

# Qualified Small Business Stock in the Life Sciences Industry

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The Internal Revenue Code (“IRC”) § 1202 provides for an exclusion from gain on the sale of qualified small business stock (“QSBS”), up to \$15 million (or 10 times the stock’s adjusted basis), if certain conditions are met. As a practical matter, the benefits of QSBS are significant and are generally available to many taxpayers owning C-corporation stock. QSBS can be issued, for example, to a limited liability company or an S-corporation. Business owners, including those in the life sciences industry, commonly overlook many issues and considerations when dealing with the qualifications for QSBS treatment. The following are a few key issues and considerations that life science business owners should consider when dealing with QSBS.

**1. General Eligibility.** QSBS is stock in a C-corporation that satisfies three initial requirements: (i) small business, (ii) original issuance, and (iii) active trade or business. Only stock can qualify as QSBS – convertible debt, options, warrants and other rights with respect to stock are not eligible for QSBS benefits.

Small Business: Generally, QSBS must be issued by a domestic C corporation (at the date of issuance) with “aggregate gross assets” totaling (i) \$50 million or less (for any QSBS acquired on or prior to July 4, 2025), or (ii) \$75 million or less (for any QSBS acquired after July 4, 2025) (such amounts include the cash or property contributed in connection with the current stock issuance), at all times from August 10, 1993 to immediately after the stock is issued. A corporation’s aggregate gross assets are generally equal to the amount of cash plus the adjusted tax basis of all other property held by the corporation. However, if any non-cash property is contributed to the corporation, that property is valued at its fair market value, not its historic tax basis, for purposes of the aggregate gross assets test. If a corporation is a qualified small business when QSBS is issued, it will not affect the QSBS status of previously issued shares if the issuer subsequently ceases to be a qualified small business. However, if a corporation’s aggregate gross assets at any time exceed (i) \$50 million (for any QSBS acquired on or prior to July 4, 2025), or (ii) \$75 million (for any QSBS acquired after July 4, 2025), the corporation cannot later issue QSBS, even if its aggregate gross assets dip below (i) \$50 million (for any QSBS acquired on or prior to July 4, 2025), or (ii) \$75 million (for any QSBS acquired after July 4, 2025) in the future. Importantly, the newly reinstated bonus depreciation and immediate expensing of domestic research and experimental expenditures under The One Big Beautiful Bill Act may allow certain corporations in the life sciences industry to further reduce their “aggregate gross assets.”

Original Issuance: Generally, to qualify for QSBS benefits, the shareholder must be the original holder who acquired the stock directly from the corporation in exchange for money or other property or as compensation. Thus, a shareholder who acquires stock in a corporation via the purchase of an existing shareholder's shares will not be entitled to QSBS benefits. Certain exceptions apply to QSBS transferred as a gift, at death, or as a

distribution from a partnership. Existing QSBS may also be exchanged in certain nontaxable stock-for-stock transactions, with the new stock retaining some or all of the original stock's QSBS benefits.

**Active Trade or Business:** To qualify as QSBS, stock must be issued by a C corporation that meets an active business requirement — at least 80% of the value of the corporation's assets must be used in a qualified trade or business during substantially all of the taxpayer's holding period for such stock. There are important limitations regarding what is a qualified trade or business, and legal counsel should be consulted.

**2. Holding Period.** An eligible taxpayer must hold the QSBS for at least five years to qualify for the full exclusion. In most cases, the start date for this five-year holding period will be straightforward. If the holder of an incentive option is exercising the option, or a note holder is converting convertible debt, the holding period will start on the date the QSBS is issued. If stock issued to a service provider is subject to vesting requirements when issued, the date of issuance of the QSBS will be the date of issuance if an IRC § 83(b) election is made or when the restrictions lapse if no IRC § 83(b) election is made. The One Big Beautiful Bill Act established a tiered-gain exclusion for QSBS acquired after July 4, 2025: (i) for QSBS held for at least three years (but less than four years): 50% exclusion; (ii) for QSBS held for at least four years (but less than five years): 75% exclusion; or (iii) QSBS held for at least five years: 100% exclusion.

