

CLIENT ALERT

The Recent Expansion of the QSBS Rules Creates New Opportunities for Venture Capital Funds and Their Investors

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INTRODUCTION

The One Big Beautiful Bill Act (the Act), which was signed into law on July 4, 2025 by President Trump, made significant changes to the qualified small business stock (QSBS) rules contained in Section 1202 of the Internal Revenue Code. As more specifically described below, the Act modernizes Section 1202 and expands the already favorable tax treatment that applies to investments in QSBS. These taxpayer-friendly changes benefit venture capital funds that intend to avail themselves of the tax benefits under the QSBS rules by (i) expanding the universe of companies that the funds can invest in, (ii) increasing the amount of gains that their respective investors can receive that are not subject to federal income tax, and (iii) providing the funds with more flexibility in terms of timing their exits from these types of investments.

BACKGROUND

Subject to certain limitations, under Section 1202, a non-corporate taxpayer (e.g., individuals, partnerships, S corporations, and common trust funds) that is an investor in a venture capital fund could exclude from the taxpayer's gross income some or all of the taxpayer's share of the eligible gains realized from the fund's sale of QSBS, as long as the fund complies with the requirements of Section 1202.

QSBS is any stock that was issued by an entity taxed as a US C corporation (including US limited partnerships or US limited liability companies that have "checked the box" to be treated as a C corporation for US federal income tax purposes) that is actively engaged in a "qualified trade or business" (i.e., a trade or business in industries other than certain professional services or other enumerated trades or businesses) with aggregate gross assets under a certain cap, which prior to the Act was \$50 million (a QSB), at the time the QSBS was acquired. The issuing C corporation also must use or have used at least 80% of the total value of its assets in the conduct of one or more "qualified trades or businesses" during substantially all of the period since the issuance of the QSBS. Importantly, a venture capital fund must acquire the QSBS directly from the issuer and the taxpayer must be an investor in the fund at the time the QSBS is acquired by the fund. Prior to the Act, a venture capital fund would have had to hold the QSBS for more than five years in order for its investors to claim the QSBS tax benefit.

Furthermore, prior to the Act, the maximum amount of eligible gain that a taxpayer could exclude with respect to a single QSB in a tax year was the greater of: (i) \$10 million (less the eligible gain taken into account by the taxpayer

under Section 1202(a) with respect to the QSB in prior tax years) or (ii) 10 times the investment basis of QSBS that the taxpayer disposed of during the tax year.

For investors in a venture capital fund, the maximum amount of eligible gain that a taxpayer could exclude with respect to a single QSB in a tax year applies to each investor in the fund.

CHANGES TO THE QSBS RULES UNDER THE ACT

The Act makes the following changes to Section 1202, affecting QSBS acquired after July 4, 2025:

1. *Gross Asset Requirement.* The gross asset requirement for an issuer to be a QSB was increased from \$50 million to \$75 million (which will be further adjusted for inflation beginning in 2027). This change significantly expands the number of companies that can be treated as a “small business” under Section 1202 and thus be able to issue QSBS.
2. *Maximum Gain Limitation.* The maximum amount of eligible gain that a taxpayer can exclude with respect to a single QSB in a tax year was increased from the greater of \$10 million or 10 times the investment basis to \$15 million (which will be further adjusted for inflation beginning in 2027) or 10 times the investment basis. The increase to the flat cap on gains from \$10 million to \$15 million makes investments in QSBs more valuable as it increases the amount of gain that is potentially not subject to tax.
3. *Minimum Holding Periods.* The minimum holding period for QSBS was reduced from more than five years to at least three years. Specifically, the amount of the eligible gains that a taxpayer can exclude will be based on the following:
 - If the venture capital fund acquires the QSBS and holds the QSBS for at least three years, the taxpayer would be able to exclude 50% of the eligible gain.
 - If the venture capital fund acquires the QSBS and holds the QSBS for at least four years, the taxpayer would be able to exclude 75% of the eligible gain.
 - If the venture capital fund acquires the QSBS and holds the QSBS for at least five years, the taxpayer would be able to exclude 100% of the eligible gain.

The changes to the holding periods do not apply to (i) any QSBS acquired by a venture capital fund prior to July 4, 2025, or (ii) any tax-free exchanges of QSBS or replacement transactions for QSBS. The date the QSBS was “acquired” for purposes of determining the relevant holding periods generally is the date the stock was acquired for cash, property, or services, but certain carryover basis transactions may result in an earlier acquisition date.

If the venture capital fund holds the QSBS for fewer than three years, then the taxpayer would not be entitled to exclude the eligible gains under Section 1202 and, instead, would be subject to short-term or long-term capital gains rates, as applicable. Further, if the taxpayer is entitled to exclude some, but not all, of the eligible gains under the QSBS rules, the portion of the gain that remains taxable is subject to a 28% tax rate as opposed to the standard 20% long-term capital gains rate for non-QSBS. Therefore, not including the 3.8% net investment income tax, the effective US federal income tax rate is 14% for a 50% gain exclusion and 7% for a 75% gain exclusion.

By reducing the minimum holding period, the Act gives venture capital funds more flexibility with respect to timing the exit of an investment in a QBS to maximize returns, while still allowing its investors to benefit from the QSBS rules.

CONCLUSION

The expansion of the QSBS rules under the Act should be a welcome development for venture capital funds and their investors. Please keep in mind that the QSBS rules are complex, and this client briefing is intended to be a high-level overview of the QSBS rules and the changes to the QSBS rules under the Act. For more information, please contact us.

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