

Qualified Small Business Stock (Section 1202)

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What are the QSBS Tax Breaks?

Qualified (Excludable) Gains for Federal Purposes (most states follow)

For stock acquired before July 4, 2025:

- Greater of \$10M (cumulative) of gain or 10× basis (annual) excluded (both are available)
 - 50% exclusion: acquired between 8/10/1993 and 2/17/2009
 - 75% exclusion: acquired 2/18/2009–9/27/2010
 - 100% exclusion: acquired after 9/27/2010

For stock acquired after July 4, 2025:

- Greater of \$15M of gain (indexed for inflation) or 10× basis (both are available)

Tiered exclusion:

- 50% if held ≥ 3 years
- 75% if held ≥ 4 years
- 100% if held ≥ 5 years

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Example: QSBS Tax Break



- Allen was issued stock in ABC Inc. on Jan. 1, 2011, in exchange for \$3 million.
- On Feb. 1, 2021, Allen sold his shares for \$30 million, which resulted in a capital gain of \$27 million.
- With a 23.8% (20% capital gains + 3.8% Net Investment Income or NII) federal capital gains tax rate, Allen would have paid \$6,426,000 in capital gains tax as a result of the sale.
- However, assuming the stock qualifies under Section 1202, Allen can exclude up to \$30 million of gain from federal taxation (10 times his initial investment).
- The entire \$27 million gain would be excluded, and Allen would pay no federal capital gains tax.

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Unlocking Tax Breaks: What Is a Qualified Small Business?



Qualified Small Business (QSB)

- U.S.-based active C corporation
- Gross assets immediately after issuance is ≤ \$50M (before July 4, 2025) or ≤ \$75M (after)
- Asset value based on cost basis, not market value*
- Eligible industries: Tech, Retail, Wholesale, Manufacturing
- Not eligible: Hospitality, Professional Services, Finance, Real Estate, Farming, Mining, Performing Arts, Athletics

Qualified Small Business Stock (QSBS)

- Shares issued by a QSB under IRC Sec. 1202 after August 9, 1993
- Must be originally issued from the company (purchase or service compensation)
- Held for a minimum period before sale
- Company must meet active business requirements during holding

* Cost basis of contributed property is FMV at time of contribution

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Example: Qualification as QSBS



ABC company, a domestic C corporation, issues stock to A in 2020 when its gross assets were \$25 million. In 2022, ABC company issues stock to B when its gross assets were \$40 million. In late 2025, ABC company issues stock to C when its gross assets were \$60 million. In 2025, A sells her shares to D.

- A's stock is QSBS because gross assets were only \$25 million at the time of the transaction (or immediately after).
- B's stock is QSBS because assets were less than \$50 million at the time of issuance.
- C's stock is QSBS because assets were less than \$75 million at the time of issuance (effective after 7/4/2025).
- D's stock is not QSBS because it is not an original issue (it was acquired from A).

Eligible QSBS Shareholders



- Individuals
- Non-grantor (irrevocable) trusts
- Estates
- Pass-through entities (Partnerships, S Corporations, Common Trust Funds and Regulated Investment Companies)*

*specific rules apply

Qualifying Partnership Distribution



- Stock must have been QSBS in the partnership's hands
- Partner must have been a partner on the date the partnership acquired the stock
- Stock distributed by partnership can qualify as QSBS only to the extent of the partnership interest owned at the time the stock was acquired.

Example: Paul Family Partnership acquired ABC company in 2023 when Paul owned 30% and Paul's brother owned 70% of the partnership. In 2025, Paul's brother sold his interest – 20% to Paul and 50% to Paul's son. In 2026, Paul Family Partnership distributes ABC company stock to the partners. The 20% distribution to Paul that relates to his 2025 interest in the partnership is not eligible for QSBS treatment; only the portion that relates to his ownership in the partnership at the time ABC company was acquired is eligible for QSBS treatment. The stock distributed to Paul's son is not eligible for QSBS treatment because his partnership interest was acquired after the partnership bought ABC company.

