THE ESTATE PLANNER

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Estate planning with QSBS

The new tax law enhances the benefits

Qualified small business stock (QSBS) can be a powerful tax and estate planning tool, enabling eligible business owners — and their heirs — to exclude up to 100% of the capital gain when they sell their stock. The One Big Beautiful Bill Act (OBBBA) enhances the benefits of QSBS by shortening holding periods (for partial exclusions), increasing exclusion limits and expanding the number of businesses that qualify.

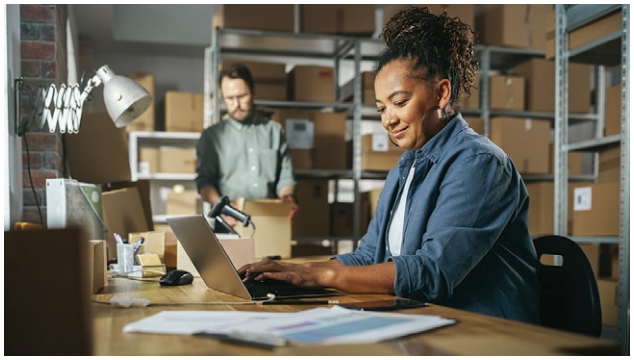
How does QSBS work?

Internal Revenue Code Section 1202 allows individuals and other noncorporate taxpayers (including U.S. trusts and estates) to exclude from federal taxable income up to 100% of eligible capital gains on the sale of stock in a C corporation that meets the definition of a "qualified small business." In addition to satisfying a gross assets test, eligible businesses must be "active," meaning they use at least 80% of their assets (by value) in one or more qualified active trades or businesses. Also, no more than 10% of their assets consist of nonbusiness real estate. Certain business types are excluded, including professional services, finance, farming, mineral production and hospitality.

To qualify for the 100% exclusion, a shareholder must:

Acquire the stock as part of an original issuance. This means the stock must be acquired directly from the corporation (or an underwriter) — rather than from another shareholder — in exchange for money, property (other than stock), or services, and

Hold the stock for at least five years after it's issued. For estate planning purposes, there's an exception to the original issuance requirement for stock received by gift or inheritance, and the transferor's holding period is tacked on to the recipient's for purposes of the five-year requirement.



What's changed?

The OBBBA makes three key changes to the QSBS framework:

1. Shorter holding periods. Although taxpayers are still required to hold QSBS for at least five years to enjoy the 100% exclusion, they're now eligible for partial exclusions for stock held for shorter periods. For QSBS acquired after July 4, 2025, taxpayers may exclude:

- Up to 50% of the capital gain on stock held for at least three years, or
- Up to 75% of the capital gain on stock held for at least four years.

Note that the taxable portion of capital gain eligible for the 50% or 75% exclusion is taxed at a 28% rate. In other words, a gain eligible for the 50% exclusion is taxed at a 14% effective rate, and a gain eligible for the 75% exclusion is taxed at a 7% effective rate. The taxable gain may also be subject to the 3.8% net investment income tax.

2. Higher exclusion limit. Previously, there was a lifetime cap on the amount of gain that could be

excluded on the sale of a particular issuer's stock equal to the greater of $10 million or 10 times the taxpayer's adjusted basis in the QSBS being sold. The OBBBA increases this "per-issuer" cap to the greater of $15 million (indexed for inflation after 2026) or 10 times the adjusted basis, for QSBS acquired after July 4, 2025.

3. Increased asset threshold for qualified small businesses. Previously, a qualified small business for QSBS purposes was one whose aggregate gross assets (including the assets of a more-than-50%-owned subsidiary) didn't exceed $50 million at any time after August 10, 1993, or immediately after the stock was issued. The OBBBA increases this threshold to $75 million (indexed for inflation after 2026).

What are the estate planning benefits?

By allowing shorter holding periods for partial exclusions and increasing the per-issuer cap and asset threshold, the OBBBA expands estate planning opportunities for owners of C corporations. Ordinarily, gifting stock to your heirs removes future appreciation from your taxable estate. Still, it creates a significant potential capital gains tax liability for the recipient, who inherits your tax basis rather than the stepped-up basis that assets transferred at death enjoy. Gifting QSBS makes it possible to remove future appreciation from your estate while preserving tax-free gains for your recipient.

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Attractive opportunities, but is it right for you?

