SCALE LLP

CLIENT ALERT

QSBS After the One Big Beautiful Bill Act

What the Section 1202 Amendments Mean for Startup Founders

Introduction

On July 4, 2025, the One Big Beautiful Bill Act (OBBBA, P.L. 119-21) enacted the most consequential changes to Section 1202 of the Internal Revenue Code since the provision was adopted in 1993. Section 1202 is one of the largest tax advantages of building a startup as a C corporation: it allows founders, early employees, and early-stage investors holding qualified small business stock (QSBS), stock acquired at original issuance from a qualifying domestic C corporation, to exclude capital gain at exit from federal tax, historically up to the greater of $10 million or 10 times basis per issuer, after a five-year hold.

The OBBBA preserved the basic architecture of Section 1202, including the C corporation requirement, the original issuance rule, the 80% active business test, and the excluded businesses list, but rewrote the math. The changes apply only to QSBS issued after July 4, 2025. Shares issued on or before that date remain governed by the prior rules, so a founder holding stock from incorporation plus shares from a later issuance in the same company now holds two distinct tax assets that must be tracked separately. Likewise, investors holding shares from before that date remain governed by the prior rules, and later investments would be governed by the new rules and must be tracked separately.

Key Changes for Stock Issued After July 4, 2025

1. **Tiered Holding Periods**
   The five-year hold is no longer all-or-nothing. Stock held three years qualifies for a 50% exclusion, four years for 75%, and five or more years for the full 100%. An acquisition at year four, which produced no Section 1202 benefit under prior law, now captures 75% of the available exclusion. The 100% exclusion at five years is unchanged; the tiers simply add optionality below it.

2. **Higher Per-Issuer Cap**
   The lifetime gain exclusion cap rose from the greater of $10 million or 10 times basis to the greater of $15 million or 10 times basis. For founders with small basis, the practical ceiling is now $15 million per taxpayer, per issuer, indexed for inflation beginning in 2027.

3. **Higher Asset Ceiling**
   The aggregate gross assets ceiling that determines whether an issuer qualifies as a small business rose from $50 million to $75 million, also indexed to inflation beginning in 2027. Startups can now raise significantly larger rounds before new issuances stop qualifying, and companies that previously crossed the threshold mid-round have new runway.

4. **Cleaner Alternative Minimum Tax (AMT) Treatment**
   Under the pre-2010 partial exclusion regime, the excluded portion was an alternative minimum tax preference item. The OBBBA's new 50% and 75% tiers carry no AMT add-back.

5. **Two Regimes, No Refresh**
   Pre-OBBBA stock cannot be brought into the new regime through restructurings, stock splits, dividends, or recapitalizations; the IRS treats those events as continuations of the original acquisition date. Gains are sourced first against the pre-OBBBA cap, then the post-OBBBA cap, with each regime's rules applying to its block.

The 28% Rate Most Holders Miss

When a partial exclusion applies, the non-excluded portion of gain within the cap is taxed at a special 28% capital gains rate, not the standard 20% or 23.8% with net investment income tax. Example: a founder with $200,000 of basis sells post-OBBBA QSBS at year three, realizing $20 million of gain. The cap is $15 million; the 50% tier excludes $7.5 million. The remaining $7.5 million within the cap is taxed at 28% and the $5 million above the cap at 23.8%, for roughly $3.29 million of federal tax (about a 16.5% effective rate). Holding the same stock five years would cut the bill to roughly $1.19 million (about 6%). The tiers are real and useful, but they are not free optionality, and exit-timing analysis should price the difference.

Practical Considerations

01 Stock Issued On or Before July 4, 2025

Confirm original issuance dates in your cap table records and track pre-OBBBA and post-OBBBA blocks separately. Avoid transactions that could alter or muddy an acquisition date; the consequences may not surface until exit. For option holders, the QSBS clock starts when shares are issued on exercise, not at option grant, which makes early exercise worth a fresh look under the new tiers.

02 Incorporating or Raising Now

Structure issuances to qualify under the new rules: confirm aggregate gross assets at or below $75 million immediately before and after issuance, verify ongoing compliance with the 80% active business test, confirm the business is not on the Section 1202(e)(3) excluded list (health, law, consulting, financial services, hospitality, and other service businesses), and avoid related party redemptions within the testing windows, which can taint new issuances.

