SWC Business Brief



Qualified Small Business Stock: A Tax-Saving Opportunity for Business Owners and Investors

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INTRODUCTION

Qualified Small Business Stock: A Tax-Saving Opportunity for Business Owners and Investors



At SWC, we know that every tax deduction counts — and that's especially true if you believe in tax planning and not tax reacting.

Suppose you started a company with relatively little capital, built it over several years, benefit from a stellar reputation both on- and off-line, and now have a buyer interested in buying the business.

Now, if the value of your shares in the business has grown substantially, a sale could produce a sizable taxable gain. But your federal tax bill could look very different if those shares qualify as *qualified small business stock* (QSBS).

Section 1202 of the Internal Revenue Code allows eligible shareholders to exclude some or all of the gain from the sale of qualifying stock from federal taxable income, subject to specific requirements and limitations. And recent changes expanded those benefits for stock acquired after July 4, 2025, including potential exclusions after shorter holding periods.

For someone forming or investing in a growing company, those rules can influence decisions being made long before anyone talks about selling or acquiring the business. The choice of business entity, the timing of a stock issuance, changes in ownership, and even the company's growth, can affect whether a future sale qualifies for favorable QSBS treatment.

In this SWC Business Brief, we cover what you need to know to take advantage of the benefits offered by the Internal Revenue Code (IRC), starting with how an ownership stake qualifies as qualified small business stock.

How Does Stock Qualify as QSBS?

Qualified small business stock (QSBS) treatment starts with the company that issues the shares. Generally, the company must operate as a domestic C corporation, and the shareholder must acquire the stock at original issuance in exchange for money, certain property, or services. The person claiming the exclusion must also qualify as a noncorporate taxpayer.

> **Timing Matters:** The size of the company at the time it issues the stock plays an important role. For stock issued on or before July 4, 2025, the corporation generally must have aggregate gross assets of $50 million or less before and immediately after the stock issuance. For stock issued after July 4, 2025, the limit rises to $75 million.



The higher threshold could matter to a growing company considering whether and when to issue shares. A business that falls below the limit today could grow beyond it later, potentially changing the QSBS analysis for future stock issuances.

The corporation's activities also have to qualify. During substantially all of the shareholder's holding period, at least 80 percent of the corporation's assets, measured by value, generally must support the active conduct of one or more qualified trades or businesses.

Section 1202 of the IRC excludes certain types of businesses. Among them are:

- Banking
- Insurance
- Financing
- Investing
- Farming
- Hotels
- Motels
- Restaurants
- Certain professional service businesses

As a result, incorporating a business and staying below the asset threshold won't, by themselves, make its shares QSBS.

New Rules Reward Longer Holding Periods

Timing has always played a major role in QSBS planning. Recent changes give shareholders who acquire qualifying stock after July 4, 2025, more flexibility.

Stock acquired before July 4, 2025, generally requires a holding period of more than five (5) years before a shareholder can claim the QSBS gain exclusion. Stock acquired after that date follows a tiered schedule:

Holding Period	Potential Gain Exclusion
At least 3 years	**50%**
At least 4 years	**75%**
At least 5 years	**100%**

Let's say you're a company founder who receives qualifying shares in a new C corporation in 2026. An unexpected acquisition offer arrives four years later. Under the newer rules, you may qualify for a 75 percent exclusion of eligible gain rather than having to reach the five-year mark before receiving any QSBS exclusion.

The amount that can be excluded remains subject to limits.

- For stock issued on or before July 4, 2025, the applicable per-issuer dollar limitation generally starts at $10 million.
- For stock issued after July 4, 2025, that figure increases to $15 million.

- An alternative limitation based on 10 times the taxpayer's adjusted basis in the QSBS sold during the tax year may apply instead.

A sale before the applicable QSBS holding period has another potential planning route. Under Section 1045 of the IRC, a noncorporate taxpayer who has held QSBS for more than six (6) months may, in certain circumstances, defer gain by purchasing replacement QSBS within 60 days and making the required election.

What If a Partnership or S Corporation Owns the Shares?

Business ownership rarely stays as simple as one founder holding one block of stock. Investors come in, and when that happens, ownership percentages change. Some investments sit inside partnerships, LLCs, or S corporations. Those arrangements can complicate QSBS treatment.

