

Entrepreneurs, Don't Leave Millions on the Table

Qualified Small Business Stock (QSBS) Explained

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Buried in the tax code sits one of the most significant, and frequently underutilized, wealth building tools for entrepreneurs: **Qualified Small Business Stock (QSBS)**.

Though it has been quietly rewarding founders and early investors since the 1990s, recent enhancements under the **One Big Beautiful Bill Act (OBBBA)** have thrust this sleeper provision back into the spotlight.

In essence, QSBS can allow entrepreneurs to exclude a significant portion of their capital gains, potentially millions of dollars, from federal tax when selling their company. For business owners contemplating a future sale, understanding QSBS isn't just advanced tax planning, it could be a competitive advantage that redefines what an "optimized exit" really means.

A Brief History of Section 1202 – Qualified Small Business Stock (QSBS)

In 1993, Congress enacted Section 1202 of the Internal Revenue Code. The provision was designed to encourage entrepreneurship and investment in new companies by offering a substantial tax benefit for shares acquired directly from the issuing corporation.

Initially, the capital gain exclusion was limited to 50% of the gain upon the sale of QSBS and required a minimum holding period of five years. In 2009, the gain exclusion increased to 75% (for QSBS acquired after February 17, 2009, and before September 27, 2010) and finally, in 2010, the gain exclusion was increased to 100% (for QSBS acquired after September 28, 2010) up to certain specified limits. This gain exclusion is generally limited to the **greater** of \$10 million or 10 times the aggregate adjusted basis of the QSBS that a shareholder sold during the taxable year.

QSBS Acquisition Date	Percentage of Gain Excludable
8/11/1993 – 2/17/2009	50%
2/18/2009 – 9/27/2010	75%
9/28/2010 – Present	100%

The move to a 100% exclusion of gain, in addition to the lowering of the corporate income tax rate from 35% to 21% under the **Tax Cuts and Jobs Act (TCJA)** of 2017, has spurred interest in investments into start-up and other small businesses by essentially creating a fully tax-exempt gain when using a C corporation structure. This has resulted in an increasing number of investors structuring investments with an eye toward QSBS status.

Following the passage of the **One Big Beautiful Bill Act (OBBBA)**, there were several enhancements made to QSBS provisions for stock issued after **July 4, 2025**. The most noteworthy enhancement is the new phased-in gain exclusion for stock held for less than 5 years, allowing for 50% exclusion after 3 years and 75% exclusion after 4 years, with the remaining amount taxed at the effective federal rate. The exclusion cap was also raised to \$15 million (vs. \$10 million previously) and the gross asset threshold was raised to \$75 million (vs. \$50 million previously). Both figures, which were previously static, will now be indexed to inflation, providing more modest increases over time.

Key Enhancements to QSBS Following Passage of One Big Beautiful Bill Act (OBBBA)

Criteria	Pre-OBBBA	Post-OBBBA
Holding Period/ Exclusion %	5-years: Up to 100% Exclusion	3-years: 50% exclusion
		4-years: 75% exclusion
		5-years: 100% exclusion
Exclusion Cap	Greater of \$10 Million or 10x adjusted basis	Greater of \$15 Million or 10x adjusted basis, indexed annually for inflation
Gross Asset Threshold at Issuance	\$50 Million or less	\$75 Million or less, indexed annually for inflation

The benefits of QSBS/Section 1202 are great; however, many companies and investors may discover that satisfying all of the requirements of Section 1202 is not that simple, in particular when incorporating or acquiring an existing business with the hopes of attaining QSBS status.

Requirements and Considerations

Section 1202 contains several key requirements that must be satisfied before QSBS status and gain exclusion may be achieved. These requirements are discussed in further detail below and are intended to identify significant issues that a business owner or investor should consider when looking to qualify as a small business. The requirements under Section 1202 include, among others:

1. Original issuance requirement: The purchaser of QSBS must have acquired the QSBS when it was originally issued, in exchange for money or property, other than stock, or as compensation for services provided to the issuing corporation. Generally, the term “original issue” refers to stock issued directly from a domestic C-corp¹ (or through an underwriter) to a qualified purchaser, and not to the actual timing of the issuance of stock.

It does not mean that only a corporation's first issuance of stock would be the only stock considered as QSBS. Additional stock may be issued in the future and qualify as QSBS if the gross asset test is satisfied at the time of issuance and immediately thereafter. Lastly, the issued stock may be common or preferred shares.

