



The Benefits and Risks of QSBS Section 1202 and Section 1045 When Investing in Micro-Cap and Small-Cap Stocks

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Executive Summary

Micro-cap and small-cap stocks offer potential for high growth, often representing emerging sectors with significant return opportunities. However, these investments also involve heightened risks, such as volatility and liquidity constraints. The Qualified Small Business Stock (QSBS) regime under Internal Revenue Code Sections 1202 and 1045 delivers powerful tax incentives for retail investors, enabling substantial gains exclusions and deferrals. Major legal upgrades in July 2025 broadened and accelerated these incentives, further strengthening the case for small public company and startup capitalization.

This report provides an overview for informational purposes only to educate and inform investors about the benefits and risks associated with investing in micro-cap and small-cap stocks through the lens of QSBS Sections 1202 and 1045. By understanding the federal and possible state-level tax advantages of QSBS Sections 1202 and 1045, investors can explore and make more informed decisions that align with their investment plans and financial goals.

This report does not constitute financial, tax, accounting or legal advice. Investors should always consult with their financial, tax, accounting and legal advisors to determine the best course of action for their investments given the complexity of QSBS under Sections 1202 and 1045. **MDB Capital is not a tax, accounting or legal advisor and does not provide tax, accounting or legal advice.**



Key Takeaways: The impact of the One Big Beautiful Bill Act (OBBBA) on QSBS Sections 1202 and 1045.

The One Big Beautiful Bill Act (OBBBA), signed into law on July 4, 2025, brings important changes for investors, founders, and stakeholders in the micro-cap and small-cap ecosystem—particularly regarding Qualified Small Business Stock (QSBS) under Internal Revenue Code Section 1202, and associated rollover provisions under Section 1045.

Most of MDB's investment opportunities can qualify as Qualified Small Business Stock (QSBS) under Internal Revenue Code Section 1202, and the associated rollover provisions under Section 1045.

While MDB is **not** a tax, accounting or legal advisor, we have summarized key takeaways on the impact of The One Big Beautiful Bill Act (OBBBA) to encourage our investors to investigate how they could possibly capitalize on the updates to QSBS Sections 1202 and 1045 for their micro-cap investments.

Here's what you need to know:

QSBS Section 1202: What Changed?

The OBBBA significantly improves the tax incentives for investing in QSBS. These updates apply to stock issued after July 4, 2025. Here's an overview:

Criteria	Prior Law	OBBBA (After July 4, 2025)
Gross Asset Limit	\$50 million	\$75 million (indexed to inflation after 2026)
Per-Issuer Gain Exclusion Cap	Greater of \$10 million or 10x basis	Greater of \$15 million or 10x basis (indexed to inflation after 2026)
Holding Period for Eligibility	5 years	3 years for partial, 5 for full exclusion
Exclusion Percentage by Holding Period	100% after 5 years	50% at 3 years, 75% at 4 years, 100% at 5 years

What Does This Mean For Investors?

- ✓ **Higher Asset Ceiling:** More growing companies can issue QSBS, broadening the pool of eligible investments.
- ✓ **Bigger Tax Windfall:** You could exclude up to \$15 million per company (up from \$10 million), and that limit will rise with inflation.
- ✓ **Earlier Partial Exclusion:** Investors no longer face a “five-year cliff”: gains can now be excluded at lower rates after 3 or 4 years—providing liquidity options earlier in the typical startup lifecycle.

Section 1045 Rollover – What Stays the Same?

Section 1045 allows a “rollover” (tax-free reinvestment) of QSBS gains into new QSBS if done within 60 days. However, under OBBBA, the expanded QSBS benefits (higher asset limits, cap, and tiered exclusions) generally do NOT apply to replacement QSBS obtained through a Section 1045 rollover if the original QSBS was acquired before July 4, 2025. In effect:

- **No “Reload”:** You cannot exchange or “roll over” pre-OBBBA QSBS for post-OBBBA QSBS to claim new, greater benefits or a refreshed holding period. The old limits remain in place for those shares, even if you roll the proceeds into newly issued QSBS.
- **Ongoing Planning:** Careful attention is needed when disposing of pre- and post-OBBBA QSBS blocks, as your eligibility and the benefit amount will depend on the original acquisition date of each block.

Why This Matters for Small- and Micro-Cap Investors

- ✓ More venture-backed companies will now qualify as QSBs.
- ✓ Liquidity events do not carry the same tax penalty if held for at least 3 years, opening the door for M&A, secondaries, and other earlier exits without sacrificing all tax efficiency.
- ✓ Founders, early employees, and syndicate investors stand to gain most, as new, larger limits can apply per company, not merely per investor or per fund.

Action Steps

- ✓ Track QSBS acquisition dates closely—legacy stock and new issuances post-OBBBA are subject to very different outcomes.
- ✓ Coordinate with tax advisors before executing Section 1045 rollovers or planning exits to ensure you maximize available exclusions under the updated rules.

