

Employee Benefit ■ Plan Review

Sales of Qualified Small Business Stock (QSBS), “Stacking” and Other Structures for Advanced Estate Planning

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As many business owners know, selling a company often results in a significant tax liability. Investors traditionally face income tax consequences on the sale of company stock, even when the business is closely held or relatively small in value. To encourage investment in innovation and entrepreneurship, Congress enacted Section 1202 of the Internal Revenue Code (IRC), allowing qualifying shareholders to exclude certain long-term capital gain from the sale of “qualified small business stock” (QSBS) and lower the amount of capital gains tax such shareholders would otherwise incur upon the sale of a business. Prior to the recent legislative change discussed below, Section 1202 provided for at least \$10 million of gain to be excluded from income for qualified investments, in taxable C corporations worth less than \$50 million at the time of the investment, that were held for at least five years.

Originally enacted in 1993, IRC Section 1202 has evolved through multiple legislative updates, with the most recent changes occurring under the H.R. 1 Budget Reconciliation Act (the Act), signed into law by President Trump on July 4, 2025. For stock acquired after July 4, 2025, the Act raised the per-taxpayer exclusion

cap from \$10 million to \$15 million, now indexed annually for inflation, and introduced a new tiered holding-period schedule – allowing 50% exclusion after three years, 75% after four years and 100% after five years (the five-year rule left unchanged from the existing statute). In addition, the Act increased the gross asset limitation to qualify for a “qualified small business” classification from \$50 million to \$75 million, also now indexed annually for inflation. It is important to note that shares acquired prior to July 4, 2025, continue to be subject to the prior provisions of IRC Section 1202. More early-stage investors may qualify in the future under the provisions of IRC Section 1202.

SECTION 1202 AND QSBS STACKING

Although the policy goal behind IRC Section 1202 is clear, its real impact is best understood in the context of how business owners are typically taxed upon liquidity events, such as a sale of the business. As an income realization event, business owners often face a combined federal long-term capital gains and net investment income (NII) tax rate on the sale of company stock. IRC Section 1202, as amended under the Act, helps mitigate this burden by allowing eligible shareholders to exclude the greater

of \$15 million of realized capital gain or 10 times the stockholders' adjusted cost basis (as calculated under Section 1202) when selling QSBS. For founders, early-stage investors and similar shareholders, this can result in significant tax savings. For example, if a founder acquired QSBS for \$1 million after July 4, 2025, as a cost basis, and later sold the stock for \$15 million, the entire \$14 million gain could be excluded under IRC Section 1202. Because the exclusion cap is the greater of \$15 million or 10 times the adjusted cost basis (as calculated for Section 1202 purposes, which in this case, \$10 million), the full gain qualifies – resulting in no federal long-term capital gains tax on this sale.

QSBS “stacking” becomes relevant when the value of the stock exceeds the \$15 million exclusion cap (or 10 times the taxpayer's adjusted cost basis). For example, if a founder acquires QSBS with a \$500,000 adjusted cost basis and later sells the stock for \$25 million, only \$15 million of federal long-term gain would be excluded – leaving \$9.5 million subject to long-term capital gains tax. To address this gap, attorneys have implemented a strategy known as “stacking.”

Stacking refers to multiplying the QSBS exclusion across multiple taxpayers. Under IRC Section 1202(h), when QSBS is transferred by a gift, the recipient steps into the shoes of the original stockholder. This process allows shares to be transferred to new recipients, while also preserving the stock's QSBS eligibility. By gifting shares to other taxpayers, such as one's children or irrevocable nongrantor trusts for the benefit of one's family members, the original stockholder may allow each individual or trust recipient to claim his, her or its own exclusion amount. With the proper structuring, irrevocable nongrantor trusts work for stacking purposes because they are treated as a separate taxpayer under federal income tax law.

COMMON STRUCTURES FOR ADVANCED ESTATE PLANNING

Several types of trusts may support QSBS stacking by creating separate taxpayers from the original stockholder. Each option comes with its own legal, tax and administrative considerations, and may or may not be appropriate depending on the business owner's broader financial goals. Some of these types of trusts include those discussed below.

