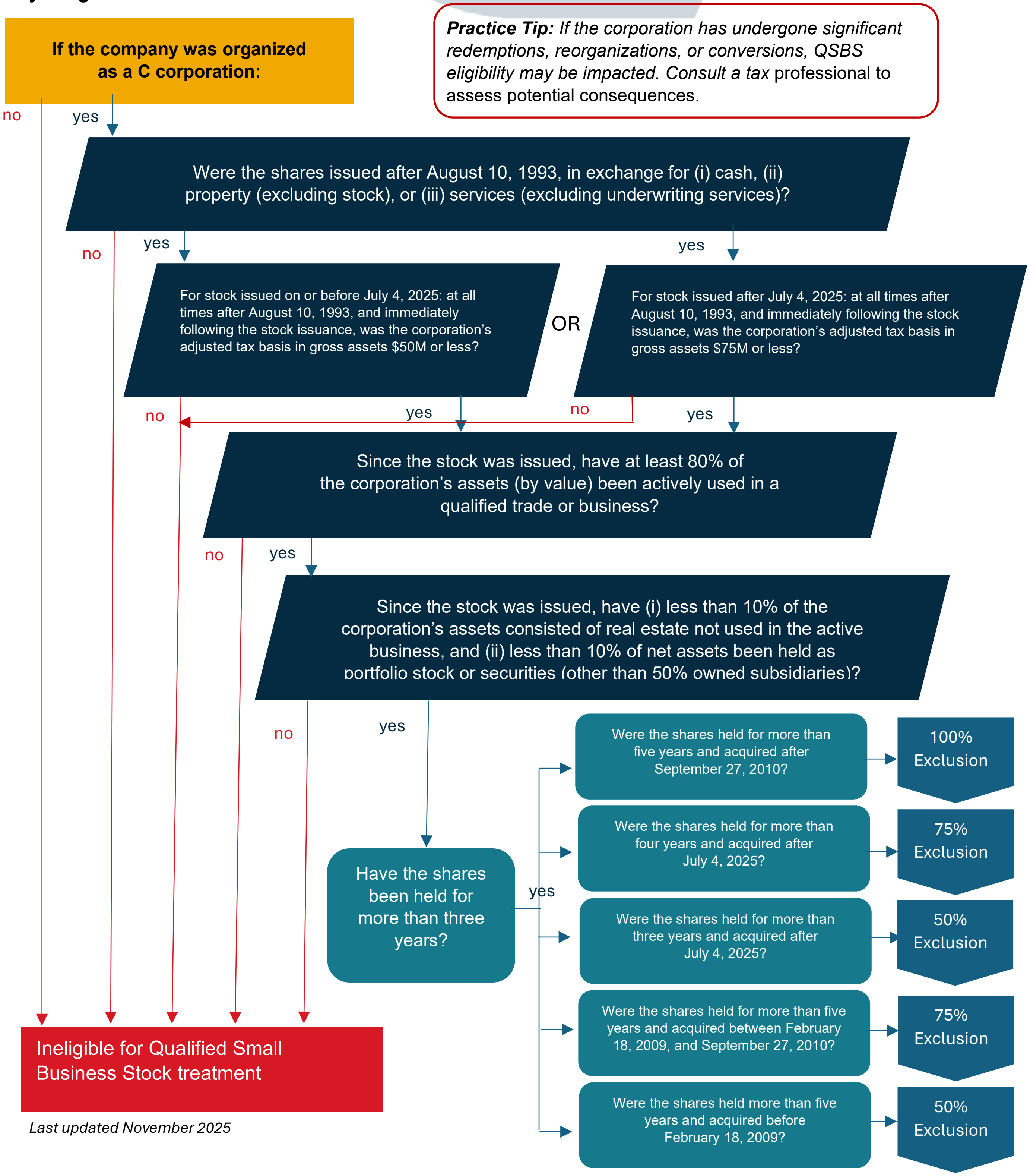
QUALIFIED SMALL BUSINESS STOCK: WHAT YOU NEED TO KNOW

At Thompson Hine, our New Ventures practice provides strategic counsel in advising technology-based and high-growth businesses across various sectors, including clean technology, healthcare, information technology, life sciences, media, and medical devices. We understand the importance of leveraging tax incentives like Qualified Small Business Stock (QSBS) to support your growth and success.