Conclusion

These enhancements make QSBS a more attractive, flexible, and valuable investment tool for MDB and micro-cap investors, but also add complexity to tax and exit strategy planning. Stay vigilant with your records, and always consult an informed tax professional about the interplay of your holding dates, Section 1202, and Section 1045 rules in this new expanded era.

Introduction to Micro-Cap and Small-Cap Stocks

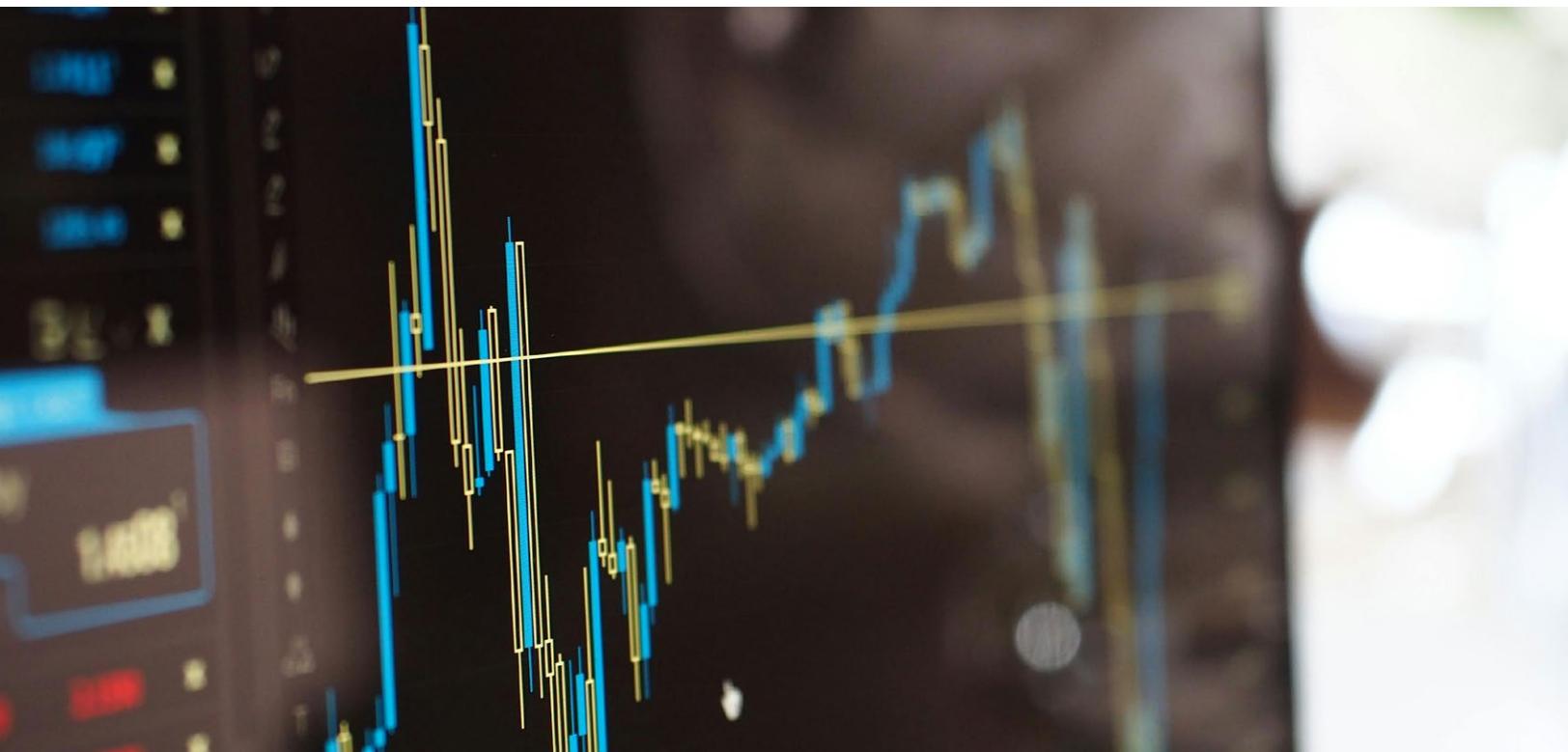
Micro-cap stocks are companies with a market capitalization between \$50 million and \$300 million, while small-cap stocks generally range from \$300 million to \$2 billion. These companies tend to be in early developmental stages, focused on innovation and market penetration. They are less covered by analysts, offering savvy investors opportunities to capitalize on information inefficiencies—but with higher volatility and risk of failure.

Advantages of investing in micro-cap and small-cap stocks include:

- ✓ **High Growth Potential:** These companies often have significant room for growth, especially if they can capture market share in their industries.
- ✓ **Market Inefficiencies:** These stocks are less covered by analysts, potentially offering opportunities to capitalize on mispricing.

