Maximize Exit Wealth: The Enhanced Power of IRC Section 1202

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For business owners, the sale of a business that they started, operated, and grew is a monumental event that warrants strategic planning to maximize the net exit value. The amendments to Internal Revenue Code (IRC) section 1202, with the enactment in July 2025 of the *One Big Beautiful Bill Act* (OBBBA) creates more planning opportunities to achieve and maximize entrepreneurial wealth. IRC section 1202 provides for the exclusion of gain from the sale or exchange of Qualified Small Business Stock (QSBS). Under the OBBBA, the benefits of IRC section 1202 were enhanced to provide greater flexibility and higher tax savings for business founders and investors.

For stock issued after July 4, 2025, the OBBBA introduced a tiered holding period, moving away from the strict five-year holding period rule that was necessary to achieve the exclusion. Now, taxpayers can qualify for a 50% gain exclusion if the stock is held for at least three years, a 75% exclusion if held for at least four years, and a 100% exclusion if held for five years or more. Additionally, the maximum gain exclusion per issuer was increased from $10 million to $15 million, with this new cap being adjusted annually for inflation starting in 2027.

For a qualifying sale, the exclusion is the greater of the new, increased $15 million exclusion (for post-July 4, 2025, issuance of QSBS) or 10 times the taxpayers aggregate basis in the QSBS. For instance, a founder who sells for $150 million and has a $15M basis in their stock could potentially shield the entire $150 million from federal tax using the 10x basis rule (e.g., $15M basis X 10 = $150M exclusion). Beyond the 100% federal exclusion, the benefits often extend to avoiding the 3.8% Net Investment Income Tax, and reducing or eliminating the Alternative Minimum Tax (AMT) for gains on stock held over 3 years.

Qualifying for the Exclusion: Company Type Limitations

Not every company qualifies for IRC section 1202 treatment. To be considered QSBS, the holder must have acquired the stock directly from the company while it was a domestic C corporation. Stock issued by an S corporation, or units issued by an LLC classified as a partnership, do not qualify directly. Fortunately, advanced strategies exist for a conversion to a C corporation, albeit the IRC section 1202 benefits would be prospective and possibly subject to certain limitations. While the tax treatment of C corporations has improved with lower tax rates, for those businesses that have not already chosen a C corporation as a choice of entity, a conversion to a C corporation needs careful study with your tax professionals.

Additionally, a C Corporation must satisfy certain financial thresholds for its equity to qualify as QSBS. For 2026, the OBBBA increased the aggregate gross asset threshold for a company to qualify as a qualified small business from $50 million to $75 million. This, combined with annual inflation adjustments, means many more companies, especially in the technology and manufacturing sectors, can now qualify for these substantial tax benefits.

The company also must meet the active business test, meaning at least 80% of its assets must be used in the active conduct of a qualified trade or business. Specifically, excluded businesses that do not benefit from this treatment include:

- Businesses in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, or financial services.
- Businesses where the principal asset is the reputation or skill of employees.
- Banking, insurance, financing, leasing, or investing businesses.
- Farming, mineral extraction, or mining businesses.
- Hotels, motels, or restaurant businesses.

Stacking and Packing the Exclusion: Trust Structure

A powerful, advanced planning technique to maximize the exclusion is stacking and packing the benefit using trusts. Because the IRC section 1202 exclusion is a per-taxpayer limit, a single founder can multiply their $15 million exclusion by transferring shares to multiple separate taxpayers, such as family members or irrevocable non-grantor trusts. Packing involves techniques to maximize the value of exclusion by increasing Taxpayers basis and, therefore, the amount of the excluded gain.

For example, a founder holding $45 million in QSBS could potentially, through careful planning and gifting of shares to two separate non-grantor trusts, allow each trust and themselves to each claim a $15 million exclusion, potentially covering the entire $45 million from federal tax. Alternatively, if a taxpayer has limited federal estate or GST exemption, Incomplete Gift Non-Grantor Trusts may be used if the donor does not want to trigger an immediate, completed gift.

Synergistic Planning: Section 1202, Estate Tax, and Asset Protection

Combining IRC section 1202 planning with estate and asset protection strategies provides a comprehensive wealth management solution. The lifetime estate and GST exemption levels were made permanent under OBBBA with future annual increases based on inflation. In 2026, the exemptions are $15 million per individual and $30 million per married couple. Accordingly, gifting QSBS early to trusts (as discussed above) allows not only for the potential for 100% income tax exclusion upon a sale, but also could remove the stocks value and future appreciation from the donors taxable estate. Likewise, proper gifting or transferring QSBS into irrevocable asset protection trusts when the donor is not subject any creditor claims protects those assets (and the proceeds from a sale of the QSBS) from and potential, future creditors of the donor. It is worth noting that with proper capitalization, the gifted stock can be nonvoting stock thereby allowing the donor to retain control of the company.

2026 New Jersey Law Update

New Jersey has updated its state tax law to align with federal treatment, specifically addressing the treatment of QSBS gain exclusion. Historically, New Jersey did not follow federal IRC section 1202 rules, subjecting even exempt federal gains to state income tax. The new law, enacted in 2025 and effective for tax years beginning in 2026, means that for qualifying sales of QSBS, New Jersey residents can now treat the gain in a similar manner to the federal, significantly increasing opportunity for wealth maximization on an exit involving QSBS.

Conclusion

OBBBA amplified the already beneficial IRC section 1202 exclusion, making it an essential consideration for business owners advanced exit planning. With shorter holding periods, higher caps, and larger company eligibility, the potential for tax-free wealth creation is significant and should not be overlooked. By incorporating careful, long-term planning with non-grantor trusts to stack the exclusion and taking advantage of the 2026 New Jersey conformity, business owners can protect their assets, minimize their tax liability, and maximize their ultimate exit proceeds.

ATTORNEYS MENTIONED

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