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To qualify for QSBS benefits under Section 1202, a company must meet specific criteria, and shareholders may be eligible for substantial tax exclusions on capital gains.

Key QSBS Requirements

- **Entity Type:** The company must be a C corporation. Certain entities—including REITs, RICs, REMICs, DISCs, cooperatives, and pass-through entities like S corporations—do not qualify. (1202(c)(1), 1202(e)(4))
- **Gross Assets Limitation:** The corporation's adjusted tax basis in gross assets MUST NOT exceed (a) $50M at any time after August 10, 1993, and at all times through the date of the stock issuance for stock issued on or before July 4, 2025, or (b) $75M at any time after August 10, 1993, and at all times through the date of issuance for stock issued after July 4, 2025. (1202(d)(1)(A))
  - This limit is measured immediately after stock issuance, meaning it includes any capital contributed in exchange for shares. (1202(d)(1)(B))
  - When calculating the asset threshold, the fair market value of contributed assets is considered rather than the adjusted tax basis. (1202(d)(2)(B))
  - The $75M was intended to be adjusted for inflation, however, due to a typo in the code, is not. Congress may correct this typo in future legislation.

Qualified Trade or Business

The company must actively conduct a qualified trade or business, which *excludes*:

- Service-based professions such as: Health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services.
- Businesses where the primary asset is employee reputation or skill.
- Banking, financing, insurance, leasing, and investing businesses.
- Farming, agriculture, mining, drilling, and extraction industries.
- Hotels, motels, restaurants, and hospitality services. (1202(e)(3))

Active Business Requirement

- Under the active business test, a parent corporation "looks through" its subsidiaries and includes a proportional share of their business assets and activities in the evaluation. 1202(e)(5)(A).
- A parent corporation must own more than 50% of the combined voting power of all voting stock or more than 50% of the total stock value. 1202(e)(5)(C). Ownership below 50% is considered a portfolio investment and does not qualify towards the active business requirement. 1202(e)(5)(B).
- A corporation may count a reasonable amount of working capital as business assets. 1202(e)(6)(A).
- Investments expected to fund research and development within two years can also qualify.
- Businesses older than two years are limited to 50% of their assets under the exceptions for working capital and research and development. 1202(e)(6)(B).

QSBS Tax Benefits

- **Capital Gains Exclusion:** If a shareholder holds QSBS for more than three years, they may exclude some or all gains from taxation, depending on the acquisition date and holding period:
  - 50% exclusion for shares held more than three years and acquired after July 4, 2025.
  - 75% exclusion for shares held more than four years and acquired after July 4, 2025.
  - 100% exclusion for shares held more than five years and acquired after September 27, 2010.
  - 75% exclusion for shares held more than five years and acquired between February 18, 2009, and September 27, 2010.
  - 50% exclusion for shares held more than five years and acquired before February 18, 2009.

- **Exclusion Limits:** A shareholder’s exclusion is capped at the greater of:
  - For stock issued on or before July 4, 2025, $10M, reduced by any prior exclusions from sales of the same company’s stock, and for stock issued after July 4, 2025, $15M (adjusted annually for inflation), reduced by any prior exclusions from sales of the same company’s stock; or
  - 10 times the taxpayer’s aggregate adjusted basis in QSBS. (1202(b))
- **Additional Considerations:**
  - Excess Section 1202 gain is taxed at a 28% capital gains rate.
  - Recent changes in capital gains tax rules may require more complex calculations for partial exclusions (50% and 75%).
  - The Alternative Minimum Tax (AMT) and 3.8% Medicare tax may still apply in certain cases.
