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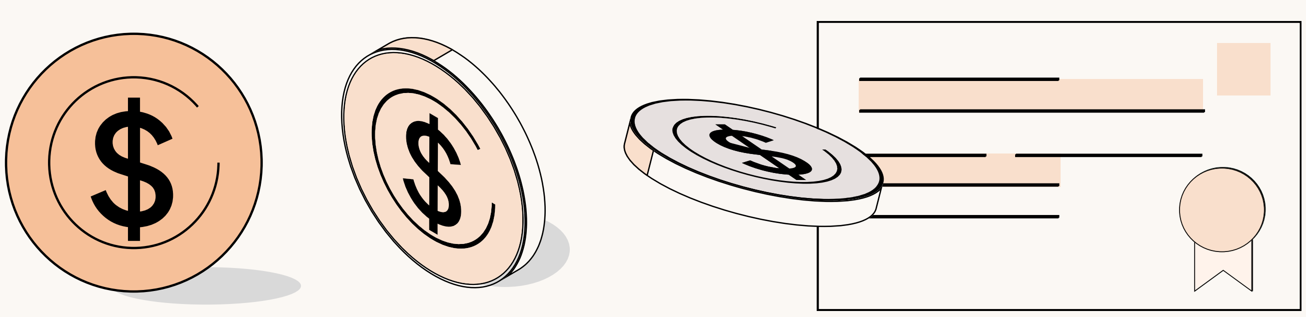
A founder's guide to qualified small business stock (QSBS)

Find out how to take advantage of the QSBS tax exclusion, which could potentially save you, your employees, and your investors millions of dollars in taxes when selling eligible company shares. In this guidebook, we'll break down QSBS benefits and rules, best practices, and business actions that impact QSBS eligibility.



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Getting started with QSBS

QSBS was designed to incentivize founders, investors, and early employees to take the risk of founding, investing in, and working at startups, which fuel the U.S. economy.

However, trying to understand whether a company is eligible for qualified small business (QSB) status—and knowing how to maintain that status so shareholders can continue to reap the rewards of this tax exclusion—isn't always straightforward. New legislation enacted on July 4, 2025 adds further complexity, expanding the eligibility criteria and benefits of QSBS—but only for shares issued on or after this date.

To help startup founders navigate the complexities of QSBS and maintain their QSBS eligibility, we've put together this comprehensive guide.

This material is provided for informational and educational purposes only and should not be construed as tax, legal, or financial advice. Situations vary and laws change. For advice specific to your individual circumstances, please consult a qualified tax, legal, or financial advisor.

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1 QSBS overview and rules

The qualified small business stock (QSBS) exclusion is a U.S. tax benefit. Eligible shareholders can exclude up to $15 million ($10 million for shares issued before July 4, 2025) in federal capital gains when selling their shares—or 10X their cost basis, whichever is greater. If they meet certain conditions, shareholders could end up paying $0 in federal taxes on their capital gains.

To be eligible for QSBS, you must exercise options or acquire your shares directly from a qualified small business (QSB) while that company is still a QSB. You also must hold those shares for at least five years before selling them to qualify for the full tax exclusion.

Note that, for shares issued after July 4, 2025, QSBS tax benefits are phased in:

- Qualifying shares held for **three years** receive a **50% capital gains tax exclusion** upon sale
- After **four years,** the QSBS tax exclusion increases to **75%**
- Shares held for **five years** before sale are eligible for up to a **100% exclusion** from capital gains tax

QSBS requirements

There are specific company and shareholder-level rules that determine whether shares qualify for QSBS treatment. For instance, a company must meet QSB requirements and shareholders must meet holding requirements.

The chart below covers the main requirements for companies and shareholders—including founders, employees, and investors. Note that this list is not all encompassing, and there are other factors that could impact the QSBS eligibility of specific shares.