Timing Is Everything: Maximize Your QSBS Advantage



Holding Period and Issuance Date Matter

- Must meet 5-year holding for full capital gains exclusion
- Determines whether the gain from the sale is eligible for 50%, 75% or 100% exclusion based on the date of issuance
- New tax law allows partial gain exclusion after 3 and 4 years for stock acquired post 7/4/2025

When Does Holding Period Begin?

- Stock issuance date starts holding period
- Convertible debt: date of conversion to equity
- LLC/Partnership to C-Corp: conversion date is key; prior appreciation is not eligible
- S corporation to C Corp: not eligible if stock was issued by S corporation
- Stock options: holding begins when exercised

How are the Gains Taxed?

If 50% Exclusion:

- One-half of qualified gain (\$10m or \$15m) is tax free
- One-half of qualified gain taxed at 28% plus 3.8% NII
- Balance of gain taxed at 20% plus 3.8% NIIT

If 75% Exclusion:

- 75% of qualified gain (\$10m or \$15m) is tax free
- 25% of qualified gain taxed at 28% plus 3.8% NII
- Balance of gain taxed at 20% plus 3.8% NII

If 100% Exclusion:

- Qualified gain (\$10m or \$15m) is tax free
- Balance of gain is taxed at 20% plus 3.8% NII

Example: Taxation of QSBS Gain with Partial Exclusion

- Allen was issued stock in ABC Inc. on Jan. 1, 2010, in exchange for \$3 million.
- On Feb. 1, 2021, Allen sold his shares for \$50 million, which resulted in a capital gain of \$47 million.
- Assuming the stock qualifies under Section 1202, Allen can exclude up to 75% of \$30 million of gain from federal taxation (10 times his initial investment).
- The first \$22.5 million gain would be excluded (\$30 Million x 75%)
- The next \$7.5 million would be taxed at 28% capital gains plus 3.8% NII
- The remaining \$17 million would be taxed at 20% capital gains plus 3.8% NII
- If the stock was purchased after 9/27/2010, the entire gain would have been excluded.

When does it make sense to use C Corporation?



Cash Flow Considerations

- Business expects to retain earnings for reinvestment rather than distributing to owners.
- Owners do not need cash flow from the business for at least 5 years.

Holding Period

- Expected sale in 5 to 10 years
- Allows eligibility for Section 1202 QSBS capital gains exclusion after 5-year holding period.

Projected Income/Losses

- If losses are expected for several years, owners may want pass-through treatment
- When profits are expected to be high, corporate tax rates (currently 21%) may be lower than personal marginal rates.

Types of Businesses

- Start-ups and high growth companies in eligible industries.
- Businesses seeking venture capital, institutional investment, or planning IPO/strategic sale.

Additional Planning with QSBS



Rollover Option – Sec 1045

- Held QSBS ≥ 6 months?
 - Can roll over gains into new QSBS within 60 days
 - Enables tax deferral if 5-year threshold not yet met

Combination with Other Strategies

- Partial ESOP with Sec 1042 rollover (allows beneficial tax treatment for stock sold to an ESOP) and partial sale with Sec 1202 tax exclusion
- Sale with Sec 1045 rollover allows deferral of the amount in excess of excludible gain by reinvesting the proceeds into another qualified QSBS investment within 60 days.
- Sale with Opportunity Zone Fund investment of gain in excess of 1202 exclusion

Full Exclusion Beats Deferral

Additional Planning with QSBS: Gifting QSBS Stock to Stack the Tax Savings



Why Gifting Works

- Recipient inherits donor's basis and holding period
- Each taxpayer can claim their own Section 1202 exclusion
- Ideal when stock value is low (e.g., early-stage business)

Who to Gift To

- Family members
- Irrevocable non-grantor trusts
- Transfers by gift, death, or qualifying partnership distribution

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Example: Gifting Stock



Scenario: Early-Stage Tech Founder

- Founder receives 1M shares at formation with \$0.01 per share cost basis in late 2025.
- Company qualifies as a QSB; industry = eligible technology sector.
- After 6 years, company sells; stock value = \$15M.

