Qualified Small Business Stock – New Enhanced Tax Benefits Under IRC §1202

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In our latest client alert, Attorneys Anthony DaSilva and Allen Falke discuss new enhanced tax benefits for Qualified Small Business Stock founders and investors, expanded both in scope and value as the result of July 2025's One Big Beautiful Bill Act (OB3). This alert should be of particular interest to those who are looking to create a new business entity and are weighing the pros and cons of the variety of choices as well as those looking to exit a business.

Overview:

Internal Revenue Code §1202 offers founders and investors the potential to exclude federal capital gains tax on Qualified Small Business Stock (QSBS) upon sale. Recent tax legislation — the One Big Beautiful Bill Act (OB3), signed into law on July 4, 2025 — has materially expanded the scope and value of the QSBS benefit for stock acquired on or after that date.

Key Enhancements Under the OB3

1. *Tiered Holding Period and Partial Exclusion*

Before OB3:

The QSBS gain exclusion generally required the shareholder to hold stock for more than five years to qualify for any exclusion.

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After OB3 (Stock Issued on or After July 4, 2025):

The prior all-or-nothing five-year rule has been replaced with a tiered holding period that provides partial tax benefits sooner:

- ≥ 3 years: 50% exclusion of gain
- ≥ 4 years: 75% exclusion of gain
- ≥ 5 years: 100% exclusion of gain (as under prior law)

This tiered approach reduces the holding period for investors and founders, enabling tax benefits even if an exit occurs before five years.

2. *Increased Per-Issuer Gain Exclusion Cap*

Before OB3:

The per-taxpayer per-issuer exclusion limit was generally the greater of $10 million or 10× the taxpayer's adjusted basis in the QSBS.

After OB3:

For QSBS acquired on or after July 4, 2025, the fixed exclusion cap is increased to $15 million per issuer (indexed for inflation beginning in 2027). The alternative cap based on 10× adjusted basis remains available.

This increase enhances the amount of gain that eligible taxpayers can shelter from federal tax, particularly benefiting individual investors and smaller stakeholders whose gains might otherwise be the lower cap.

3. *Expanded Gross Assets Threshold*

Before OB3:

A corporation had to have $50 million or less in aggregate gross assets to issue QSBS.

After OB3:

For QSBS issued on or after July 4, 2025, the gross asset cap is raised to $75 million, with annual inflation adjustments beginning in 2027.

This change broadens the pool of businesses eligible to issue QSBS, allowing larger (and potentially later-stage) startups to qualify as "small businesses" under §1202.

What Remains the Same

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- Eligible taxpayer requirement: Only non-corporate taxpayers (individuals, trusts, estates, and certain passthrough owners) remain eligible for the exclusion.
- Corporate form requirement: The issuing entity must be a domestic C corporation.
- Must be original issuance stock (directly from a corporation)
- Active business and qualified trade business requirements: The issuer must meet the active trade or business and qualified business tests (i.e., a business other than one involving services, finance or hospitality).
- The alternative 10× basis cap continues alongside the increased per-issuer cap.

Plan B – What if I am Ineligible under §1202?

You may be eligible to benefit under §1045 if you cannot benefit under §1202. Section 1045 permits sellers of QSBS to defer the gain on the sale of stock that is held more than 6 months if the sale proceeds are used to purchase other QSBS. Section 1045 differs from §1202 in that it provides for tax deferral on the gain from the sale of QSBS, not the exclusion from tax on the gain. A shareholder who has not held QSBS for 5 years or who has gain in excess of the limits under §1202 may, therefore, benefit from the tax deferral benefit offer under §1045, and potentially later qualifying for QSBS treatment.

Bottom Line

The One Big Beautiful Bill Act significantly strengthens §1202 for small and emerging company founders and investors by shortening paths to tax benefits, raising exclusion caps, and expanding the number of eligible companies. If shareholders cannot benefit under §1202, consider whether tax deferral is available under §1045.

Please contact us if you would like to discuss the updated law or whether tax deferral on the sale proceeds is available.

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