COMPANY REQUIREMENTS	
Incorporated as a U.S. C corporation	✅
Gross assets under $75 million	✅
At least 80% of assets are used in the "active conduct of one or more qualified trade or business"	✅
Not an excluded field (e.g. consulting, sports, law, health, financial services, banking, farming, and hospitality services)	✅
Has not held more than 10% of net assets in stock or securities in other corporations that are or were not wholly owned	✅
Has not held more than 10% of total assets in real property not used in the active conduct of a qualified trade or business	✅

SHAREHOLDER REQUIREMENTS	
Shares originally issued from the company	✅
Exercised options or acquired shares while the issuing company was a QSB	✅
Held shares for a minimum of 3–5 years before selling	✅

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2 Types of equity and holding requirements

Shareholders must hold qualifying shares for at least three years before selling them to benefit from 50% capital gains tax relief, and for a minimum of five years to benefit from the full tax exclusion. The start date of the holding clock depends on the type of equity issued. For instance:

Restricted Stock Awards (RSAs)

The holding period for RSAs begins on the grant date, as long as the recipient files an 83(b) election. If the equity holder doesn't file an 83(b) election within 30 days of receiving their RSAs, the applicable holding periods will begin as each tranche of the equity vests.

Stock options

Stock options must be exercised to trigger the start of the holding period. The exercise must also take place while the company is still a QSB; otherwise, the shares won't qualify for QSBS.

If a shareholder chooses to spread the exercise process across several years, the holding period for each tranche of shares begins on the relevant exercise date. So, if an employee exercised 3,000 shares in 2020 and another 3,000 shares in 2024, the clock would start ticking for the first 3,000 shares in 2020, but not until 2024 for the second batch of shares.

The chart below outlines the holding start dates for different security types.

EQUITY TYPE	HOLDING START DATE
Convertible note/ SAFE	Upon conversion to stock
Preferred stock	When you purchase
Stock options	1. When you buy shares or exercise stock options 2. If you early exercise and file an 83(b) election, the clock starts on the date of the early exercise 3. If you exercise early and do not file an 83(b) election, the clock starts with each new tranche of shares as they vest
Restricted stock award (RSA)	1. If you file an 83(b) election, the clock starts for all shares when your RSA is issued 2. If you don't file an 83(b) election, the clock starts with each new tranche of shares as they vest
Restricted stock unit (RSU)	As the shares vest and settle *(Generally, RSUs aren't eligible for QSBS because they are issued by later stage companies)*

3 Documentation for tax filing and investors

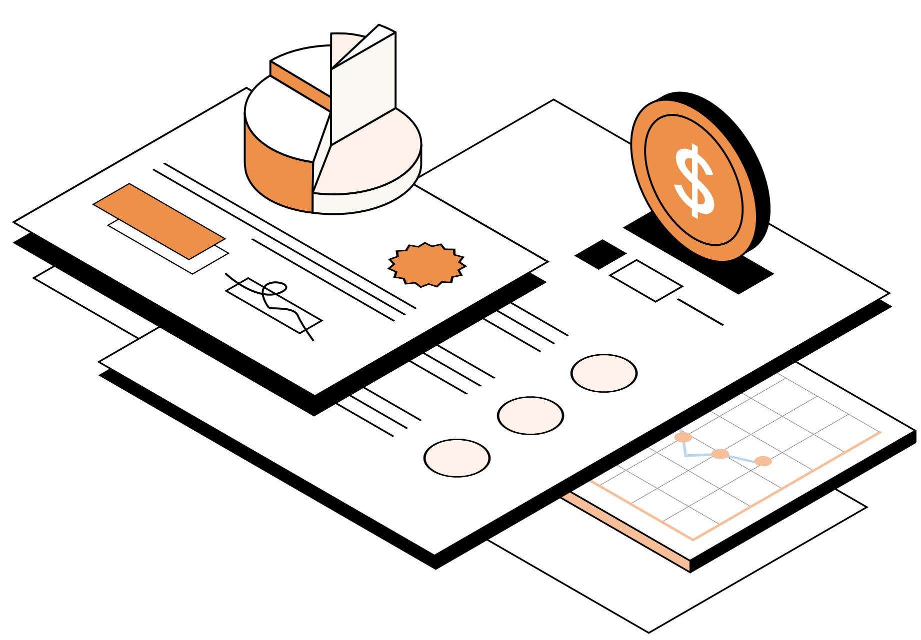
QSBS provides a significant tax advantage for founders, investors, and employees. To reap the benefits of QSBS, you need to properly document your company's QSB status and provide shareholders with the necessary paperwork. This requires meticulous record-keeping and an understanding of IRS guidelines.

In this section, we'll cover the essential documents you need to maintain, the importance of professional eligibility reviews and attestation letters, and best practices for tax filing.

Essential QSBS documentation

It's important to have the following documents on hand, so you can confirm your company's QSB status for investor requests, and defend the QSBS status of your own shares during a potential IRS audit.