A partnership, including an LLC taxed as a partnership, or an S corporation can hold QSBS and potentially pass the tax benefit through to eligible noncorporate owners. However, timing matters.

An owner generally needs to hold an interest in the pass-through entity when that entity acquires the QSBS and continue holding that interest through the sale. Someone who joins the partnership after it acquired the stock generally cannot expect to share fully in the QSBS exclusion associated with that earlier investment.

Changes in ownership percentages require attention as well. An owner's potential exclusion generally depends on that person's proportionate interest when the pass-through entity acquired the QSBS. Buying a larger stake later doesn't necessarily increase the amount of QSBS gain that owner may exclude.

For an S corporation, maintaining its S election throughout the QSBS holding period also matters. Losing that status while the S corporation owns the shares could jeopardize the shareholders' ability to claim the exclusion when the stock is sold.

These rules make ownership changes worth reviewing before the documents are signed, especially when the business entity already holds stock that may qualify for QSBS treatment.

A Transfer Today Can Affect a Sale Years From Now

The original-issuance requirement creates another potential trouble spot. Buying shares directly from an existing shareholder generally doesn't satisfy that requirement, although Section 1202 provides exceptions for certain transfers. These include gifts and transfers at death, as well as qualifying distributions from a partnership to a partner.

Other transactions carry more uncertainty. For example, an individual who already owns QSBS may consider contributing those shares to a partnership or S corporation as part of a restructuring. That transfer can create substantial risk to the original-issuance requirement.

Similar concerns arise when someone gives away an interest in a partnership or S corporation that already owns QSBS. The recipient generally shouldn't assume that receiving an interest in the entity also transfers the existing owners' ability to exclude gain associated with stock the entity acquired earlier.

Succession Planning: For business owners contemplating succession planning, bringing family members into the business, admitting new investors, or reorganizing ownership, the qualified small business stock consequences deserve attention alongside the business terms of the transaction. If this is something you're considering, consult with a CPA or tax planning partner who has broad expertise in business succession and estate planning.



Starting as an LLC? The Timing of a C Corporation Conversion May Matter

Many businesses begin life as partnerships or LLCs taxed as partnerships. But here's the thing: Ownership interest in a partnership *doesn't* qualify as qualified small business stock (QSBS). However, a later conversion to a C corporation may result in newly issued corporate stock that can potentially qualify.

This creates a practical timing issue for a business whose owners think a sale could eventually become part of the plan.

The QSBS holding period generally begins when the corporate stock is issued. Years spent owning the partnership interest apparently don't count toward that holding period. A founder who operates an LLC for four (4) years and then converts it to a C corporation shouldn't assume those first four (4) years count toward the QSBS holding requirement.

The corporation also needs to satisfy the applicable *aggregate-gross-assets* test when the shares are issued. A company that waits until after substantial growth to consider a conversion may find that it has already exceeded the applicable threshold.

Understanding The Aggregate-Gross-Assets Test: For QSBS purposes, this test looks at the value of what the corporation owns when the stock is issued. It generally includes the company's cash, plus the tax basis of its other property. If property was contributed to the corporation, that property is generally counted at its fair market value at the time it was contributed. The corporation must stay within the applicable asset limit before the stock is issued and immediately afterward, including any cash or property it receives in exchange for the new shares.



Several transaction structures may accomplish a partnership-to-corporation conversion, and the tax treatment depends on how the transaction is carried out. That makes the conversion itself something to plan for rather than a box to check after deciding to incorporate.

Put QSBS on the Agenda Before There's a Buyer

You don't need to know today whether your company will eventually sell for $5 million, $50 million, $500 million, or never sell at all. But certain decisions made along the way can preserve or narrow the possibility of using the qualified small business stock (QSBS) exclusion later.

If you're forming a company, converting an LLC or partnership to a C corporation, issuing shares to new investors, changing ownership, or considering a transfer of stock, reviewing QSBS with your CPA or tax planning partner at that point can reveal consequences that may be difficult to address years later.

Our team here at SWC can review your ownership and entity structure to see how the QSBS requirements may apply. We can also help you spot issues that may affect the tax treatment of a future sale before you complete a transaction or make the structure harder to change.

If you're considering a decision today that could affect a future sale, contact us to discuss it before moving forward: (858) 487-4580 | admin@swc.cpa

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