

BIGGER BENEFITS FOR (BIGGER) SMALL BUSINESSES: Q.S.B.S. CHANGES IN O.B.B.B.

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INTRODUCTION

Among the slew of changes in tax law from the One Big Beautiful Bill (“O.B.B.B.”) are increased benefits to taxpayers who own “Qualified Small Business Stock” (“Q.S.B.S.”).

The Q.S.B.S. regime was created by the Revenue Reconciliation Act of 1993. The goal was to assist start-ups by incentivizing entrepreneurs and investors to invest sweat or money in small businesses and start-ups. The House Ways & Means Committee at the time explained the purpose of the Q.S.B.S. as follows:

The committee believes that targeted relief for investors who risk their funds in new ventures, small businesses, and specialized small business investment companies, will encourage investments in these enterprises. This should encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing.¹

The Q.S.B.S. rules broadly allow for tax-free sales of Q.S.B.S., up to a certain limit. The benefit is subject to meeting several requirements, among which is a requirement for a five-year holding period by the seller.

PRINCIPAL REVISIONS

The O.B.B.B. makes the following changes, which apply to stock acquired after July 4, 2025, the date on which the O.B.B.B. was enacted into law:

- The limit on the amount of gain that can be excluded in a given year is now the greater of (i) \$15 million, adjusted for inflation and (ii) 10 times the adjusted basis of all Q.S.B.S. from the same issuer sold in that year. Previously, the \$15 million limit was \$10 million with no inflation adjustments.
- The holding-period requirement is softened by allowing partial exclusions of 50% of gain and 75% of gain for holding periods of three years and four years, respectively.
- To be a small business eligible to issue Q.S.B.S., a company’s gross assets used in its trade or business cannot exceed \$75 million, an increase from \$50 million.

¹ H.R. Rep. No. 103-111 (1993).

PRIOR RULES AMENDED

Code §1202 lays out the requirements for and benefits of Q.S.B.S. As in effect through July 4, 2025, 100% of the gain from the sale of Q.S.B.S. stock could be excluded from taxable income if the seller held the Q.S.B.S. for more than five years.² The amount of gain that was excluded was limited to the greater of (i) \$10 million or (ii) 10 times the aggregate adjusted bases of all Q.S.B.S. issued by a particular corporation and sold by the seller during the taxable year.³ For stock issued as of the effective date of the amendment, the \$10 million cap is \$15 million, adjusted for inflation.

Stock was required to meet the following conditions in order to qualify as Q.S.B.S.:⁴

- The stock was required to be issued by a “qualified small business.” No change was made to this requirement.
- The stock was required to be acquired at its original issuance.⁵ An exception existed for stock acquired by gift. The transferee was treated as having acquired the stock in the same manner as the transferor (piggybacking on the transferor’s acquisition at “original issuance”) and having held the stock for the period the transferor held the stock (piggybacking on the transferor’s holding period in getting to the required holding period of three, four or five years). No change was made to this requirement.

Because the per-issuer limitation on gain exclusion applied to each “taxpayer,” in cases where the \$10 million limit (for stock issued on or before July 4, 2025) or \$15 million limit (for stock issued after July 4, 2025) applies, making an eligible transfer “by gift” to another taxpayer, such as an adult child or a trust treated as a separate taxpayer, has the effect of multiplying the potential overall gain exclusion.

- The stock was acquired (i) for money or other property besides stock or (ii) as compensation for services provided to the issuing corporation. No change was made to this requirement.
- The issuing corporation must be involved be an active business, as defined. No change was made to this requirement.
- The issuing corporation must be a taxable C-corporation, not an S-corporation, a quasi-flow through predecessor of an L.L.C. No change was made to this requirement.

QUALIFIED SMALL BUSINESS

To be a qualified small business, a corporation must meet the following requirements:⁶

² Code §§1202(a)(1), 1202(a)(4)(A).

³ Code §1202(b)(1).

⁴ Code §1202(c).

⁵ Certain redemptions can cause a violation of this requirement.

⁶ Code §1202(d)(1).

- The corporation must be a domestic C corporation.
- At all times from August 10, 1993 (when the Revenue Reconciliation Act was enacted) to immediately after the issuance of the Q.S.B.S. in question, the “aggregate gross assets” of the corporation never exceed \$50 million. The cap on gross assets used in its trade or business is \$75 million.
- The corporation agrees to submit reports to the I.R.S. and to its shareholders as the Treasury may require.

The following rules apply for measuring aggregate gross assets:

- The amount of “aggregate gross assets” is equal to the amount of cash and the aggregate adjusted bases of other property held by the corporation.⁷
- Property contributed by a shareholder to the corporation is treated as having a basis equal to its fair market value at the time of contribution.⁸
- The amount of aggregate gross assets immediately after the issuance is determined by taking into account amounts received in the issuance.⁹
- Corporations that are part of the same parent-subsidary group (greater-than-50% common ownership measured by vote or value) are treated as one corporation.
- In measuring greater-than-50% ownership, options are treated as stock, and stock owned by (i) partnerships or (ii) estates or trusts are attributed to partners or beneficiaries.¹⁰

ACTIVE BUSINESS

To meet this requirement, the corporation must meet the following tests:¹¹

- It must use at least 80% of its assets in the active conduct of one or more qualified trades or businesses. For this purpose, assets are measured by fair market value, with a look-through rule interests in greater-than-50% subsidiaries.
- It must not be a current or former D.I.S.C., R.I.C., R.E.I.T., R.E.M.I.C., or cooperative.

A trade or business that is a “qualified trade or business” generally means any trade or business other than the following businesses:

- Businesses that provide services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, and any trade or business where the principal asset is the reputation or skill of its employees

⁷ Code §1202(d)(2)(A).

⁸ Code §1202(d)(2)(B).

⁹ Code §1202(d)(1)(B).

¹⁰ Code §1563(d)(1).

¹¹ Code §1202(e)(1).

- Banking, insurance, financing, leasing, investing, or similar businesses
- Certain businesses involved in mining, oil or gas wells, and similar fields.
- Hotels, motels, restaurants, or similar businesses

There is relatively little guidance on businesses that are considered to be qualified. The tax laws permit certain start-up and research and development activities to qualify as being used in an active business. The active business requirement will not be satisfied if either (i) real estate not used in an active trade or business or (ii) stock or securities in non-subsidiary corporations exceed 10% of the total value of the corporation's assets. An active trade or business does not include (a) ownership of real estate, (b) dealing in real estate, or (c) renting real estate.

CONCLUSION

The O.B.B. changes make the Q.S.B.S. rules significantly more taxpayer-friendly by allowing for more gain exclusion, bigger businesses to qualify as qualified small businesses, and partial exclusions for holding periods shorter than five years.

