OBBBA Reforms: Making Gains with Your Qualified Small Business Stock

By Suzanne Thau, Esq.[1]

Suzanne Thau discusses the One Big Beautiful Bill Act's (OBBBA) changes to Internal Revenue Code section 1202 that will allow more individuals to claim capital gain exclusion benefits.

Among the many changes ushered in by the One Big Beautiful Bill Act (OBBBA), few are as significant as those made to the qualified small business stock ("QSBS") regime set forth in section 1202 of the Internal Revenue Code (the "Code").

Section 1202 of the Code was originally enacted in 1993 as a means of stimulating investment in early-stage businesses by providing non-corporate taxpayers (such as individuals and trusts) with a capital gains exclusion when they eventually sold the stock of entities organized as C corporations that they had initially acquired directly from the issuer. Throughout the years, legislators have amended this Code section in an effort to stimulate the economy and promote small business growth, with great gains recently made in this regard in the technology sector.

Key OBBBA Changes to QSBS Regime

The latest changes made by OBBBA, which apply to stock acquired after July 4, 2025, seek to extend these benefits to more companies and industries generally.

First, OBBBA raises the asset limit for an entity to qualify as a qualified small business ("QSB") from \$50 million to \$75 million, meaning many more corporations can extend QSBS income tax benefits to their shareholders. The section 1202 benefit, coupled with the 2017 reduction in the corporate income tax rate and the deductibility of fringe benefits, makes the corporate structure more appealing than ever, particularly to serial entrepreneurs who will likely seek an exit strategy.

Second, OBBBA introduces a tiered gain exclusion based on the length of the taxpayer's holding period. Assuming the taxpayer acquired the stock after July 4, 2025, a phased approach to gain exclusion applies, with the taxpayer entitled to 50% capital gain exclusion for a 3 year holding period, 75% capital gain exclusion for a 4 year holding period, and 100% capital gain exclusion for a holding period of 5 or more years.

Third, OBBBA increases the per-issuer, per-taxpayer limitation on the permissible capital gain exclusion to the greater of (i) the cumulative limitation of \$15 million (up from \$10 million pre-OBBBA) and (ii) the so-called annual limitation of ten times the taxpayer's basis, indexed for inflation starting in 2027. QSBS stock acquired before July 4, 2025 is subject to the pre-OBBBA requirements (namely, the five-year holding period, \$10 million cumulative limitation and \$50 million gross asset limit), with the acquisition date determined on a lot by lot basis.

Individual Estate and Income Tax Planning in Light of OBBBA

Future of "Stacking"

Given the significant advantages of the QSBS designation and the resulting income tax benefits, practitioners have long focused on strategies designed to allow individual taxpayers to take advantage of multiple QSBS exclusions with respect to the same QSBS stock. An individual QSBS owner can claim at least one $15 million cumulative exclusion upon sale, but this may not be sufficient to fully insulate him or her from capital gain exposure. Through the use of a non-grantor trust, which is treated as a separate entity from the taxpayer for income tax purposes, that same taxpayer may be able to claim two or more $15 million capital gain exclusions, potentially eliminating the capital gain exposure entirely. This strategy has been used successfully by early entrepreneurs in the tech industry, including those involved with Roblox, Uber, Airbnb, and Zoom.

The question that practitioners grapple with is: How many trusts, and resulting capital gain exclusions, are too many? This was a gray area before OBBBA and remains so. Although section 1202 is highly technical and complex, there are no accompanying Treasury Regulations. Instead, practitioners have to rely on limited IRS guidance and section 643(f) of the Code, an anti-abuse rule which provides that multiple trusts will be treated as one single trust for tax purposes if they have the same trust creators and the same beneficiaries and were created for the principal purpose of tax avoidance. Some enterprising practitioners have suggested that OBBBA's lack of an explicit limit on stacking, given the considerable attention devoted to this topic prior to its passage, is a tacit approval of the practice. Practitioners taking this aggressive approach propose the formation of multiple non-grantor trusts, each for a different and distinct beneficiary (clearly avoiding a literal reading of IRC 643(f)). For example, the trust creator or "grantor" could create a separate trust for each of his or her then living children and grandchildren. If the client has an appetite for risk, he or she could consider the addition of a single pot or collective trust for the benefit of all of the beneficiaries. A more conservative approach is for an individual client to claim one QSBS exclusion in his or her own right and then form one non-grantor trust to claim one additional QSBS exclusion.

To this point, this Article has only contemplated basic non-grantor trusts, which essentially allow for discretionary distributions to be made to a child or other relative of the taxpayer over that beneficiary's lifetime.

Additional income tax benefits, such as the complete avoidance of state income tax in certain jurisdictions, can be achieved through the formation of specialized non-grantor trusts known as incomplete non grantor trusts or INGs (commonly known as a DING when formed in Delaware or a NING when formed in Nevada) to hold QSBS stock. While New York amended its tax law in an attempt to close this loophole, its treatment is still unclear. The interaction of charitable remainder trusts, which are classified as income tax exempt entities but still can carry out taxable income to non-charitable beneficiaries when distributions are made to them, with the QSBS rules also remains unclear.

As more individuals and trusts liquidate their QSBS holdings over the next three years and seek to take advantage of the QSBS benefits, the limits of this capital gains exclusion may be tested and the IRS may be forced to offer more practical guidance as to just how many non-grantor trusts really are "too many."

Income Tax Reporting

Another issue left unresolved by OBBBA is whether a married couple filing jointly can claim two QSBS capital gain exclusions. The language of Code section 1202 is ambiguous, stating clearly that, in the case of a married couple filing separately, each spouse is entitled to half of the stated cumulative exclusion. By implication, when a married couple files jointly, each spouse should be entitled to a full QSBS capital gains exclusion, but the later text of section 1202 refers to a married couple sharing one exclusion.

Again, this was a hotly debated topic prior to OBBBA and is still not addressed. All practitioners agree that spouses should own QSBS stock separately and spouses should make transfers between each other as soon as possible to accomplish this result. Some tax practitioners, when filing an income tax return for a married couple filing jointly, will claim two QSBS exclusions, arguing that a reasonable basis exists for this position and offering full disclosure of the position to the IRS.

Given the continuing ambiguity in this area, a prudent approach is for spouses to immediately split their QSBS holdings and adopt a wait and see approach. Spouses can hold the QSBS stock separately and start the minimum three year runway for QSBS benefits, and in the meantime additional guidance on this issue may finally come to light.

Corporate Tax Strategy in Light of OBBBA

To this point, we have focused on the recipient of QSBS stock. However, OBBBA's changes to Section 1202 will have implications for capital raising and exit strategies in the corporate context as well. At the most basic level, given the enhanced $75 million gross asset limitation, more corporations will fall within the QSBS rules and existing corporations can raise additional equity before hitting the limitation. In raising equity, these corporations have to continue to be wary of "significant redemption" rules that can taint new issuances.

In conclusion, OBBBA made potentially far reaching changes to the QSBS regime, and only time will tell how these legislative changes will impact taxpayer behavior and future economic growth.

Endnotes

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