WHAT SMALL BUSINESS STOCK QUALIFIES FOR PREFERENTIAL CAPITAL GAINS TAX TREATMENT?

The Internal Revenue Code provides special preferential capital gains tax treatment to eligible shareholders of a qualifying small business upon sale or exchange of their stock in the business ("Qualified Small Business Stock" or "QSBS"). Essentially, significant appreciation may be excluded from capital gains tax upon a sale or exchange of stock that qualifies as QSBS.

The rules defining what stock qualifies for this special treatment are complex and focus on the following:

- The structure of the entity (must be a domestic C Corporation or LLC that is treated as a C Corporation for income tax purposes);
- The nature of the business (must be engaged in a qualifying active trade or business and have less than a set maximum threshold of gross assets at the time the stock is issued); and
- The ownership structure of the shares (the shareholder must have acquired the stock directly from the issuing company - or by gift or inheritance from the original acquirer - and meet certain holding period requirements). The 2025 Tax Act changed several of the qualification rules for the business and the shareholders as follows:
- The maximum permissible gross asset value of the Qualified Small Business at the time of the original issuance of the stock was increased from $50,000,000 to $75,000,000.
- The mandatory 5-year holding period for stock issued prior to July 4, 2025 was changed for stock issued after that date. The new law provides for tiered holding periods with corresponding increases in the percentage of gain excluded from capital gains tax: 3 years for 50%, 4 years for 75% and 5 years for 100%.
- The aggregate amount of gain that can be excluded per taxpayer was increased from the greater of (a) $10,000,000 or 10 times the taxpayer's basis in the stock to (b) $15,000,000 or 10 times the taxpayer's basis in the stock.

While the changes to Internal Revenue Code Section 1202 have increased the number of taxpayers who are eligible for special capital gains tax treatment on the disposition of their QSBS, the limitations on the amount of gain that can be excluded per taxpayer continue to pose a problem for taxpayers who wish to sell all or a large portion of their QSBS. One solution to this problem is a technique referred to as "QSBS stacking," the goal of which is to spread the capital gain among multiple taxpayers each of which have their own capital gain exclusion thereby benefiting from multiple capital gain exclusions.

In order to take advantage of this QSBS stacking technique, the original owner of the QSBS can gift the stock to family members and certain types of irrevocable trusts, referred to as "nongrantor trusts," which are treated as separate income taxpayers. The goal is that upon sale of the stock by the separate income taxpayers, each taxpayer could claim the full exclusion from capital gains tax.

While QSBS stacking can be a very useful technique for reducing capital gains tax, it is not without risk. The anti-abuse rules of Internal Revenue Code Section 643(f) target the use of multiple trusts with similar grantors and similar beneficiaries which have the principal purpose of avoiding federal income tax. As such, it is very important to analyze whether each potential recipient would violate these rules as there are both civil and criminal penalties

for violations.