**3. Exclusion Limits.** For any QSBS acquired on or prior to July 4, 2025, there is a "standard" \$10 million limit to the exclusion amount. For any QSBS acquired after July 4, 2025, there is a "standard" \$15 million limit to the exclusion amount. Such limits are cumulative, meaning they apply over the lifetime of the investments in QSBS in a particular issuing corporation. In addition to the "standard" limitations, taxpayers can qualify for a separate gain exclusion cap equal to ten times adjusted tax basis of the QSBS sold in any particular year. The 10x limitation is applied on an annual basis and is calculated as ten times the adjusted basis in the QSBS stock sold during the tax year. The additional limitation based on adjusted basis is particularly beneficial for taxpayers with high-basis stock, and there are potential planning opportunities to use the 10x basis limitation to increase QSBS benefits that would be available under the applicable "standard" limitation. Calculating the adjusted basis can be complex as it depends on various factors, including the original purchase price, any additional investments, and certain adjustments. The adjusted basis can change over time, necessitating careful consideration to ensure the shareholder maximizes the annual exclusion without exceeding it.

**4. Properly Track and Document.** Many shareholders fail to maintain accurate records and documentation related to the QSBS. Properly tracking the acquisition, holding period, and adjusted basis of QSBS is essential to claim the tax benefits. Inadequate documentation often leads to compliance issues.

**5. Subsidiary of Corporation.** If the corporation owns a subsidiary meeting the definition of "subsidiary" in IRC § 1202(e)(5)(C), then the assets and business of that subsidiary must be factored into the determination of whether such corporation is satisfying the active business requirements.

**6. Founder's Consideration For QSBS.** If founders desire their stock to qualify for QSBS treatment, they should be careful to document their cash or property (tangible or intangible) contributions to the issuer in exchange for the QSBS. If intangible assets or goodwill is used

to pay for QSBS, make sure that it qualifies as “property” for purposes of IRC § 351(a). In the life science industry, a wide range of tangible and intangible assets can qualify as “property” for purposes of IRC § 351(a); however, the most significant assets transferred in a life science IRC § 351 transaction are often intangible. These assets can include patents, trade secrets, trademarks, proprietary data, know-how, and goodwill.

**7. Inadvertent Disqualifications.** Often shareholders inadvertently disqualify their QSBS by engaging in activities or transactions that jeopardize their QSBS status. For example, if a qualified small business later expands into an industry that does not meet the requirements of a qualified trade or business, it could jeopardize the QSBS eligibility of the stock. Additionally, a corporation will fail the 80% (by value) asset test if its aggregate investment assets (assets such as stock investments and cash, less cash qualifying for the working capital exception), plus non-trade or business real estate assets, plus disqualified trade or business assets add up to more than 20% of the value of the corporation’s assets.

**8. Rollover and Exchange Errors.** QSBS investors may have opportunities to defer gains under IRC § 1045 to roll over the built-in gain into other QSBS or non-QSBS under certain circumstances, allowing them to reinvest the proceeds from the sale of QSBS into new QSBS without immediate tax consequences. If all of the requirements of IRC § 1202 are satisfied, QSBS can also be exchanged for other QSBS in a tax-free transaction under IRC §§ 351 or 368. If the stock received in exchange for QSBS is not QSBS, then IRC § 1202(h)(4)(B) generally allows for a tax-free rollover of the amount of built-in gain at the time of the exchange. That limitation does not apply, however, if the replacement stock is issued by a corporation that is a qualified small business. Additionally, investors must reinvest the proceeds from the sale into another qualified small business within a 60-day window. Failing to meet this deadline can lead to capital gains taxes (if the stock was not held long enough to satisfy the holding period requirements discussed above). The rollover provision is also contingent on reinvestment in another qualified small business. If the new investment does not meet all of the necessary criteria, the gain will not be deferred. The aforementioned tax-free rollover/exchanges are complex and can be problematic if not understood and executed correctly.

**9. State Tax Reporting.** QSBS tax treatment can vary at the state level, and some states may not conform to federal rules. Failing to understand and comply with state-level tax implications can lead to unexpected tax liabilities or missed opportunities for tax savings.

**10. Redemptions.** IRC § 1202(c)(3) prevents an issuing corporation from redeeming and reissuing stock that will qualify for QSBS treatment. The redemption rules are subject to exceptions for de minimis redemptions and redemptions triggered by a termination of the services of an employee or director, or by death, divorce, disability or mental incompetence.

This above list covers just a few of the key issues and considerations to take advantage of the exclusion of gain provided for QSBS. Many of the above issues are complicated and assuring the requirements of QSBS are met can be troublesome. It is recommended that business owners consult with their legal advisors on these issues.