1. **QSBS attestation letter:** A formal letter asserting that your company meets QSB criteria and your shares are compliant with QSBS requirements, as outlined in the Internal Revenue Code Section 1202.
2. **Proof of QSBS eligibility**: Documents that verify your company is a QSB, like incorporation documents, financial statements, and descriptions of your business's products or services. (See the QSBS checklist in chapter 4.)
3. **Stock purchase records:** Detailed records of stock purchase dates, amounts, and valuation at the time of purchase. This information is crucial for determining the holding period and calculating potential capital gains. (Shareholders can find this information in their Carta account or portfolio.)
4. **Stock sale records:** Proof of when and how the stock was sold, including sales agreements and proceeds.



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Professional QSBS eligibility review

Given the complexities and strict requirements of QSBS, many companies decide to work with an independent third party to confirm their eligibility and provide QSBS attestation. To help you comply with company and shareholder requirements,

QSBS experts can:

1. **Verify eligibility:** For shares to qualify for QSBS, the shareholder must be able to demonstrate that the company was a QSB when they received their shares. They must also show that the company met the active business requirement for "substantially all" of their holding period, which can be challenging as an individual shareholder. By working with a third-party provider to assess whether a shareholder's stock qualifies as QSBS, the company can prevent costly errors further down the line.
2. **Help you navigate complex regulations:** QSBS regulations are complicated and subject to interpretation. An independent expert can provide clarity and guidance on maintaining QSBS status for as long as possible, and for as many shareholders as possible.
3. **Provide an attestation letter:**
    a. An attestation letter is more than just a formality; it's an important document that adds credibility to a shareholder's QSBS claim. This letter should be drafted by an independent third party who has thoroughly reviewed your company's documentation and can attest to your compliance with QSBS requirements.
    b. Many investor rights agreements (IRAs)—including the National Venture Capital Association's IRA template—state that a company will send investors the information required to claim QSBS within 20 business days, if requested. The problem is that maintaining accurate, up-to-date records can be costly and time-consuming if not handled properly. Confirming your company's QSB status annually (or more often) makes it easier to build a paper trail, so you can locate the right documents when it comes to filing taxes.

Best practices for tax filing

To help founders, investors, and employees save money through QSBS, it is best practice for companies to verify their QSB status annually and provide proper documentation to demonstrate the eligibility of their stock. This annual review not only confirms that a company was a QSB when issuing the shares, but also that no disqualifying events have since invalidated its QSBS status. (Chapter 5 covers disqualifying events in more detail.)

Shareholders also have a part to play in claiming the QSBS tax exclusion. As a founder and shareholder, here are some best practices to follow when filing your annual tax return:

1. **Provide your tax advisor with annual QSBS attestation letters,** ensuring they have all the necessary documentation to file your taxes accurately.
2. **Attach the attestation letter to your tax return** when you sell or dispose of your shares. This demonstrates compliance with QSBS requirements and helps to preempt questions from the IRS.
3. **Keep QSBS-related documents organized and accessible,** including shareholder purchase and sale records and confirmation of your stock's eligibility.

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Carta QSBS Attestation

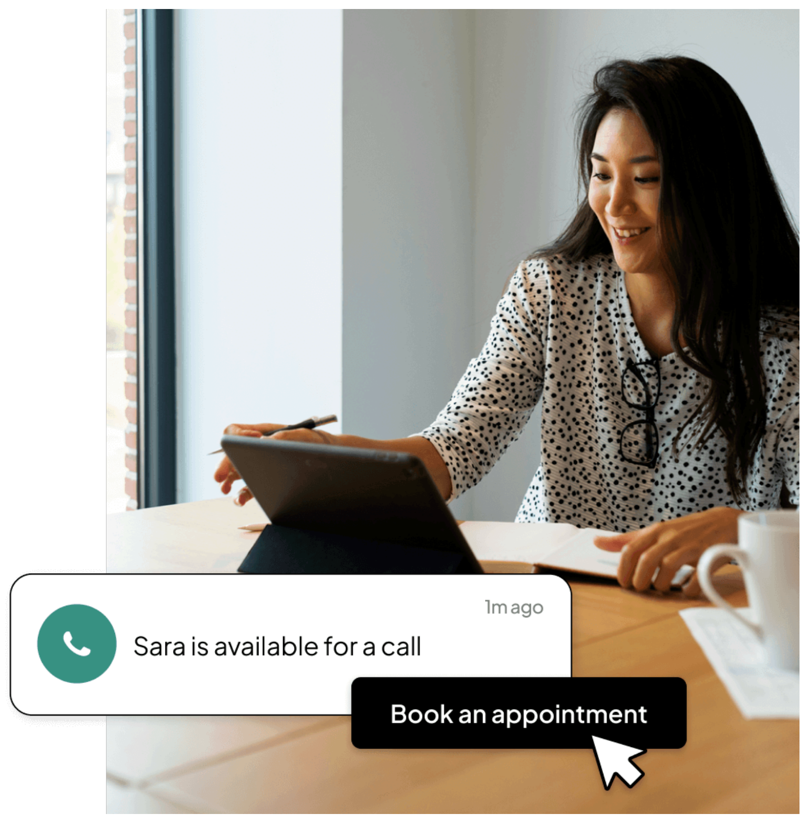
Carta can confirm your company's QSB status, tag shares that are eligible for QSBS within the platform, and provide an attestation letter for you to share with investors and shareholders. Carta customers can also benefit from expert guidance on navigating ongoing company eligibility requirements—all for a fraction of the cost of using a traditional provider.

