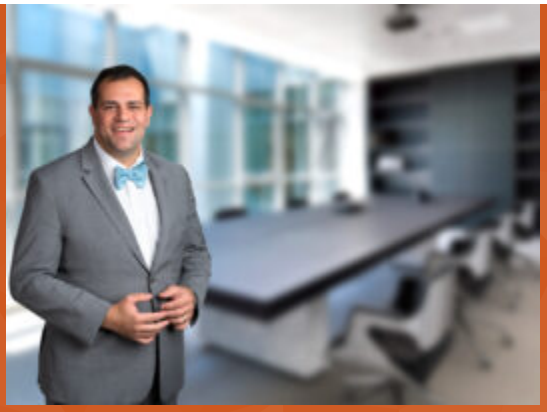
Client Alert: Section 1202 Qualified Small Business Stock

Expanded scope and benefits of QSBS under Public Law 119-21

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On July 4, 2025, President Trump signed Public Law 119-21 (popularly referred to as the "One Big Beautiful Bill Act," but that official short title was removed from the bill during the Senate amendment process) into effect, enacting a broad range of tax and spending policies (for purposes of this Client Alert, we refer to it as the "2025 Tax Act").

While the 2025 Tax Act contains hundreds of provisions, it contains several sweeping U.S. federal tax changes relevant to startup and emerging businesses as well as venture capital and private equity investors, making particularly significant changes to Section 1202 of the Internal Revenue Code of 1986, as amended (the "Code"), enhancing the attractiveness of Qualified Small Business Stock ("QSBS").

Background

QSBS was originally enacted in August 1993 and provided investors a 50% tax exclusion on capital gains (at a time when the capital gains rate was 28%) up to the greater of $10 million or ten times the taxpayer's adjusted basis. In 2009, Congress increased the tax exclusion on QSBS from 50% to 75%. In 2015, the Protecting Americans from Tax Hikes Act permanently increased the QSBS exclusion to 100% for original issuances of stock made after September 27, 2010. While the 2017 Tax Cuts and Jobs Act ("TCJA") made no changes to QSBS, it did reduce the corporate tax rate from 35% to 21%.

While the 2025 Tax Act made significant changes to QSBS, certain general criteria remain unaffected: (1) the issuing corporation must be a domestic C-corporation (or limited liability company that has checked the box to be taxed as a C-corporation);[1] (2) the issuing corporation must be an "active business" in a qualified trade or business for substantially all of the taxpayer's holding period and be a C-corporation when the QSBS is sold;[2] (3) only non-corporate U.S. taxpayers (individuals, trusts, partnerships, LLCs, and S-corporations) are eligible to hold QSBS and where relevant, pass through gain to their owners who can claim the QSBS exclusion;[3] (4) the QSBS must be originally issued to the taxpayer claiming the exclusion in exchange for money, property (other than stock), or as compensation for services provided to the issuing corporation;[4] (5) and the issuing corporation must comply with certain redemption restrictions to maintain QSBS eligibility.[5] Additionally, for QSBS issued prior to July 5, 2025, the taxpayer's holding period for gain exclusion remains five years,[6] the per-taxpayer, per-issuing corporation gain exclusion remains capped at $10 million or ten times the taxpayer's adjusted basis,[7] the cash and tax basis of the issuing corporation's "aggregate gross assets" must have been less than $50 million at the time of the stock issuance.[8]

Changes Under the 2025 Tax Act

Changes to QSBS as a result of the 2025 Tax Act are only effective for stock issued after July 4,

2025; however, the 2025 Tax Act makes three significant changes to Code Section 1202 that present a substantial opportunity making QSBS even more appealing and lucrative for companies and investors alike:

1. **Aggregate Gross Asset Threshold Increased.** Under the 2025 Tax Act, the aggregate amount of cash and tax basis of the issuing corporation's gross assets must be less than $75 million at the time of the stock issuance, representing a $25 million increase. Companies and investors would welcome this increase on its own, but for stock issuances after December 31, 2026, the aggregate gross asset threshold will be indexed for inflation.
2. **Maximum Gain Exclusion Increased.** Under the 2025 Tax Act, the maximum amount of gain eligible for exclusion on a per-taxpayer, per-issuing corporation basis is now equal to the greater of $15 million or ten times the taxpayer's adjusted basis in the QSBS. Similar to the increase in the aggregate gross asset threshold above, while the $5 million gain exclusion increase is welcome in its own right, for stock issuances after December 31, 2026, the $15 million exclusion amount will be indexed for inflation.
3. **Taxpayer Favorable Changes to QSBS Holding Period.** The 2025 Tax Act introduces a tiered gain exclusion mechanism to allow taxpayers to benefit from partial QSBS exclusions, provided that their holding period is at least three years long. Under the 2025 Tax Act, if the taxpayer's holding period is (i) at least three years but less than four, the applicable exclusion is 50%, (ii) at least four years but less than five the applicable exclusion is 75%, and (iii) at least five years, the applicable exclusion is 100%. This is a significant (and welcome) deviation from prior law, that imposed an "all or nothing" 5 year holding period cutoff requirement (disregarding the applicability of Code Section 1045).

The changes to QSBS are significant and are expected to have a substantial positive impact on companies and investors alike. For more information, please contact Joe Hunt.

[1] Code Section 1202(d)(1)

[2] Code Section 1202(e)

[3] Code Section 1202(a)(1)

[4] Code Section 1202(c)(1)(B)

[5] Code Section 1202(c)(3)

[6] Code Section 1202(a)(1)

[7] Code Section 1202(b)(1)

[8] Code Section 1202(d)(1)(A)