03 Considering an Acquisition Offer

The decision is now a gradient rather than a binary. Waiting from year three to year four increases the excluded portion by half; from year four to year five, by a third. For founders facing real liquidity needs or an offer that may not survive a wait, the 75% exclusion at year four is materially better than forfeiting the benefit, and for many holders it will be the practical sweet spot.

04 Building On An LLC or S Corporation

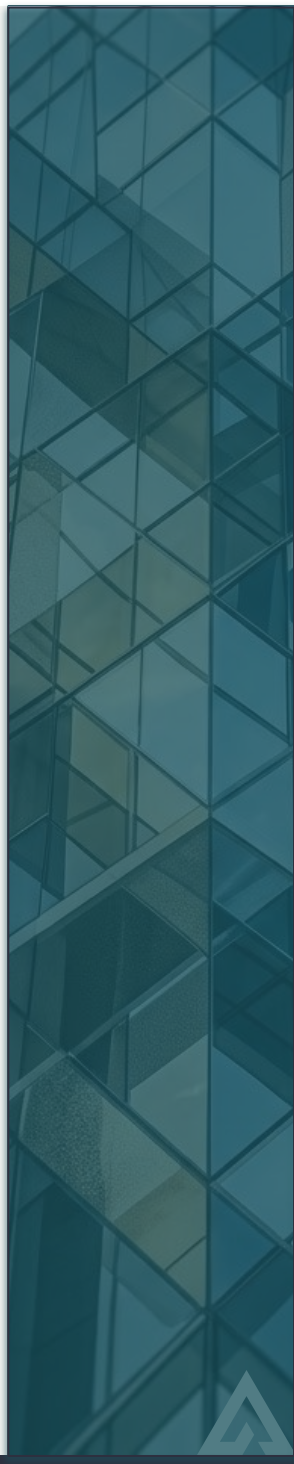
Section 1202 remains C corporation-only, but the conversion analysis has shifted. A pass-through that converts, issues stock, and exits four years later now captures a 75% exclusion on up to $15 million per shareholder, where prior law gave nothing before year five. The asset test is run at conversion based on the business's fair market value, so timing matters for companies approaching $75 million. Businesses with no exit horizon or that distribute most earnings annually generally still should not convert; the corporate-level tax drag outweighs an exclusion that is never captured.

05 Planning Around the Cap

The $15 million cap applies per taxpayer, per issuer. Gifting strategies that stack the cap across multiple non-grantor trusts remain available and are now a third more valuable, and partial exclusion exits make basis management and 10x-basis planning relevant again.

06 Relocating

Section 1202 is a federal exclusion, and not every state conforms. Several states tax QSBS gain in full regardless of the federal exclusion, and others conform only partially. State of residence at the time the gain is realized can rival the federal rules in importance, and taxing authorities examine the substance of a residency change, not just the paperwork.



What Did Not Change

The requirements that most often disqualify stock survived the OBBBA untouched: the issuer must be a domestic C corporation throughout the relevant periods; stock must be acquired at original issuance for money, property, or services; at least 80% of assets must be used in the active conduct of a qualified trade or business for substantially the entire holding period; the excluded trade or business list still applies; and the redemption taint rules still capture buybacks near in time to new issuances. These rules apply equally to both vintages of stock, and they remain the most common ways QSBS treatment is inadvertently lost.

Next Steps

The new rules are already in effect for stock issued after July 4, 2025, and IRS implementation guidance continues to develop. Companies should review capitalization records now to tag stock by regime, and any contemplated issuance, conversion, redemption, or exit should be tested against the new thresholds before it is executed. We are monitoring IRS guidance and will provide updates as interpretive questions are resolved.

Scale LLP's Corporate & Securities Team

Scale's Corporate & Securities team partners with founders, management teams, investors, and boards to help businesses grow, raise capital, execute transactions, and navigate complex corporate matters. We provide strategic, business-aligned counsel across the full company lifecycle—from formation and financing through acquisitions, exits, and ongoing governance—helping clients move faster, reduce friction, and capitalize on opportunities as they arise.

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The recent Section 1202 changes create new planning opportunities—but they also introduce new tracking, timing, and compliance considerations. Scale's Corporate & Securities team helps founders, investors, and growth-stage companies evaluate QSBS eligibility, structure financings, and maximize available tax benefits.