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## A Guide to QSBS: How Qualified Small Business Stock Can Create Tax Savings



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Adding to its complexity, tax planning is riddled with endless acronyms. Nonetheless, we believe that founders, executives and employees of startups will likely benefit from paying attention to one in particular: QSBS, which stands for qualified small business stock. Designed to encourage investment in small businesses, Section 1202 of the Internal Revenue Code sets forth the QSBS exclusion from federal capital gains tax, which enables taxpayers selling their QSBS to potentially exclude some capital gains from taxable income when selling their shares.

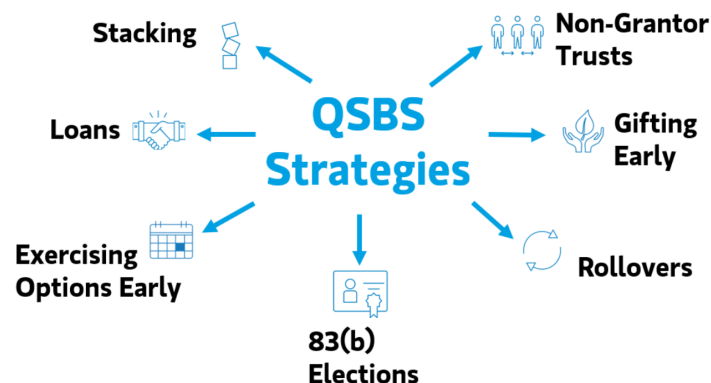
In this primer, we outline the planning necessary to allow QSBS investors to maximize their after-tax returns. We begin by reviewing QSBS basis and the required qualifications, considerations for QSBS “stacking” and other potentially tax-saving strategies. Please see Exhibit 1 for strategies to be discussed throughout this primer.

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### Exhibit 1: QSBS Strategies for Maximizing After-Tax Returns to Investors



Source: Morgan Stanley Wealth Management Global Investment Office

While the QSBS capital gain exclusion may deliver powerful federal income tax savings, the eligibility criteria can be complex. For the IRS to consider a company a qualified small business, it must:

- Be registered as a US C-corporation;
- Have had aggregate gross assets of no more than \$75 million at all times before and immediately after the issuance of shares; and
- Have at least 80% of its assets (by value) used in the active conduct of one or more qualified trades or businesses.

Importantly, certain business types are not eligible for classification as qualified small businesses. Among others, these include businesses in financial services and service-related industries, as well as those in the fossil fuel and farming industries and in the hotel and other hospitality industries.

Moreover, the IRS requires the following criteria for QSBS shareholders:

- Shareholders must have acquired the shares at original issue—that is, not through purchase on a secondary market.
- Shares must be held for at least five years prior to sale to receive the full 100% capital gain exclusion. Taxpayers receive a phased exclusion, starting with QSBS holding periods of three or more years.

- Shareholders must have not had more than 2% of shares repurchased by the issuing company two years prior to and two years after the issuance of the QSBS stock.
- If a shareholder transfers shares to a disqualifying entity, such as a grantor trust, the value of such shares is included in the shareholder's lifetime \$15 million exclusion. Grantor trusts are considered disqualifying entities, because QSBS limitations are based on a per-taxpayer basis, and a grantor trust is not considered to be a separate taxpayer.

On July 4, 2025, President Trump signed the One Big Beautiful Bill Act into law, with provisions that expand QSBS benefits. Specifically, for stock acquired after July 4, 2025, we note some impactful changes:

- **Exclusion amount.** Previously, the QSBS capital gain exclusion topped out at the greater of \$10 million or 10 times the investor's adjusted basis. The 2025 bill increased the exclusion amount to the greater of \$15 million (\$7.5 million for married taxpayers, filing separately) or 10 times the investor's adjusted basis. The 2025 bill stipulates that this exclusion amount will be adjusted higher for inflation, starting in 2027.
- **Gross asset test.** Previously, the capital gain exclusion required the size of the business to not exceed \$50 million in aggregate assets at the time of equity issuance. The 2025 bill increases this limit to \$75 million in aggregate gross assets at issuance.
- **Holding period.** Prior tax law offered 100% exclusion for QSBS held more than five years. The bill now adds a 50% capital gain exclusion for QSBS held for three years or 75% for QSBS held for four years. QSBS held for at least five years continues to qualify for the 100% capital gain exclusion.

