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Section 1202 – Enhanced Opportunities in Increased Exclusions and Caps

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Prior to the One Big Beautiful Bill Act signed by President Trump on July 4, 2025 (the "OBBBA") , Section 1202 provided that non-corporate taxpayers that acquired qualified small business stock after August 10, 1993 ("QSBS") could sell the stock after a 5-year holding period and exclude a certain amount of gain from gross income, provided that such stock and its issuance meet a number of requirements. The OBBBA retains most of the existing rules under Section 1202, but makes several key changes with respect to QSBS acquired after July 4, 2025 (the date of enactment of the OBBBA).

Under the new OBBBA rules, a phased-in increase in the exclusion enables a qualified QSBS stockholder to exclude gain starting after a 3-year holding period, determined based on how long the QSBS is held - for QSBS held for at least 3 years, 50% of the gain is excluded; for QSBS held for at least 4 years, 75% of the gain is excluded; and for QSBS held for 5 years or more, 100% of the gain is excluded. The exclusions are, however, subject to limitations. The per-issuer limitation is now the greater of: (a) $15 million indexed for inflation (up from a fixed $10 million under the prior rules); and (b) 10 times the basis (no change from the prior rules).

> *Observations: The prior Section 1202 rules required a greater than 5-year holding period before any gain could be excluded. The new 3-year and 4-year holding period tiers should enable more exits before the 5-year mark, as there is now at least some gain exclusion (50% and 75%, respectively) that could be available in those cases. The 3-year minimum holding period is more suitable to the current M&A environment where holding periods for investors are often less than 5 years.*

Both the increase in the limitation from $10 million to $15 million and the new inflation adjustments should obviously benefit qualifying stockholders who wish to sell their QSBS. Again, this increased tax incentive should encourage more exits and increase M&A activity.

In addition, with respect to stock issued after July 4, 2025, a "qualified small business" is now defined as a C corporation whose aggregate gross assets do not exceed $75 million indexed for inflation (up from a fixed $50 million under the prior rules) before and after the relevant stock issuance.

Observations: The increase to $75 million with an inflation adjustment modernizes Section 1202 and now permits it to remain current. The prior threshold of $50 million was based on 1993 legislation and was not increased until the OBBBA.

Keep in mind that the term aggregate gross assets generally means the amount of cash plus the adjusted basis of other property held by the corporation. By anchoring the definition to the adjusted basis, corporations with highly appreciated property whose fair market value may exceed the thresholds may nevertheless still qualify as a qualified small business if the adjusted basis is sufficiently low. While the basis of directly acquired property is generally the cost, contributed property generally takes a basis equal to fair market value on the contribution date.

The use of C corporations with the intention of qualifying for the QSBS benefits skyrocketed after the 2017 Tax Cuts and Jobs Act mainly due to the reduction of the corporate income tax rate to a flat 21%. The OBBBA does not change the 21% corporate tax rate, and the Section 199A 20% QBI deduction provision (also first part of the 2017 Tax Cuts and Jobs Act) is now made permanent. As a result, choice of entity decisions should still be based on a review of relative income tax rates, the potential incidence of double taxation for C corporations, and expected exit structures for business owners.

As noted above, there are a number of other requirements surrounding QSBS which need to be considered at the time of the issuance of the stock as well as at conception of the business model of the corporation. For these reasons, it is important to have QSBS-specific counsel involved at the outset of an entity's lifecycle.

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