



Introduction to Qualified Small Business Stock (QSBS)

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KNOWLEDGE

Learning Objectives

CPE Information

Recommended CPE: 1

Delivery Method: Group Internet Based

Field of Study: Specialized Knowledge

Program Level: Basic

Advanced Preparation: None

Prerequisite: None



Identify what qualifies as QSBS and how the exclusion applies.



Determine who qualifies and who doesn't through real-world examples.



Evaluate when to obtain a valuation and how to prepare for a QSBS review.

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Agenda

- Legislative History & Shareholder Benefits
- Company Requirements
- Partnership Conversions
- Mergers & Acquisitions
- Valuation
- Real-World Examples

WELCOME

Today's Presenters



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Legislative History & Shareholder Benefits

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Pre-OB3 Legislative History

- 1993 Revenue Reconciliation Act
 - 50% exclusion of gain up to \$10M or 10X basis (greater of)
 - Unexcluded gain taxed at 28%
 - 7% of excluded gain is AMT preference item
- Requirements
 - Must hold shares for more than 5 years
 - Shares must be issued prior to issuer reaching \$50M in assets
- Slight change in 2009 to increase exclusion ratio to 75%
- Major change in 2010 to permit 100% exclusion and removal of AMT preference

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Pre-OB3 Shareholder Exclusions

| Share Issuance Dates | Capital Gain Exclusion | AMT Preference | Tax Rate on Unexcluded Gain |
|----------------------|------------------------|----------------|-----------------------------|
| 8/11/93 – 2/17/09 | 50% | 7% | 28% |
| 2/18/09 – 9/27/10 | 75% | 7% | 28% |
| 9/28/10 – 7/3/25 | 100% | 0% | N/A |

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Updates From OB3

- Tiered exclusion based on holding period
 - 50% exclusion of gain if held >3 and <4 years
 - 75% exclusion of gain if held >4 and <5 years
 - 100% exclusion if held >5 years
- Exclusion increased to \$15M or 10X basis (greater of)
- Gross assets test is now \$75M and will be indexed for inflation

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OB3 Shareholder Tiered Exclusions

| Holding Period | Exclusion Ratio | Tax Rate on Unexcluded Gain | NIIT on Unexcluded Gain | Effective Federal Tax Rate on Total Gain |
|-----------------|-----------------|-----------------------------|-------------------------|--|
| >3 and <4 years | 50% | 28% | 3.8% | 15.90% |
| >4 and <5 years | 75% | 28% | 3.8% | 7.95% |
| >5 years | 100% | N/A | N/A | 0.00% |

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Company Requirements

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Company Requirements

- Must be stock in a C corporation
- Shares must be issued before \$75M in assets (\$50M for shares issued pre-OB3)
 - Beware of redemption black-out periods
 - Convertible instruments (i.e., options and convertible notes) don't count until conversion
- Active Business Requirements
 - 80% of assets used in a qualified trade or business (QTOB)
 - Must be a QTOB (non-QTOBs defined in the statute)
 - Only de minimis stock in other corporations (think cash management strategies)
 - Excess cash relative to company value can cause issues
 - If you own your building, can't rent out much of it

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Partnership Conversions and M&A

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Partnership Conversions

- Partnerships such as limited partnerships and limited liability companies treated as partnerships for tax purposes can convert to C corporations and then qualify
- FMV of assets need to be less than \$75M on conversion date (\$50M pre-OB3)
 - For QSBS-purposes, the FMV of assets is the enterprise value (not just hard assets)
 - This FMV will also be the basis for purposes of determining the greater of \$15M or 10X basis exclusion limit
- There are partnership tax considerations when converting such as:
 - Suspended losses
 - Built-in gains
 - Double taxation if profitable

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Mergers & Acquisitions

- What happens if the company you work for is acquired in an all-stock deal?
- If the buyer is a QSB, then it's like nothing happened to your stock
 - Tax basis, QSBS basis, and holding period all tack on
- If the buyer is not a QSB, then:
 - Same as above, except your excludable gain is limited to what it would have been if it was a cash deal

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Valuation Considerations

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Standard of Value – Fair Market Value

- Internal Revenue Service – Publication 561
- Fair Market Value (FMV) is the price at which property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both having reasonable knowledge of the relevant facts.
- The Appraisal Report should contain/present the necessary information considered by the Appraiser in meeting this standard of value.