It is also worth noting that the QSBS exclusion is not available to investors/taxpayers that are themselves a C-corporation.

Stock received by certain transfers may continue to qualify for QSBS preferential tax treatment.

Acceptable transfers include transfers of QSBS by gift or inheritance to a beneficiary directly or to a trust for their benefit. It also includes a distribution by a partnership to a partner (but only if the partner held their partnership interest on the date the partnership acquired the QSBS).

Active business requirement: The corporation must use at least 80% of its assets, measured by value, in the active conduct of one or more qualified trades or businesses. Additionally, if the corporation owns more than 50% (by vote or value) of a subsidiary corporation's stock, then the corporation must include its ratable share of the subsidiary's assets and activities in analyzing the active business requirement.

A qualified trade or business does not include, among others, any trade or business engaged in the performance of services in the fields of health, law, accounting, brokerage services, financial services, engineering, architecture, actuarial science, athletics, performing arts and consulting. Although these specific fields are enumerated in the statute, questions may arise as to whether certain business activities fall within these fields. For example, the field of “health” is likely not as broad as one may think, as companies that support health care service providers and patients but do not themselves provide services in the field of health might not be engaged in “health” for purposes of Section 1202. What represents consulting is another significant issue, as the term “consulting” is vague and is not defined by Section 1202 or the relevant regulations thereto.

2. Gross asset test: A qualified small business is generally a domestic C-corporation with aggregate gross assets of \$50 million or less (or \$75 million or less for stock issued after July 4, 2025). Generally, the aggregate gross assets of the corporation (and any of its predecessors) must not have exceeded the applicable asset threshold at any time between August 10, 1993 and the date of the issuance of the stock for which preferential treatment under Section 1202 is sought. Additionally, the aggregate gross assets of the corporation immediately after the issuance must not exceed the applicable asset threshold.

The gross asset test is generally based upon the tax basis of assets as opposed to fair market value. However, when contributing property other than cash or incorporating an existing business, the fair market value at the time of the contribution is utilized in determining the aggregate gross assets of the corporation at the time of the issuance and for purposes of any future issuances. Finally, all corporations that are members of the same parent-subsidiary controlled group (defined as more than 50% ownership) are treated as one corporation for purposes of determining the total gross assets.

Per-Issuer Limitation on Gain Exclusion

A crucial aspect of the tax benefits available under Section 1202 is that the limitation on gain exclusion is applied on a per-issuer basis. Provided each taxpayer meets all of the requirements under Section 1202, a well-structured plan could potentially exclude up to 100% of Federal capital gains tax. As noted above, the per-issuer limitation is generally the greater of:

- \$10 million for QSBS acquired pre-OBBBA, not indexed for inflation, or \$15 million for QSBS acquired post-OBBBA, indexed for inflation starting in 2027
- 10 times the aggregate adjusted basis of the QSBS that the taxpayer sold during the taxable year

Coordinating rules prevent double-dipping between pre-OBBBA and post-OBBBA QSBS shares, meaning a Taxpayer cannot treat the \$10 and \$15 million caps as separate buckets for the same company. The exclusion limitation is applied to all eligible gain that is taken into account under Section 1202(a) for the taxable year and is reduced by the aggregate amount of eligible gain realized by the taxpayer in a prior taxable year that is attributable to dispositions of stock issued by the issuing corporation to the taxpayer.

Eligible gain is any gain from the sale or exchange of pre-OBBBA QSBS held for more than five years, while post-OBBBA QSBS shares have partial eligibility after 3-year (50%) and 4-year (75%) holding periods.

As a further benefit, pass-through entities, such as LLCs and partnerships, may make investments in QSBS, and the gain exclusion applies at the individual taxpayer/investor level (for non-corporate shareholders such as an individual, trust or estate). As a result, the total gain exclusion on QSBS sold by a pass-through entity may be significantly higher than the \$10 million/10x basis cap. For a family-owned business with one shareholder, an individual may also be able to increase the gain exclusion amount by gifting some of the QSBS to family members, usually through an irrevocable trust, prior to the sale of such stock.

What Is QSBS Stacking?

QSBS 'stacking' refers to the aggregation of multiple QSBS holdings via different eligible issuers (e.g., individuals, trusts and estates) to maximize exclusion benefits – potentially up to 100% of Federal capital gains tax.