QSBS offers extraordinary tax and estate planning opportunities, and the benefits are even more attractive under the OBBBA. Bear in mind that these opportunities aren't right for everyone. Talk to your professional tax and estate planning advisors for additional details.

QSBS "stacking" multiplies the tax benefits

It's possible to amplify the tax benefits of qualified small business stock (QSBS) through a strategy known as "stacking." As noted in the main article, these benefits are available to individuals who receive stock as a gift or by inheritance. By gifting QSBS to one or more family members — either directly or through a carefully designed irrevocable nongrantor trust — you can enable each recipient to exclude up to $15 million in capital gain for federal tax purposes.

Suppose, for example, that Robert starts a technology company, organized as a C corporation, on January 1, 2026, with an investment of $200,000 in exchange for one million shares of the company's stock. By January 1, 2031, the company is worth $30 million. If Robert sells the company, he'll be entitled to exclude $15 million of capital gain (assuming his basis is equal to the original $200,000 investment), leaving nearly $15 million in taxable gain. If, instead, Robert gifted half of his stock to an irrevocable nongrantor trust for the benefit of his daughter before selling the company, both he and the trust could each claim a $15 million exclusion, allowing them to sell the company tax-free.

Fairness and flexibility

A pot trust can benefit all of your children

A trust is one of the most versatile and practical tools in an estate plan. It allows you to manage how and when your assets are distributed, often avoiding probate and ensuring that your wishes are carried out efficiently. If you have children, creating trusts for them can offer a range of benefits beyond simply naming them as beneficiaries in your will.

Many parents' estate plans call for their assets to be split equally and used to fund a separate trust for each child. But, depending on your family's situation, it may be preferable to pool your assets into a single "pot" trust (sometimes referred to as a family trust). Let's take a closer look at how a pot trust works.

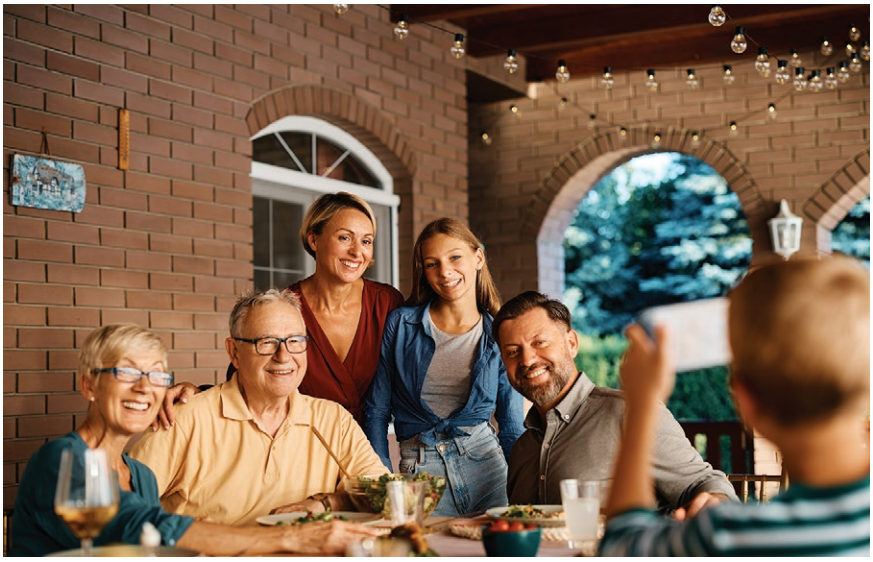
Different children, different funding needs

Most parents want to avoid "playing favorites," so separate trusts appeal to their sense of fairness. But "equal" and "fair" aren't necessarily the same thing. Think about how you use your funds now. If one of your children has a specific need — such as paying for college tuition or medical care — you'll likely pay for it without feeling any pressure to spend the same amount on your other children.

> *A pot trust can be a great way to continue meeting your children's individual needs and avoid giving one child a windfall.*

View your estate plan in the same light: Fairness means providing for your children's needs, regardless of whether you distribute your assets equally.

For example, suppose you have two children, James and Janice, ages 23 and 18, respectively. James recently graduated from college and Janice is about to start. You've already spent more than $200,000 on James' tuition and other college expenses.



If you were to die tomorrow, and your estate plan divides your wealth equally between James and Janice, James will come out ahead. That's because he already received the benefit of $200,000 in college expenses. Janice, on the other hand, will need to tap her trust fund to pay for college.