HOW IT WORKS

Automated QSBS review & share tagging

We'll automatically check QSBS eligibility every 12 months and tag all QSBS-eligible shares in-product.

With your company's cap table on Carta, we can accurately report on holdings and transaction dates, ensuring your QSBS eligibility is audit-defensible.



Company & shareholder attestation letters

Other providers charge $50K+ for attestation letters. Carta is the only provider to issue annual attestation letters for both companies and individual shareholders—at a fraction of the cost.

Shareholders can download a tailored attestation letter from their Carta account for tax filings or personal records.

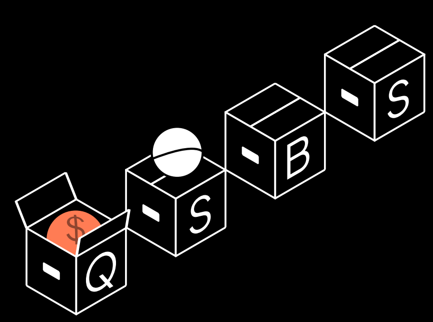
Unlimited QSBS education sessions

Carta's in-house QSBS experts can help educate you on strategies to maintain your QSB status for as long as possible.

Access to as many advisory sessions as you need is included in the cost of a Carta subscription, with no hidden fees.

Defensible, down to the letter

With attestation letters delivered in just days, help your shareholders win big on taxes—while staying effortlessly compliant.



Learn more about QSBS Attestation from Carta →

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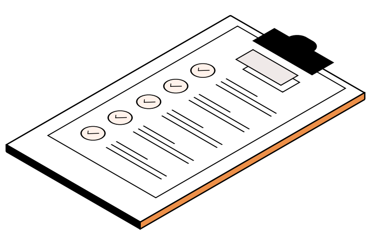
4 QSBS checklist

Investors may send you a checklist to determine whether your company meets QSB requirements and if their shares qualify for QSBS. To be eligible, you must answer "Yes" to all of the following criteria.

1

"Qualified small business" requirement



	Yes	No
• On each issue date, the Company was a domestic C corporation.	☐	☐
• At all times of the Company's existence after August 10, 1993 through the time immediately following the Issue Date, the Company's aggregate gross assets were $50 million or less. (Note that this increases to $75M for shares issued after July 4, 2025.)	☐	☐
• The Company will comply with any IRS reporting requirements with respect to Section 1202.	☐	☐

2

"Qualified trade or business" requirement

	Yes	No
The Company is engaged in a qualified trade or business. A "qualified trade or business" is any business other than (i) 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 one or more of its employees; (ii) any banking, insurance, financing, leasing, investing, or similar business; (iii) any farming business (including the business of raising or harvesting trees); (iv) certain natural resource production or extraction businesses; and (v) any business of operating a hotel, motel, restaurant, or similar business.	☐	☐

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3

“Eligible corporation” requirement

	Yes	No
Is the Company an entity other than a DISC, a former DISC, a RIC, a REIT, a REMIC, or a cooperative?	☐	☐