For example, assuming all requirements of Section 1202 are met – if a partnership with 10 partners (each owning 10%) sells its QSBS with \$0 basis for \$100 million – then each partner may exclude its ratable share of the gain (i.e., \$10 million per partner). The gain exclusion is not limited to \$10 million for the partnership; all \$100 million of the gain qualifies for the exclusion because it is determined per each individual partner.

Examples

Business Owner Example – stock issued before July 4, 2025

Founder started XYZ Company, a technology business incorporated as a C-corporation with gross assets less than \$50 million in 2015. She received 100,000 original issuance shares with a \$0 basis upon the company's formation. Subsequently, in 2021, more than five years after the Founder received her QSBS, XYZ Company was acquired by ABC Public Company in a stock purchase at \$50 per share. She will receive \$5,000,000 from the scheduled liquidity event. Her gain will be \$5,000,000 ($\$5,000,000 - \$0 = \$5,000,000$). Normally, this capital gain would be included in her income tax. However, the entire \$5,000,000 gain can be excluded from income tax because it is covered as part of the Section 1202 100% exclusion for QSBS acquired after September 27, 2010. The Founder will receive the entire \$5,000,000 income tax-free.

Business Owner Example – stock issued after July 4, 2025

Entrepreneur founded ZYX Incorporated, a logistics company incorporated as a C-corporation with gross assets less than \$75 million in August 2025. Initially, he received 100,000 original insurance shares with a basis of \$4,000,000. In 2031, more than five years after the Entrepreneur received his QSBS, ZYX Incorporated is acquired by CBA Private Equity Firm for \$400 per share. He will receive \$40,000,000 from the sale. His gain will be \$36,000,000 ($\$40,000,000 - \$4,000,000 = \$36,000,000$). The entire \$36,000,000 gain will be excluded from income tax because it is covered as part of the Section 1202 100% exclusion for QSBS acquired after July 4, 2025 at the exclusion cap of the greater of \$15,000,000 (indexed for inflation) or 10x adjusted basis ($10 \times \$4,000,000 = \$40,000,000$). The Entrepreneur will receive the entire \$36,000,000 income tax-free.

It is also worth noting that if the sale occurred in 2029, or 3 years after Taxpayer received his QSBS, 50% of the entire gain will be excluded from income tax, and the remainder will be subject to income tax (75% if liquidity event occurred in 2030, 4 years after Taxpayer received his QSBS).

Employee Example – stock issued after July 4, 2025

Employee was hired by ZYX Incorporated, a logistics company incorporated as a C-corporation with gross assets less than \$75 million in December 2025. As part of their compensation, the Employee was awarded 10,000 shares of qualified small business stock (QSBS) for services rendered to the company with a basis of \$50 per share. ZYX Company's gross assets were also less than \$75 million right after the Employee received their shares. In 2031, more than five years after the Employee received their QSBS, ZYX Incorporated is acquired by CBA Private Equity Firm for \$400 per share. The Employee will receive \$4,000,000 from the sale. Their gain will be \$3,500,000 [$(\$400 - \$50) \times 10,000 = \$3,500,000$]. The entire \$3,500,000 gain will be excluded from income tax because it is covered as part of the Section 1202 100% exclusion for QSBS acquired after July 4, 2025. The Employee will receive the entire \$4,000,000 income tax-free.

Conclusion

The gain exclusion on the sale of QSBS provided by Section 1202 of the IRS code is a powerful tool for America's small businesses. A confluence of factors over the last two decades, including the permanent 100% gain exclusion, the lowering of the corporate tax rate on C-corporations from 35% to 21% and the most recent enhancements for QSBS acquired after July 4, 2025 under the One Big Beautiful Bill Act, have led this once overlooked provision to become an increasingly sought-after structure by founders and investors alike.

Furthermore, advanced planning strategies such as "QSBS stacking" may provide additional opportunities to help reduce Federal capital gains tax, lower future estate tax and enhance asset protection, especially for a family-owned business valued above a single issuer's limitation.

As illustrated above through some of the key requirements and considerations, the rules of Section 1202 are complex and must be carefully analyzed to ensure eligibility for the gain exclusion. Taxpayers should consult with their professional tax advisors when considering claiming the Section 1202 gain exclusion benefit.

¹ Other than a domestic international sales corporation (DISC) or former DISC, a regulated investment company, real estate investment trust, real estate mortgage investment conduit or a cooperative. Internal Revenue Code, Section 1202(e)(1)(B), (4).

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