Benefits of a pot trust

A pot trust can be a great way to continue meeting your children's individual needs and avoid giving one child a windfall, as James

received in the example above. As the name suggests, you pool assets into a single trust and give your trustee full discretionary authority to distribute the funds among your children according to their needs.

Essentially, a pot trust allows the trustee to spend your money the way you would if you were alive. If one of your children has substantial educational expenses or medical bills, the trustee has the authority to cover them, even at the expense of your other children's inheritances.

For many families, a pot trust makes sense when children are relatively young and are likely to have differing needs that can change dramatically over time. If appropriate, your plan can call for the pot trust to be divided into separate trusts for each child at some point in the future — for example, when the youngest child reaches 21, 25 or some other milestone.

Your trustee choice is critical

For a pot trust to be effective, it's critical to choose your trustee — as well as a backup trustee — carefully. As with any type of trust, your trustee should be trustworthy and impartial and have the skills necessary to manage the trust assets. But for a pot trust, the trustee must be able to communicate effectively with the beneficiaries.

Because distributions depend on each beneficiary's unique needs, the trustee must understand those needs, as well as your objectives for the trust. Also, ensure that the trustee is able to explain the reasoning behind his or her decisions to all the beneficiaries.

Maintaining family harmony

A pot trust can be an excellent option for parents who want flexibility in providing for multiple children. Including one in your estate plan can provide peace of mind that your assets will be used wisely and fairly, supporting your children according to their needs while maintaining a unified approach to preserving family wealth.

Contact your estate planning advisor to learn more about a pot trust. Ask your estate planning attorney to draft your trust document. ▮

Pass your values on to heirs with an incentive trust

Your estate planning goals should go beyond simply dividing your assets among heirs. For example, you may want to pass on your values to loved ones. An incentive trust can offer a powerful way to do both.

Influencing loved ones

By linking asset distribution to specific goals or behaviors, an incentive trust can encourage your heirs to live responsibly while ensuring your estate is managed according to your wishes.

Specifically, an incentive trust can:

Promote financial responsibility. Parents can use an incentive trust to prevent heirs from squandering inherited wealth. A trust might match a beneficiary's earned income or make distributions only after financial milestones are met.

Encourage education or career development. The trust can provide funds for tuition or living expenses while a beneficiary is in school or can reward them for earning a degree.

Discourage harmful behaviors. The trust can withhold distributions if a beneficiary is convicted of certain offenses or fails periodic drug tests.

Support charitable values. The trust might match donations a beneficiary makes to qualified charities, reinforcing philanthropic priorities.

Beyond behavior-based goals, incentive trusts can also address practical concerns such as protecting family businesses, minimizing estate taxes and managing assets for beneficiaries who may lack financial experience.

Creating a more effective trust

An incentive trust works like a traditional trust, with a trustee managing the trust's assets for its beneficiaries. But unlike typical trusts that distribute funds automatically or at the trustee's discretion, incentive trusts require guidelines to be met before distributions occur.

The key to a successful incentive trust lies in thoughtful design. Here are steps to make your trust more effective and less likely to create tension among beneficiaries:

Choose the right trustee. The trustee's role in an incentive trust is especially complex. He or she must interpret the trust's conditions reasonably, apply them consistently and sometimes make difficult judgment calls. For this reason, consider appointing a professional fiduciary — such as a corporate trustee or trust company — rather than a family member. Professional trustees bring neutrality, expertise and administrative continuity.

Be flexible. The terms of your trust should be specific enough to guide your trustee yet flexible enough to adapt to changing circumstances. For instance, you might define "employment" broadly to include entrepreneurship, self-employment or caregiving for a family member. Similarly, you could allow the trustee some discretion to make exceptions in cases of illness or economic hardship.

The key to a successful incentive trust lies in thoughtful design.

Avoid overly strict terms. While it may be tempting to use an incentive trust to prevent "bad" behavior, overly strict conditions can create resentment or unintended consequences. For example, a clause that cuts off a beneficiary for failing a drug test might discourage him or her from seeking help. Instead, consider positive incentives, such as paying for treatment or matching income when recovery milestones are met.

It's also essential to regularly revisit your trust and update it as needed. Reviewing your trust periodically ensures that its terms remain consistent with your goals, tax laws and family circumstances. A CPA working in coordination with an estate tax attorney can help assess whether updates are needed.

A thoughtful legacy

An incentive trust isn't about control — it's about care. It allows you to guide future generations while leaving them with both financial stability and a sense of purpose. The right structure can promote responsibility, protect assets and help ensure that your family's values endure.