4

“Active business” requirement

	Yes	No
• For substantially all of the Stockholder’s holding period, at least 80% of the value of the Company’s assets were used in the conduct of one or more “qualified trades or businesses.”	☐	☐
• For substantially all of the Stockholder’s holding period, no more than 10% of the value of the Company’s assets (in excess of liabilities) consisted of “portfolio stock.”	☐	☐
• For substantially all of the Stockholder’s holding period, no more than 10% of the total value of the Company’s assets consisted of real property not being used in the active conduct of a qualified business.	☐	☐

5

Redemption analysis

	Yes	No
• The Company has not redeemed stock from the Stockholder or, to the Company’s knowledge, any related party (within the meaning of Sections 267(b) or 707(b) of the Stockholder) at any time during the four-year period beginning on the date two years before the Issue Date of the stock in question, other than de minimis redemptions and certain disregarded redemptions.	☐	☐
• The Company has not redeemed stock during the two-year period beginning on the date one year before the Issue Date with an aggregate value (as of the time of the redemption) exceeding 5% of the aggregate value of all the Company’s stock as of the beginning of such two-year period, other than de minimis redemptions and certain disregarded redemptions?	☐	☐

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5 Factors that can lead to disqualification

Not being aware of the QSBS nuances can lead to unknowingly disqualifying your company's QSB status and even disqualifying shares that were previously QSBS eligible. This is why it's essential to understand how certain business decisions can impact eligibility and why it's so important to have continuous support to navigate questions and decisions that could impact your QSBS status.

1. Exceeding the $75M asset threshold

Under the expanded QSBS rules (enacted on July 4, 2025), your company must have less than $75 million in gross assets at the time of share issuance and immediately thereafter. Factors like acquisitions, fundraising rounds, licensing agreements, and inventory could push your company over the $75M threshold, so it's important to regularly review your company's QSB status. (Note that, for shares issued prior to July 4, 2025, this threshold is $50 million.)

At Carta, we can help companies structure their funding rounds to maintain QSB eligibility and potentially save shareholders millions in capital gains taxes.

2. Too much cash, investments, or real estate

Your company's QSB status can be affected by how you manage your inventory and balance sheet. For instance:

- **Excessive, non-operating cash:** Although there is an exception for working capital requirements and cash needed for startup research and development, it's important to document your use of funds to maintain QSBS eligibility.
- **Passive Investments:** Your company will no longer meet the active business requirement for QSB if more than 10% of the value of its assets (in excess of liabilities) is held in stock or securities other than subsidiaries.
- **Subsidiary companies:** If you own 50% or more (by voting rights or value) of a subsidiary, its business activities are aggregated per QSB requirements. If you own less than 50% of a subsidiary, it would be considered portfolio stock or securities and can trigger a disqualification (as mentioned above).
- **Real estate ownership:** If more than 10% of the value of your company's assets is tied up in real estate not used in your trade or business, you'll no longer meet the "active business requirement." Rental property is not considered property used in a trade or business.

Carta can help you evaluate how mid-term and long-term investments may affect your company's QSB status—including treasuries, money market funds, real estate, cryptocurrencies, and other minority-stake investments in private or public equities.

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3. Business model changes

If your company was previously a QSB but has since changed its business model or product/service offering and started performing non-qualifying activities, your QSB status may be affected because of the active business requirement. This requirement states that at least 80% of the value of a corporation's assets must be used in the active conduct of one or more qualified trades or businesses.

- For the stock to maintain its QSBS status, your corporation must meet the active business requirement for substantially all of a shareholder's holding period.
- A business is **not** considered a “qualified trade or business” if it:
  - Performs services related to health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, finance, banking, insurance, leasing, investing, or brokerage;
  - Relies on an employee or owner's reputation (for instance, if it endorses products or services, uses an individual's image, or asks an employee to appear at events or on media outlets);
  - Produces products, such as fossil fuels, for which percentage depletion (a type of tax deduction) can be claimed;
  - Operates a hotel, motel, restaurant, or similar business;
  - Is a farming business.

4. Secondary transactions

Redemptions can create up to a two-year blackout period for QSBS. Carta can help you determine whether or not a planned redemption will affect shareholders' QSBS status, as well as calculate the allowable limits so QSBS status is not affected.

Stock won't qualify as QSBS if:

1. The company bought back stock from the shareholder or someone related to them within a four-year period, starting two years before the stock was issued.
2. In the two years starting one year before the stock was issued, the company bought back its own stock, and the total value of these buybacks was more than 5% of the value of all its stock at the beginning of this two-year period.