Result

- Entire \$15M potentially excluded from federal capital gains tax under Section 1202.

Gifting Scenario:

- Founder receives 1M shares at formation with \$0.01 per share cost basis in late 2025.
- Company qualifies as a QSB; industry = eligible technology sector.
- Founder gifts shares 2/3 of shares equally to two irrevocable non-grantor trusts
- After 6 years, company sells; stock value = \$45M.

Result

- If shares gifted to two irrevocable non-grantor trusts, exclusion could be multiplied to \$45M total (founder + two trusts).

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Additional Planning with QSBS: Planning Sales to Use Both Exclusions



- Allen was issued stock in ABC Inc. on Jan. 1, 2011, in exchange for \$1 million.
- On Feb. 1, 2024, Allen sold half of his shares for \$15 million, which resulted in a capital gain of \$14.5 million.
- Assuming the stock qualifies under Section 1202, Allen can exclude up to \$10 million of gain from federal taxation (greater of \$10m or 10 times basis of sold shares).
- On January 15, 2025, Allen sells the other half of his shares for \$15 million, which resulted in a capital gain of \$14.5 million. Allen can exclude \$5 million of gain from federal taxation (10 times his remaining basis).
- This example highlights how the basis exclusion can be used annually regardless of the year acquired.

QSBS: Other Issues



- **State Taxes** – Not all states follow the federal rules regarding QSBS (California, for one, does not)
- **Documentation** – Important to keep documentation to verify QSBS, including stock subscription agreements, financials, documentation of contributed property
- **Potential Disqualifying Events** – Puts, redemptions, non-original issue stock, buying partnership interest after purchase of QSBS, asset sales rather than stock sales
- **Qualified Trade or Business** – Defined as any business except...
- **Active Trade or Business** – At least 80% of company assets must be used in business
- **Basis** – Contributed property basis is FMV to both company and shareholder. Thus, affecting FMV of assets test and excluding gain from QSBS treatment

QSBS: Other Benefits




- **Raising Capital** - Qualification as QSBS is attractive to potential investors due to tax benefits
- **Attracting Talent** – Potential executives could be attracted to work for a start up with equity compensation plans using QSBS stock
- **Retaining Talent** – Equity compensations with vesting periods may encourage retention of key talent in competitive markets
- **Incentive for Long-Term Investment** – Benefits of 5 year holding period will likely encourage holding the stock

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Lisa Featherngill, CFP®

SVP, National Director, Strategic Wealth & Business Advisory



101 S. Stratford Rd, Suite 210, Winston-Salem, NC 27104

Email: Lfeatherngill@comerica.com

Cell: 804.651.6523

PROFESSIONAL EXPERIENCE

35 YEARS Number of years in financial industry

Comerica Wealth Management, National Director of Strategic Wealth & Business Advisory

- Leads a team of experienced and credentialed wealth planning specialists who develop customized wealth planning solutions for business owners and other high net worth individuals
- Works with clients' advisors to ensure planning is implemented to support achieving estate, tax, wealth transfer, business succession, family, professional and asset growth goals

Abbot Downing/Wells Fargo, SVP, Head of Legacy and Wealth Planning

- Responsible for a comprehensive suite of services, including Abbot Downing Clarity, customized financial, wealth transfer planning and planning for business transitions
- Led teams of experienced and credentialed professionals that delivered wealth management and financial planning strategies to high and ultra high net worth clients

Arthur Andersen, Manager, Personal Financial Planning and Family Wealth Planning

- Provided clarity, guidance and confidence to multi-generational, very-high-net worth clients with complex financial structures through tax and financial planning advice

EDUCATION

George Mason University, Fairfax, VA
B.S.: Bachelor of Science, Accounting

PROFESSIONAL DESIGNATIONS

Certified Financial Planner®
CFP®

ABOUT ME

- AICPA roles include: Advanced Estate Planning Conference Committee Member, Former Chair; PFP Executive Committee and PFS Credential Committee, Former Chair

Lisa was named one of the 50 Most Influential Women in Private Wealth, PAM in 2015 and 2016.

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