ESTATE PLANNING RED FLAG

Failing to properly plan for beneficiaries predeceasing you

When people think about estate planning, they often focus on how their assets will be distributed after their death — but few consider what happens if a child or other beneficiary dies before they do. While it's difficult to imagine such a scenario, planning for it is essential to ensure your estate is distributed according to your wishes. Without clear instructions, your assets may be redirected by default inheritance laws, potentially leading to unintended outcomes or family disputes.

An effective estate plan anticipates contingencies, such as a predeceased heir. For example, you may want your child's share to pass directly to his or her children (your grandchildren) or instead be divided among your remaining beneficiaries.

These details can be specified in your will or trust through two standard distribution designations: per capita (which means "by the head") or per stirpes (which means "by the branch"). If your documents don't address this situation, the distribution could be determined by state law, which may not reflect your intentions.

Let's suppose that Joan has three children: Anna, Bennet and Cristine. Anna has three children, and Bennet and Cristine each have one child. If Joan leaves her assets to her children per capita, then they'll be divided equally among them. If Anna predeceases Joan, then her assets will be divided equally between Bennet and Cristine, effectively disinheriting Anna's three children. Had Joan left her assets to her children per stirpes, then Anna's children would have split her one-third share.

Another distribution method is by representation, under which all members of the same class or generation are treated equally. This method works similarly to per stirpes unless more than one child predeceases you.

Going back to the previous example, suppose that both Anna and Bennet predecease Joan. If Joan's assets are distributed by representation, then Cristine would receive one-third, while Anna's children and Bennet's children would split the remaining assets four ways. Under the per stirpes method, Cristine would receive one-third, Bennet's child would receive one-third, and Anna's children would split the remaining third three ways.

New Year, New Look at Your Estate Planning

Now is a great time to review your plan with an eye to life changes that have occurred and those that might lie ahead.

Credit: iStock Photo

Life and circumstances change, and your estate planning documents most likely need to change with them—or should at least be reviewed. It's critical to your peace of mind (and that of those you care about) that your plan reflect your goals and offers the protections you want and need most.

We recommend reviewing estate plans at least every two to three years. But reviews should also occur whenever your life changes. Please consider whether any of these issues might apply. We're happy to help.

1. Beneficiaries change or require confirmation. It is not uncommon for clients to forget individuals who no longer occupy an important place in their lives, but who are designated to receive significant bequests in wills or trusts. Or they might think that simply designating a beneficiary in a will applies to other investments, such as IRAs. New interests or activities can mean you want to add or remove charities.

2. Birth of a child. While it may seem obvious to update your estate plan to include newly born children, reviewing the guardians for your minor children is also important. Similarly, you should review the trustees named to manage a child's inheritance. You might want to plan for specifics, such as education or special needs.

3. A change in your estate's value. Have you acquired or sold property or adjusted your investment strategy? A significant change in the value of your estate should cause a review.

4. A change in your estate's composition. If you buy or sell a business or real estate, you should address those changes in your estate plan. Perhaps you launched a new business and need a business succession plan.

5. Executors or trustees are no longer the "right fit." Consider the people you appointed to act on your behalf. Has anyone aged, moved away, passed away, or no longer the "right fit"? Are they still willing and capable of performing as you'd like them to? Who might be the best choice now and for the future?

6. You need a health or other proxy. Determine who will make medical decisions for you and enforce your wishes with respect to life support should you be incapacitated. A financial power of attorney might also be necessary.

7. Your marital status changes. Your estate plan should be updated to reflect marriage or divorce. If you marry, for example, will your entire estate go to your spouse? How might any children involved be treated—yours and your spouse's? Naming individuals specifically could avoid conflicts, even lawsuits.

8. You move to a new state. Since each state has its own laws, establishing proof of your change in residency is critical, especially for tax purposes. Even such seemingly minor differences as the number of document witnesses can be issues. New powers of attorney and advance medical directives might be necessary.

9. You purchase a second residence out-of-state. Which state should be designated as your principal residence for tax purposes? We can help you think that through along with any other obligations you might face.

10. New tax laws are in place. Tax laws are always changing. Together we can discuss such changes and how they affect your planning. In any review of your estate planning, changes in tax law are always fundamental.

To discuss these or other concerns, please call us at 312.900.0150 or e-mail me directly at jmichael@themichaellawgroup.com.

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