Nongrantor Trusts

Nongrantor trusts are irrevocable trusts treated as separate taxpayers from the donor-stockholder and may qualify for their own QSBS exclusion. For example, if a founder gifts \$5 million of QSBS to an irrevocable nongrantor trust before a binding sale, the trust may exclude up to \$15 million of gain from the sale of its shares – independent of the founder's own exclusion amount. There are, however, important trade-offs for the founder's consideration. The founder must relinquish access and control over the transferred shares, and the founder cannot act as a trustee. Furthermore, the gift to the irrevocable nongrantor trust will require the founder to use his or her federal gift tax exemption to avoid paying gift tax upon the transfer. These trusts are also responsible for paying their own income taxes while being subject to compressed trust income tax brackets, meaning they reach the highest federal income tax rate on relatively low-income levels.

Incomplete Nongrantor Trusts (INGs)

INGs are self-settled trusts that may allow founders to preserve their federal gift tax exemption amount by keeping the amounts transferred in the founder's taxable estate while creating a trust that qualifies as a separate taxpayer for federal income tax purposes. In certain states, they may also help reduce or avoid state income tax. However, ING treatment

varies by jurisdiction, and there remains uncertainty as to whether these trusts fully qualify for stacking.

Charitable Remainder Trusts (CRTs)

Though less commonly used in this context, CRTs may offer an alternative approach for founders with charitable goals. These trusts are exempt from income tax, but distributions to noncharitable beneficiaries are generally taxable. The treatment of QSBS gain, including the eligibility for stacking, within this structure remains unsettled and therefore requires careful planning.

PLANNING CONSIDERATIONS AND POTENTIAL PITFALLS

Although QSBS stacking can offer significant income tax advantages, its success depends on precise execution and careful coordination. Transfers must occur before a binding sale agreement is in place, and the original holding period and QSBS eligibility must be preserved. Also, if multiple trusts are used, the trusts must have different beneficiaries. Missteps such as late-stage gifts, broken holding periods or converting trust structures midstream may disqualify the gain from income tax exclusion.

Moreover, increased IRS scrutiny and limited regulatory guidance pose additional threats to the success of these structures. For example, IRC Section 643(f) may allow the IRS to collapse multiple trusts if such trusts appear primarily tax-motivated, and certain states – like California and New York – do not conform to the federal QSBS exclusion or treat ING as separate taxpayers for state income tax purposes. For these reasons, it is important for founders to discuss their estate and income tax planning goals with their advisors well in advance of any potential sale.

IN SUMMARY

- IRC Section 1202 allows qualifying shareholders of C

corporations to exclude certain long-term capital gain from the sale of QSBS and lower the amount of capital gains tax such shareholders would otherwise incur upon the sale of the stock of the C corporation. For stock acquired after July 4, 2025, the H.R. 1 Budget Reconciliation Act increased the per-taxpayer exclusion cap from \$10 million to \$15 million, now indexed annually for inflation, and introduced a new tiered holding-period schedule for taking advantage of the exclusion.

- Stacking refers to multiplying the QSBS exclusion across multiple taxpayers. Under IRC Section 1202(h), when QSBS is transferred by a gift, the recipient steps into the shoes of the original shareholder. This process

allows shares to be transferred to new recipients, while also preserving the shares' QSBS eligibility. By gifting shares to other taxpayers, the original shareholder may allow each individual or trust recipient to claim their own exclusion amount.

- IRC Section 1202 offers a powerful opportunity for income-tax-efficient planning, particularly for founders and early investors in high-growth companies. For business owners anticipating capital gains beyond the individual QSBS exclusion cap, strategies like stacking may help maximize the benefit – if structured carefully and well in advance of a sale.

CONCLUSION

IRC Section 1202 offers a powerful opportunity for

income-tax-efficient planning, particularly for founders and early investors in high-growth companies. For business owners anticipating capital income tax gains beyond the individual QSBS exclusion cap, strategies like stacking may help maximize the benefit – if structured carefully and well in advance of a sale. As with other advanced estate planning techniques, success depends on thoughtful execution, individual circumstance and legal guidance. 🌟

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