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Strategic Tax Planning for High-Net-Worth Individuals

Paper III: Capturing Venture Tax Alpha

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1. Introduction

Section 1202 of the Internal Revenue Code (IRC) provides a significant federal tax incentive for non-corporate investors (individuals, trusts, and estates) who invest in "Qualified Small Business Stock" (QSBS). The primary benefit is the exclusion of a portion—or all—of the capital gains realized upon the sale of such stock. For venture capital investors, this provision is a cornerstone of tax planning, as it can effectively reduce the federal capital gains tax rate on eligible exits to 0%.

The QSBS landscape was fundamentally altered by the One Big Beautiful Bill Act (OBBBA), enacted on July 4, 2025. This legislation introduced tiered exclusion percentages based on shorter holding periods and significantly increased the monetary caps for stock acquired after July 4, 2025, offering an unprecedented opportunity for venture investors to maximize after-tax returns.

2. Core Eligibility Requirements

To qualify for Section 1202 treatment, both the issuing corporation and the investor must meet specific criteria at the time of issuance and throughout the holding period.

Corporate Requirements

- **Domestic C-Corporation:** The entity must be a U.S. C-corp. at the time of issuance and during substantially all of the investor's holding period.
- **Gross Asset Test:** Immediately after issuance, the corporation's aggregate gross assets must not exceed specific thresholds: US$50 million for stock issued on or before July 4, 2025, and US$75 million (indexed for inflation starting in 2027) for stock issued after July 4, 2025.
- **Active Business Requirement:** At least 80% of the corporation's assets must be utilized in the active conduct of one or more "qualified trades or businesses". Disqualified sectors include professional services (law, health, engineering), banking, insurance, farming, and hospitality.

Investor Requirements

- **Non-Corporate Holder:** The investor must be an individual, trust, or estate. Pass-through entities (partnerships/LLCs) can hold QSBS, and the exclusion flows through to the individual partners, provided they held their interest in the partnership on the date the partnership acquired the stock.
- **Original Issuance:** The stock must be acquired directly from the corporation in exchange for money, property, or services (excluding underwriting).

Exclusion Percentages and Holding Periods (Post-OBBBA)

The exclusion percentage represents the specific portion of eligible capital gains realized from the sale of QSBS that is completely exempt from federal income tax, with the exact amount determined by how long the investment was held. The OBBBA introduced a "dual-track" system based on the acquisition date, establishing a tiered reward system for shorter hold durations:

Holding Period Milestone	Exclusion Percentage (Post-OBBBA Shares)	Effective Federal Tax Rate (vs. 23.8% LTCG Baseline)
Less than 3 Years	0%	23.8% (Standard LTCG + NIIT)
At least 3 Years but < 4 Years	50%	11.90%
At least 4 Years but < 5 Years	75%	5.95%
5 Years or More	100%	0.00%

3. The "Tax Alpha" in Action: Case Example & Section 1045 Rollovers

To understand how these provisions operate under the new law, consider the powerful compounding effect of utilizing a Section 1045 rollover combined with holding period "tacking".

The Scenario

- **Investor:** A New York-based Venture Partner (Individual).
- **Initial Investment (Company A):** On August 1, 2025, the Partner invests US$2 million in a Seed Round for Company A.
- **The Early Exit:** Only 18 months later (February 1, 2027), Company A is acquired. The Partner receives US$10 million in cash proceeds, realizing an US$8 million gain. Because the hold period is under 3 years, this gain is normally fully taxable at the 23.8% federal rate (US$1.9 million tax).
- **The Strategic Pivot (Section 1045 Rollover):** Within 60 days of the sale, the Partner reinvests the entire US$10 million into a Series B round for Company B (a Qualified Small Business). The US$8 million gain is deferred under Section 1045, and the Partner's basis in Company B becomes US$2 million (Cost of US$10 million minus deferred gain of US$8 million).
- **The Final Liquidity Event:** On August 1, 2029, Company B goes public, and the position is sold for US$25 million.

Holding Period Calculation (Tacking)

- **Company A:** 1.5 Years
- **Company B:** 2.5 Years
- **Total Tacked Holding Period:** 4.0 Years

Outcome Comparison

Tax Metric	No 1045 Rollover	With 1045 + Tacking
Total Gain	US$23,000,000	US$23,000,000
Exclusion Tier	0% (Short Hold)	75% (4-Year Hold)
Excludable Gain	US$0	US$11,250,000 (US$15M Cap x 75%)
Federal Tax	US$5,474,000	US$2,796,500
Tax Alpha	US$0	US$2,677,500 Savings

4. Strategic Enhancements: Gain Limitations & Cap Stacking

Gain Limitations & The 10x Basis Rule

The amount of gain eligible for exclusion is limited to the greater of a fixed dollar amount (cumulative) or 10 times the investor's aggregate adjusted basis in the stock, subject to a US$75 million hard ceiling.

- Pre-July 4, 2025: US$10 million
- Post-July 4, 2025: US$15 million (indexed for inflation starting in 2027)

The 10x Basis Leverage: For large investments, the 10x basis cap can far exceed the US$15 million limit. For example, a US$20 million investment could theoretically shield up to US$200 million in gain.

