documentation requirements, the taxpayer will need to have documentation to support the capitalization history, issuance, and ownership records. The practical takeaway is that supporting documentation will determine whether the 10x basis opportunity may be available to the taxpayer.



What Section 1045 May Solve When Timing Is Not Ideal

Additional QSBS planning should be considered in connection with larger sales when recognized gains exceed the taxpayer's exclusion limitation or when a shareholder sells the QSBS stock before meeting the required holding period. In those situations, Section 1045 may offer a path to defer gain if the proceeds are reinvested in other QSBS within the required window. In general, the shareholder must have held the stock for more than six months, the sale must be for cash, and the reinvestment must occur within 60 days.

Section 1045 is often most relevant when timing is out of the taxpayer's control — an early acquisition offer or other liquidity event that occurs before a Section 1202 holding period is satisfied. When QSBS is held indirectly through a partnership, there are flexible options available to effectuate a Section 1045 rollover whether the partner or partnership sold 'relinquished' QSBS, or the partner or partnership acquired new 'replacement' QSBS.



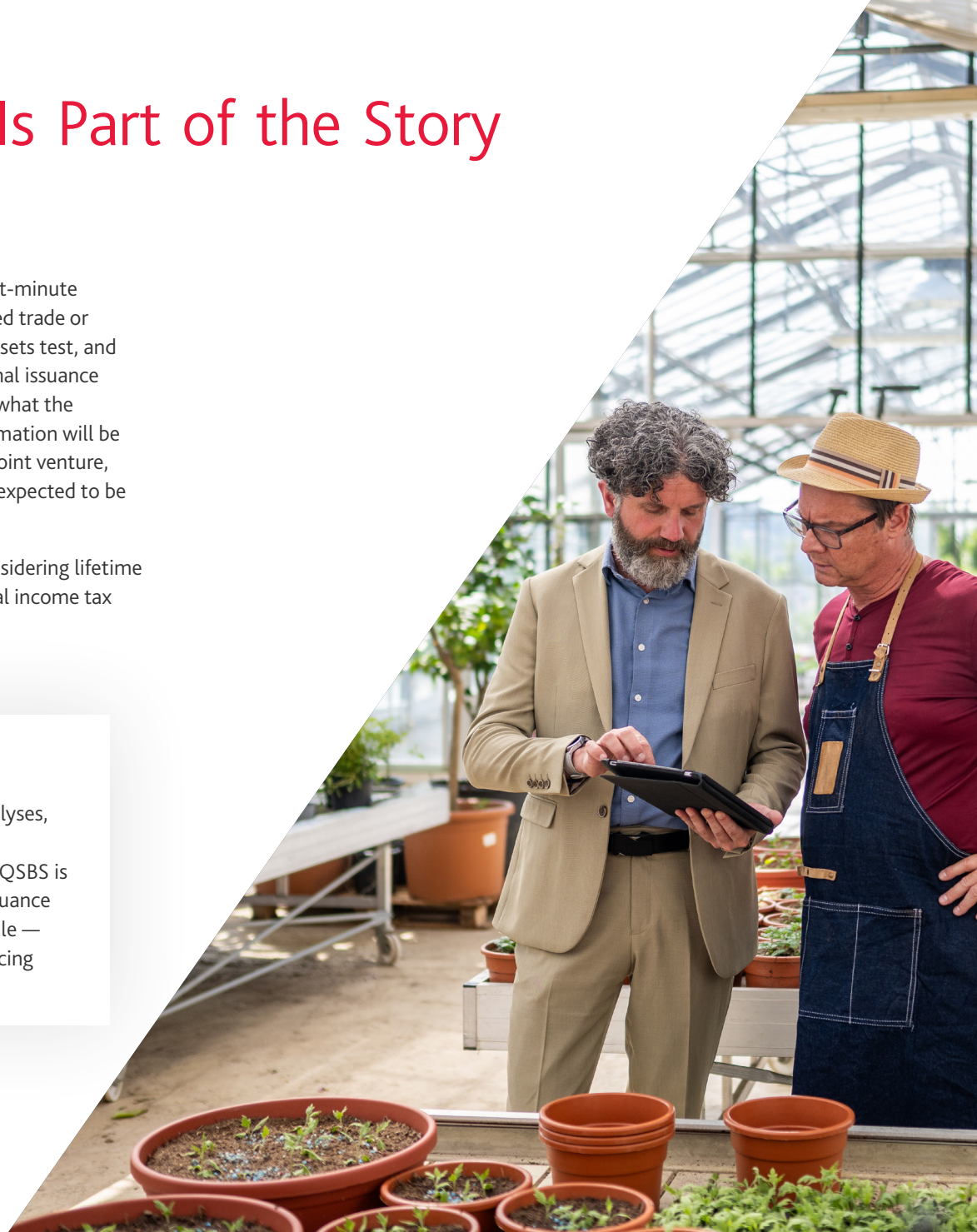
What to Do Now If QSBS Is Part of the Story

The most effective QSBS outcomes tend to be a result of discipline rather than last-minute structuring. That includes confirming whether the business appears to be a qualified trade or business, evaluating financials and capitalization history for the aggregate gross assets test, and verifying the existence of issuance and transfer documents that memorialize original issuance requirements. For investors with direct ownership, it may also include confirming what the issuer has done to substantiate QSBS treatment and how (and where) QSBS information will be reflected in reporting. Investors with indirect ownership through a partnership or joint venture, when Schedule K-1 reporting is involved, should ask how a QSBS potential gain is expected to be reported on the Schedule K-1.

Finally, QSBS frequently intersects with estate planning. For taxpayers already considering lifetime gifts or trust planning, QSBS can change the modeling — both in terms of potential income tax outcomes at exit and wealth transfer goals over time.

HOW BDO CAN HELP

BDO's Private Client Services professionals can assist with QSBS feasibility analyses, investor due diligence, and integrated income and estate tax planning around potential Section 1202 exclusion and tax-deferred rollover strategies. Because QSBS is documentation-driven and highly dependent on facts and circumstances at issuance and over the shareholder's holding period — not just the facts at the time of sale — early evaluation can be key to preserving flexibility, utilizing benefits, and reducing surprises later.





Have questions or want to learn more? Contact us!

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