Options holders need to exercise their options and convert them into shares before securities become QSBS-eligible. For unvested options that permit early exercise, this scenario could occur due to an exercise shortly after the grant followed by an 83(b) election, because the QSBS needs to be held at least five years for the full exclusion amount to apply. Additionally, QSBS-eligible stock can come from company grants or individuals' purchases of founder shares.

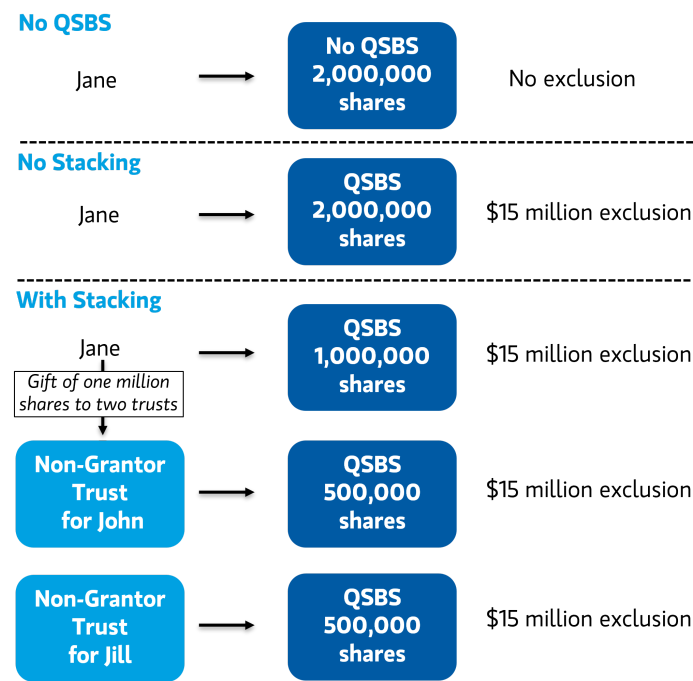
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Founders and executives should be mindful of certain company actions that can invalidate their company's recognition as a qualified small business:

- **Redeeming shares in size.** The issuer must not have carried out significant redemptions—exceeding 5% of the aggregate value of its outstanding shares—for at least two years before issuance.
- **Making illiquid investments.** Deploying corporate capital in noncash securities with lock-up periods of greater than 24 months.
- **Changing the business model.** Shifting activity into a nonqualifying business.
- **Exceeding asset thresholds.** Should the company grow to more than \$75 million in outstanding shares (or \$50 million on or before July 4, 2025), newly issued shares cannot qualify for the QSBS exclusion. This scenario may occur after multiple funding rounds. Shares held prior to exceeding the applicable threshold should remain QSBS-eligible. This threshold will increase, indexed to inflation, starting in 2027. After July 4, 2025, corporations may issue new QSBS stock if the corporation has exceeded \$50 million but not exceeded \$75 million in aggregate gross assets.

QSBS shareholders may be able to boost federal income tax savings by “stacking” the QSBS exclusion across multiple entities. Because the QSBS exclusion applies on a per-taxpayer basis, a QSBS shareholder can share the benefits of QSBS with other separate taxpayers, including non-grantor trusts with distinct beneficiaries (see Exhibits 2 and 3). Each taxpayer may qualify for a lifetime exclusion of up to \$15 million, so that multiple exclusions may be claimed—a process known as “stacking.” The stacking strategy does not require an individual (or trust) who acquired the stock through gift or bequest to have personally satisfied the five-year holding period. In other words, the holding period's start date is tacked on to the QSBS's original issue date. Stacking may be coordinated with other estate-planning strategies, such as gifting to non-grantor irrevocable trusts. Shareholders should work with their attorneys and advisors to ensure that transfers are structured appropriately to realize the QSBS capital gain exclusion benefit.