Cap Stacking via Multiple Entities and Trusts

Because the US$15 million limit is applied *per-taxpayer*, investors can multiply their total exclusion limits by gifting QSBS to multiple non-grantor trusts (e.g., separate trusts established for children or family members). Each non-grantor trust is treated as an independent taxpayer, granting each entity its own separate US$15 million cumulative cap or 10x basis capacity.

5. State Tax Conformity & Residency Planning

State tax treatment is one of the most critical exposure points for venture investors, as non-conforming states can lead to substantial tax "leakage".

- **Conforming States (NY & NJ):** New York generally conforms to federal Adjusted Gross Income (AGI) for individuals. Effective January 1, 2026, New Jersey fully conforms to Section 1202, exempting QSBS gains from its Gross Income Tax to the extent they are exempt federally. In our case example, a NY or NJ resident captures an additional ~US$1 million in state tax savings.
- **Non-Conforming States:** Pennsylvania, Alabama, and Mississippi do not recognize the exclusion. Alabama specifically decoupled from the OBBBA expansion of Section 1202.
- **California Residency Implications:** California completely disallows the federal gain exclusion under IRC Section 1202, a stance re-confirmed by SB 711 (2025). If the investor in our case example were a California resident, the entire US$23 million gain would be taxed at California's top marginal rate (13.3%), resulting in a US$3 million+ state tax bill irrespective of the federal Section 1045 rollover.

Strategic Edge

Proactive residency planning—specifically executing a legitimate change of domicile to a conforming or zero-tax state (such as Texas or Nevada) well in advance of a liquidity event—is vital to protecting QSBS-driven Tax Alpha from state-level degradation.

6. Structuring Pitfalls & Common Audit Risks

Capturing the QSBS tax exclusion requires meticulous compliance throughout the investment timeline. Below are the core operational rules paired with the most frequent failure points targeted during IRS audits:

1. Investment Instruments & Issuance

- **Core Rule:** The QSBS holding period "clock" only begins when the stock is legally issued as equity.
- **Common Pitfall (SAFE & Convertible Misunderstandings):** Investors frequently assume their holding clock begins when a SAFE or convertible note is signed. In reality, the clock is paused until the instrument formally converts into equity in a priced round, causing many to miss their 3/4/5-year tax milestones by months or years.
- **Common Pitfall (Secondary Purchases):** QSBS status demands an original issuance directly from the company. Purchasing existing shares from another shareholder via a secondary transaction completely disqualifies the stock.

2. Redemptions & "Anti-Churning" Rules (§ 1202(c)(3))

- **Core Rule:** To stop corporations from "refreshing" outstanding stock to artificially harvest QSBS status, the IRS enforces two rigid lookback windows:
  - The 4-Year Rule: Stock is disqualified if the corporation redeems any stock from the taxpayer (or related persons) within a 4-year window (2 years before and 2 years after issuance).
  - The 2-Year Significant Redemption Rule: Disqualifies all stock issued in a round if the corporation redeems more than 5% of the total aggregate value of its stock within a 2-year window (1 year before and 1 year after issuance).
- **Common Pitfall (Redemption Taint):** Unplanned, company-led stock buybacks or founder liquidity events can inadvertently trigger these rules, invalidating the QSBS status of co-investors.

3. Asset Composition & Business Drift

- **Core Rule:** The 80% active asset test must be maintained during "substantially all" of the investor's holding period. Crucially, after a corporation has been in existence for 2 years, no more than 50% of its total assets can qualify as "active" if they are held as working capital or treasury assets.
- **Common Pitfall (Business Drift):** Startups frequently pivot. If a technology company begins generating significant revenue from un-qualified activities—such as providing specialized "consulting services" that utilize over 20% of company assets—the entire corporation fails the active business requirement.

4. Growth Ceilings & Massive Capital Infusions

- **Core Rule:** The US$75 million Gross Asset Test acts as a strict, permanent limit at the time of issuance.
- **Common Pitfall (Asset Threshold Breach):** A company may cross the US$75 million threshold immediately prior to an investor's specific closing. For example, while the 10x basis rule allows large investments to scale, a single US$100 million venture investment would instantly disqualify itself, as the company's post-issuance aggregate gross assets would automatically exceed the US$75 million maximum ceiling.

5. Partnership-Level Disqualifications

- **Core Rule:** For pass-through entities (partnerships/LLCs), QSBS eligibility is evaluated strictly at the individual partner level. A partner must hold their underlying interest in the fund on the exact date the fund acquires the QSBS.
- **Common Pitfall (The "Late Joiner" Penalty):** Limited partners who enter a venture fund through subsequent closings after a QSBS asset has been acquired are legally ineligible to claim the tax exclusion on that specific asset's eventual sale.

7. Conclusion

Section 1202 offers one of the most powerful tax-saving frameworks for venture investors, transforming pre-tax outcomes into significantly enhanced after-tax returns. However, as outlined above, capturing these benefits is far from automatic. Seemingly minor structuring decisions—such as the timing of SAFE conversions, secondary purchases, or business pivots—can instantly invalidate your QSBS eligibility. To truly capture this "Tax Alpha" and avoid costly state-level or compliance traps, you need a fully integrated advisory approach spanning investment structuring and exit planning.

For those interested in exploring a personalized strategy on QSBS and tax optimization, please schedule a free 30-min consultation with tax@unityinvestments.com.

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