HCE
Acquisitions

An introduction to Qualified Small Business Stock

What is Qualified Small Business Stock (QSBS)?:

Qualified Small Business Stock (QSBS) is a tax incentive under Section 1202 of the Internal Revenue Code that allows business owners and investors to exclude up to 100% of capital gains when selling stock in a qualifying business. This can result in significant tax savings for business owners looking to exit.

Benefits of QSBS:
✅ Up to 100% Capital Gains Tax Exclusion – Sellers can exclude the greater of either $10 million in stock or 10x the initial investment from federal capital gains tax.
✅ Applies to Business Owners & Investors – Both founders and early investors may qualify.
✅ No Alternative Minimum Tax (AMT) Impact – The QSBS exclusion is exempt from AMT calculations.
✅ Eligible for Rollover (Section 1045) – If QSBS is sold before five years, proceeds can be reinvested into another QSBS to maintain tax benefits.
✅ No Net Investment Income Tax (NIIT): QSBS gains are not subject to the 3.8% NIIT

Who should know QSBS and why:

Who	Why
Business Owners	Structuring your company correctly can result in millions tax savings when it comes time to sell.
CPAs, Tax Advisors, Wealth & Financial Advisors	Ensure your clients know about QSBS and structure their business to take advantage of it when the time comes.
M&A Advisors & Business Brokers	Help clients retain more of their exit proceeds by preparing for and leveraging QSBS tax exemptions.
Private Equity & Investors	Investing in QSBS-qualified businesses can provide tax-free capital gains, significantly enhancing after-tax returns.

Section 1045 Rollover

The Section 1045 rollover allows investors who sell Qualified Small Business Stock (QSBS) before meeting the five-year holding period to defer capital gains taxes by reinvesting the proceeds into another QSBS within 60 days.

How It Works:
1. Investor Sells QSBS Early: If an investor sells their QSBS before five years, they would normally be subject to capital gains tax on any profits.
2. Reinvestment Within 60 Days: To qualify for the 1045 rollover, the proceeds must be reinvested into another QSBS within 60 days of the sale.
3. Tax Deferral Until New Sale: The capital gains tax is deferred until the new QSBS investment is eventually sold.
4. Maintaining 1202 Eligibility: The new QSBS must meet Section 1202 qualifications (e.g., issued by a C-corp, active trade/business requirement). If held for a full five years cumulatively across both investments, the original QSBS exclusion can still apply.

Does Your Business Qualify for QSBS?: To be QSBS-eligible, a business must meet the following criteria:

Entity Type	The issuing company must be a U.S. C corporation (S-corporations, LLCs, and partnerships do not qualify).
Stock Issuance	The stock must be acquired directly from the company at original issuance in exchange for money, property, or services. Secondhand purchases do not qualify.
Holding Period	Stock must be held for at least five continuous years before sale to be eligible for the full tax exclusion.
Gross Assets	The company must have $50 million or less in aggregate gross assets at the time of stock issuance. This includes cash and the adjusted tax basis of assets.
Active Assets	At least 80% of the company's assets must be used in an active trade or business.
Ownership Restrictions	The stockholder must be an individual, trust, or pass-through entity. Corporations cannot qualify for the exclusion.
Stock Redemption Limitations	If the company repurchases a significant portion of its stock within one year before or after issuance, it may disqualify QSBS treatment. The IRS considers redemptions exceeding 5% of the company’s stock as a potential disqualifier.
Business Activities	Eligible industries include manufacturing, technology, retail, and most service based businesses. Ineligible businesses include: • any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees • any banking, insurance, financing, leasing, investing, or similar business • any farming business (including the business of raising or harvesting trees) • any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A • any business of operating a hotel, motel, restaurant, or similar business

⏳ Timing is critical—QSBS eligibility must be structured properly before a sale occurs to take advantage of the tax benefits.

How To Take Advantage of QSBS:

1. Confirm whether your business qualifies for QSBS and adjust the structure if needed.
2. Hold stock for at least 5 years: If you need to sell before then, consider using a Section 1045 rollover to reinvest the proceeds into another QSBS-qualified business and maintain your tax benefits.
3. Structure the sale as a stock sale: QSBS benefits only apply to stock sales, not asset sales. Many buyers prefer asset sales for liability reasons, but negotiating a stock sale is essential to maintaining tax advantages.
4. Maintain proper documentation: keep accurate financial records, stock certificates, and corporate tax filings that verify eligibility. Ensure that your company's financials reflect active business operations and that all stock issuances are well-documented before the sale.
5. File for QSBS tax exemption: The QSBS exclusion must be reported on your tax return under Section 1202 for the year in which the sale occurs. Use IRS Form 8949 and Schedule D to properly claim the exemption. Consulting a CPA or tax advisor ensures compliance and helps maximize your exemption.

Selling Your Business or Need Help with QSBS? HCE Acquisitions Can Help:

HCE Acquisitions specializes in acquiring, preserving, and growing small to medium-sized businesses, providing owners with flexible, strategic exit solutions that maximize value. We work closely with sellers to ensure smooth, timely transitions and long-term business success—whether through a full buyout, partial sale, or phased transition.

For eligible sellers, we help QSBS benefits, allowing you to potentially eliminate capital gains taxes and keep more of your proceeds.

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