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Valuation Methodologies

- Income Approach – typically employed using a discounted cash flow methodology. Value is based on the present value of future expected cash flows.
- Market Approach – employed using a guideline public company method or the guideline merged and acquisition method. Value is based on multiple of revenue, EBITDA or some other relevant income stream.
- Asset Approach – employed based on the adjusted net book value of assets. This method is commonly used for asset intensive business.

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Discounts – Control & Marketability

- At the time of conversion from an LLC to a C-Corp, discounts for lack of control and lack of marketability would not typically apply.
- The value is based on the assets of the LLC; not the individual equity interests being exchanged for stock.
- Discounts for lack of control and lack of marketability would become relevant later when valuing the C-Corp's stock for gift and estate tax purposes.

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Indications of Company Value

- **Equity-based compensation:** Section 409A and other similar valuation rules are applicable to equity compensation arrangements in partnerships and LLCs, such as stock appreciation rights and other phantom equity plans. BM1
- A valuation from a qualified, independent appraiser is advised to determine the fair market value (FMV) of the common stock and establish a compliant strike price for the options/equity awards.
- An entity valuation does not directly determine QSBS eligibility, but should not be ignored as a data point.

Slide 19

BM1 Deleted (“aggregate gross assets”) from the 3rd bullet.
Brian McClellan, 2025-12-10T17:21:51.517

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Indications of Company Value

- Funding rounds typically set a pre-money and post-money valuation, which are negotiated figures reflecting investor expectations and market conditions:
 - Pre-money valuation = Company value before new investment.
 - Post-money valuation = Pre-money valuation + new capital raised.
- Funding round valuation \neq QSBS valuation basis. QSBS determination focuses on **aggregate gross assets**, not market value or negotiated round pricing. BM1
- However, a large pre-money valuation strongly suggests the company's fair market value exceeds the QSBS threshold.

Slide 20

BM1 Changed from "valuation" to "determination".
Brian McClellan, 2025-12-10T17:24:42.680

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Indications of Company Value

- Secondary transactions involve the sale of shares post-issuance, often by employees or early investors in private markets or liquidity events.
- **QSBS eligibility** depends on the company's **aggregate gross assets as of the issuance date**, not on the price of stock in secondary trades.
- Secondary prices can **signal perceived enterprise value**, which may influence IRS scrutiny.

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Real-World Examples

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Secondary Sales & Redemptions

- In this scenario, the founder and a few early employees sell common stock to an investor who is already on the cap table
- The company then exchanges the common stock the investors just purchased for the latest round of preferred stock
 - Did the company just redeem the common stock?

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Redemptions Related to Terminations

- Example 1 – An employee early exercises a nonqualified stock option, timely files an 83(b) election, terminates services before all shares are vested, and the company repurchases the unvested shares
 - QSBS regulations disregard repurchases related to terminations *if* the shares were acquired in connection with the performance of services
- Example 2 – Two individuals form a corporation (50/50 split) and the shares are not subject to vesting, so no 83(b) election was ever filed; after one year, the company repurchases all of one of the founder's shares for more than \$10,000 in connection with their termination
 - Were the repurchased shares acquired in connection with the performance of services?

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Partnership Conversion

- Two founders organize an LLC treated as a partnership for income tax purposes (90/10)
- After some R&D and product testing they agree to convert the LLC into a C corporation
- A valuation is completed and an enterprise FMV of the new C corporation is \$10M immediately after the conversion
- One founder's exclusion limitation is up to \$90M, the other's is \$15M

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IPOs & Specific Identification

- How does it work if you own shares in a company that has IPOd and you own shares that qualify for QSBS, and shares that don't qualify?
 - Brokerages don't usually track the origin of shares
 - Your records are key
 - Private company shares acquired pre-IPO are not "covered securities" so no cost basis reporting
 - Keep track of how many shares qualify/have been used for exclusion

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