These rules exist to stop companies from reissuing stock they just repurchased as QSBS. They also help to provide guidelines for company actions, which are performed when a company has "excess cash" or is "too big."

But there are exceptions. For example, small-scale buybacks don't count against QSBS status, nor do buybacks related to an employee or director leaving the company, or due to death, divorce, disability, or mental incompetence.

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6 How M&A transactions impact QSBS

Being acquired is often considered a success story for most startups. But founders, early investors, and early employees can be left with a sour taste in their mouths if they have qualified small business stock in the acquired company that has yet to meet the minimum three-year holding period. Is there any way to protect or preserve the status of your exclusion at an acquisition?

The answer is yes, but it requires some knowledge of the Internal Revenue Code, and you'll have to take some extra steps to preserve your exclusion.

How different types of acquisition impact QSBS

How you preserve your exclusion depends on how the acquisition unfolds. Let's take a look at cash-out liquidation and stock-for-stock swap acquisitions.

Cash liquidation

IRC Section 1045 allows for a rollover of otherwise taxable proceeds from a cash-out acquisition into a newly identifiable QSB. This rollover allows you to:

- Defer recognition of capital gains that would otherwise be the result of the acquisition.
- Reinvest the proceeds into another QSB, preserving the QSBS exclusion from their original holdings.

Example

In 2017, a founder invested $100,000 into their business in exchange for shares in their company. When the company gets acquired in 2020, the founder sells their shares for $5M and recognizes a long-term capital gain of $4.9M. This isn't ideal, since their shares were only two years away from a completely tax-free sale.

Enter Section 1045 of the Internal Revenue Code. Imagine that the founder does their due diligence and identifies a promising new QSB. They decide to reinvest the $5M proceeds from the sale of their company shares into this new business. Three years later, in 2023, the founder sells the new shares for $10M in a secondary transaction. They can claim the $10M exclusion and won't owe any federal income tax from the sale (and potentially no state income tax either).

- **5-year holding period:** You might be thinking, "Wait, this founder didn't meet the five-year holding period in the new replacement QSB. They reinvested in 2020 and subsequently sold in 2023. How can they claim the full $10M exclusion?" Section 1045 allows for tacking the original holding period onto the shares received at reinvestment. So, the founder's holding period wasn't three years at sale; it was six years since the original acquisition was in 2017.
- **Cost basis:** You might have also noticed that the reinvestment amount was $5M, not $100,000. Don't the rules for QSBS exclusion state that the seller of QSBS can claim either the greater of $10M or 10X the basis of their shares? Shouldn't the founder be entitled to a $50M gain exclusion? Unfortunately, the answer here is no. The founder's basis in the reinvestment shares remains $100,000. In calculating the basis of the replacement investment, Section 1045 requires a reduction of the eligible exclusion amount ($4.9M) at the time of reinvestment, so our founder is still limited to the original investment of $100,000.

Cash liquidation (continued)

There are some requirements that you need to meet for the Section 1045 rollover to be successful:

- You held the originally issued QSBS for at least 6 months.
- You must successfully reinvest your proceeds from the liquidation within 60 days of that transaction.
- The reinvestment must be for stock in a newly identified QSB.
- You cannot use the proceeds to acquire convertible debt or SAFEs.
- The reinvestment must be properly reported on your income tax return(s) in order to preserve eligibility, so make sure your CPA is well versed in the rules and regulations pertaining to code section 1045.

Stock-for-stock swap

Some acquisitions allow holders of QSBS to swap their shares with shares of the acquiring company. A stock-for-stock swap at a merger or acquisition usually doesn't result in a taxable transaction if it meets the nonrecognition swap rules in Code Section 351 or Section 368's tax-free reorganization rules.

Example

In 2020, an investor received shares in a QSB for a capital investment of $100,000. Three years later, in 2023, the company is acquired by a public, non-QSB company. At the time of acquisition, the investor's shares are valued at $6M. The investor receives shares in the acquiring company, and the acquisition constitutes a Section 368 nonrecognition event. If the investor sells their shares for $10M in 2026, what are the tax implications?

The investor can exclude $6M from their income tax return(s) in the year of sale but will realize a long-term capital gain on the remaining $4M of gain. Because of the stock swap, the investor can preserve and continue the required five-year holding period. But, since the acquiring company was not a QSB, the gain exclusion the investor can claim is limited to the gain at the time of acquisition. Had the acquiring company been a QSB, the investor could have claimed a $10M gain exclusion.