CLIENT EDUCATION HANDOUT

Qualified Small Business Stock

How founders and investors can protect a possible QSBS tax benefit before an exit

Prepared by	JH Group CPA, A Professional Corporation
Best for	Founders, early investors, startup employees with stock, and business owners considering a C corporation structure.
Main point	QSBS can be powerful, but it is not automatic. The stock, company, shareholder, holding period, and records all need to line up.

Plain-English takeaway: Do not wait until a sale is already signed. QSBS planning works best when the company is formed, funded, issuing stock, raising capital, or preparing for an exit.

What QSBS May Do

QSBS stands for qualified small business stock. If all federal rules are met, a non-corporate taxpayer may be able to exclude part or all of the gain from selling the stock.

This is usually a federal income tax benefit. California generally does not follow the federal QSBS gain exclusion or rollover rules, so California tax may still apply.

The Big Date Split

Stock timing	Federal exclusion timing	Key limits
Stock acquired after Sept. 27, 2010 and on or before July 4, 2025	Generally 100% exclusion if held more than 5 years and all Section 1202 rules are met.	Per issuer: greater of $10 million, reduced by prior eligible gain, or 10 times basis. Company gross assets generally tested against $50 million under prior law.
Stock issued after July 4, 2025	Tiered exclusion: 50% after 3 years, 75% after 4 years, and 100% after 5 years or more, if all Section 1202 rules are met.	Per issuer: greater of $15 million, reduced by prior eligible gain, or 10 times basis. Company gross assets threshold increased to $75 million. Inflation adjustments begin after 2026.

Why this matters: A founder or investor may now have partial federal QSBS relief before the old five-year mark for qualifying post-July 4, 2025 stock. But older stock still needs the older holding-period rule.

Basic QSBS Checklist

A quick screen only. Each item needs document support.	
C corporation stock	The stock must be stock of a domestic C corporation. S corporation stock does not qualify.
Original issue	The shareholder generally must receive the stock directly from the company for cash, property other than stock, or services.
Small enough at issuance	The company must meet the gross-asset test when the stock is issued. This test can be lost if the company is already too large.
Active business	At least 80% of the company assets generally must be used in an active qualified business during substantially all of the holding period.
Qualified industry	Many service and investment-type businesses are excluded, including accounting, law, consulting, financial services, brokerage, banking, insurance, financing, leasing, farming, hotels, restaurants, and similar businesses.
Holding period	The holding period depends on when the stock was acquired or issued. Post-July 4, 2025 stock has the new 3/4/5-year tiered framework.
No bad redemptions	Certain company stock buybacks around the issuance can taint the stock.
Records	The company and shareholder need documents to prove issuance date, purchase terms, capitalization, gross assets, active business use, and stock ownership history.

Common Mistakes

1. Assuming all startup stock is QSBS. It is not. The company, stock issuance, business activity, and shareholder all need to qualify.
2. Converting or reorganizing without checking the QSBS effect. Some transactions preserve treatment; others can limit or complicate the benefit.
3. Missing the California answer. A federal exclusion may not remove California tax.
4. Ignoring redemptions. Certain buybacks before or after an issuance can damage QSBS status.
5. Waiting until closing. By then, records may be missing and planning options may be limited.

What To Gather For a QSBS Review

- Stock purchase agreements, option exercise documents, restricted stock agreements, or founder stock paperwork.
- Cap tables from formation through the expected sale date.
- Articles of incorporation, bylaws, board consents, investor financing documents, and amendment history.
- Financial statements around each stock issuance date, especially balance sheets and capitalization details.
- Tax returns and entity classification history.
- Description of business activities, products, revenue streams, assets, subsidiaries, and major pivots.
- Any redemption, repurchase, tender offer, secondary sale, or related-party transfer history.
- State residency history for the shareholder, especially if California is involved.

Planning Questions To Ask Early

Before forming or converting	Should the business be a C corporation, and what non-tax costs come with that choice?
Before raising capital	Will the new money push the company over the gross-asset threshold at issuance?
Before exercising options	When does the shareholder's holding period start, and what cash/tax risk comes with exercise?
Before an exit	What stock lots may qualify, what gain limit applies, and does a Section 1045 rollover need to be considered?
Before moving states	How will California or another state treat the gain?

Section 1045 Rollover Option

If QSBS is sold before the shareholder is ready to use the Section 1202 exclusion, Section 1045 may allow gain deferral when replacement QSBS is purchased within the required 60-day window. This rule has strict timing and reporting requirements.

Action item: If a client may sell QSBS held more than 6 months but before full exclusion, flag the sale before closing. The 60-day replacement window is short.

When To Schedule a Review

A QSBS review is worth doing when any of these are true:

- You are a founder or early employee with founder stock, restricted stock, exercised options, or shares from a startup.
- You invested directly in a private C corporation.
- Your company is raising capital, buying back shares, reorganizing, or preparing for sale.
- You expect a large gain and want to know the federal and California tax picture before signing a deal.
- Your records do not clearly prove stock issue date, basis, C corporation status, and company gross assets at issuance.

Important Caveats

This handout is general education only. QSBS results depend on facts, documents, dates, entity history, industry activity, shareholder status, federal law, state law, and tax return reporting.

JH Group CPA should review the actual records before giving a conclusion about whether stock qualifies or how much gain may be excluded or deferred.

Source Notes

- 26 U.S.C. Section 1202, current Code text as of June 25, 2026: federal QSBS exclusion rules, holding periods, gain limits, asset tests, active business rules, excluded industries, transfers, and redemptions.
- 26 U.S.C. Section 1045, current Code text as of June 25, 2026: rollover of gain from QSBS to replacement QSBS.
- Franchise Tax Board Summary of Federal Income Tax Changes, Public Law 119-21 Section 70431: California does not conform to the federal expansion of the QSBS gain exclusion.
- FTB 2025 California form instructions: California does not conform to the federal QSBS deferral and gain exclusion under IRC Sections 1045 and 1202.

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