Exhibit 2: Potential QSBS Paths for Investors



Source: Morgan Stanley Wealth Management Global Investment Office  
Note: The \$15 million exclusion amount reflects changes introduced in the One Bill Beautiful Bill Act, signed into law on July 4, 2025.

Exhibit 3: Leveraging QSBS and Stacking Strategies Can Help Investors Reduce Capital Gains Taxes

Amounts in Millions	No QSBS	No Stacking	With Stacking
Quantity of Shares	2.0	2.0	2.0
Sale of Proceeds	\$50.0	\$50.0	\$50.0
Total Embedded Gain	\$50.0	\$50.0	\$50.0
QSBS Exclusion	\$0.0	\$15.0	\$45.0
Remaining Gain	\$50.0	\$35.0	\$5.0
Potential Taxes Due	\$11.9	\$8.3	\$1.2

Source: Morgan Stanley Wealth Management Global Investment Office  
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While stacking likely represents the most common QSBS strategy, shareholders may implement other strategies to attempt to limit taxable capital gains. They include:

- **Making an 83(b) election to expedite satisfaction of five-year holding requirement.** Individuals may use this election on restricted stock awards (RSAs). This includes RSAs received upon exercise of nonqualified stock options (NQSOs) with early-exercise provisions. For employees granted RSAs or NQSOs with early-exercise provisions, making an 83(b) election may help facilitate QSBS eligibility because the holding period begins as of the restricted stock grant date—rather than the vesting date—potentially starting the clock on satisfying the requisite holding period sooner.
- **Exercising options early.** Exercising options that deliver fully vested stock starts the clock on the holding periods as of the date of exercise. Option holders must first verify the exercise provisions in their stock option agreement before pursuing this strategy.
- **Pursuing alternative liquidity strategies.** Given increasing demand for liquidity, shareholders may sell shares that could eventually be QSBS-eligible. We recommend that shareholders check eligibility well before selling and consider alternatives such as a loan or selling non-QSBS eligible equity, rather than selling QSBS-eligible shares before the various holding period requirements are satisfied.
- **Leveraging careful estate-planning strategies.** Shareholders may consider funding trusts with QSBS early to minimize the use of lifetime gift-tax exemptions and compound estate-planning benefits. Gifting the shares prior to significant appreciation allows individuals to maximize their use of lifetime federal estate-tax exemptions.

- **Taking advantage of potential rollovers.** Serial entrepreneurs may roll over the capital gains from selling QSBS shares held for more than six months if the proper election is made. Under Section 1045, a taxpayer must purchase the new QSBS-eligible stock within 60 days of the prior sale. This strategy may be particularly useful when the original company is purchased or acquired prior to achieving the desired three-, four- or five-year holding period requirements. The shares in the new company retain their original acquisition date for purposes of QSBS eligibility. The taxpayer's basis of the QSBS in the new company is adjusted downward by the amount of gain deferred on reinvestment.
- **Confirming strategies with certified tax planners.** Shareholders may limit potential audit risk by confirming QSBS eligibility ahead of a sale with certified tax planners and obtaining a letter from their company's finance and legal teams certifying QSBS status.

## Conclusion

To maximize potential federal income tax savings, we encourage founders, private-company executives and other startup employees to learn about QSBS and QSBS strategies well in advance of a potential sale of QSBS shares. An optimal strategy will depend on a client's specific circumstances, needs and preferences. Please reach out to your attorney or tax advisor for assistance in sorting out these critical details—and to your Morgan Stanley Financial Advisor for financial guidance and assistance in executing your QSBS plan.

### Disclosure Section

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