Risks include:

- ✗ **Volatility:** Stock prices can fluctuate significantly, **making these stocks more volatile than large-cap stocks.**
- ✗ **Liquidity Risk:** These stocks may have lower trading volumes, making it difficult to enter or exit positions without impacting the price.
- ✗ **Business Risk:** Smaller companies are more vulnerable to operational and financial challenges, increasing the risk of failure.



Understanding QSBS and the Benefits of IRC Section 1202

Qualified Small Business Stock (QSBS) refers to shares in a small business that meet specific criteria under Section 1202 of the Internal Revenue Code. Section 1202 allows non-corporate taxpayers a partial or full exclusion of capital gains tax on the sale or exchange of qualified small business stock provided certain conditions are met. It is designed to encourage investment in small businesses.

Key Benefits of Investing in QSBS under Section 1202

Investing in QSBS under Section 1202 can provide the following benefits:

✓ **Capital Gains Exclusion, Accelerated:** For QSBS acquired after July 4, 2025, retail investors can now exclude up to:

- 50% of capital gains after 3 years
- 75% of capital gains after 4 years
- 100% of capital gains after 5 years

Note: Prior law only permitted 100% exclusion after 5 years, and only if the stock was acquired after September 27, 2010.

✓ **Larger Exclusion Limits:** The per-issuer gain cap has increased from \$10 million to \$15 million (or ten times the investor's QSBS basis, whichever is greater), indexed for inflation after 2026.

✓ **Greater Company Eligibility:** The maximum allowable assets at time of stock issuance has been raised from \$50 million to \$75 million (indexed to inflation beginning 2027), enabling more companies to qualify as QSBS issuers.

✓ **Stacking State and Federal Benefits:** In conforming states, federal and state QSBS benefits may combine for dramatic after-tax returns; in states lacking conformity, gains may remain taxable at the state level.

✓ **Encouragement of Small Business Investment:** Section 1202 is designed to spur investment in startups and small businesses, directly supporting innovation and American job creation.

QSBS Section 1202 Eligibility Requirements (2025 Update)

- ✓ **Eligible Company Structure:** The company must be a U.S. C corporation when the stock is issued and throughout the investor's holding period.
- ✓ **Gross Assets Test:** At the time of stock issuance, aggregate gross assets (including funds from the stock's issuance) cannot exceed \$75 million (up from \$50 million for stock issued before July 4, 2025).
- ✓ **Active Business Requirement:** At least 80% of a company's assets must be actively used in a qualifying trade or business. Excluded businesses include health, law, engineering, architecture, accounting, finance, mining, hospitality, and certain service sectors.
- ✓ **Stock Acquisition Rules:** Investors must acquire QSBS directly at original issuance (not via secondary market); investments through funds or partnerships have special requirements.
- ✓ **Holding Period:** To unlock gain exclusion, post-July 4, 2025 QSBS requires a minimum 3, 4, or 5-year hold for 50%, 75%, or 100% exclusion, respectively. Pre-July 5, 2025 QSBS remains subject to the old 5-year, \$10 million rules.

A qualified business or trade means any business or trade EXCEPT the following:

- ✗ 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 the trade or business is the reputation or skill of one or more of its employees. Any banking, insurance, leasing, financing, investing, or similar businesses.
- ✗ Any farming business (including the business of raising or harvesting trees).
- ✗ Any business involving the production or extraction of products of a character for which percentage depletion is allowable under Code Section 613 or 613A.
- ✗ Any business of operating a hotel, motel, restaurant, or similar business.

Understanding IRC Section 1045 Rollovers: Deferring Capital Gains

IRS Section 1045 allows investors to defer capital gains tax on the sale of QSBS if the proceeds are reinvested in new QSBS within 60 days. This provision, known as a “rollover,” can be especially valuable for investors who want to continue investing in small businesses without triggering immediate tax liabilities.

How does the Section 1045 rollover work?

When an investor sells QSBS, they can defer recognizing the capital gain if they use the sale proceeds to purchase new QSBS within 60 days. The deferred gain is then carried over to the new investment, which will only be recognized when the new stock is sold (unless further rolled over).

Requirements to qualify for a Section 1045 rollover

To qualify for a Section 1045 rollover, the following requirements apply:

- ✓ **Tax Deferral Through Rollover:** If an investor sells QSBS held at least six months, Section 1045 allows them to defer gain by rolling proceeds into new QSBS within 60 days.
- ✓ **Holding Period Carry Over:** The prior (sold) QSBS holding period can be tacked onto the replacement QSBS, facilitating eventual full exclusion under Section 1202.
- ✓ **No Cap on Deferral Gain:** There is no dollar limit on the amount of gain that may be deferred; serial rollovers can keep capital gains untaxed until a final, qualifying sale.
- ✓ **Strict Qualification:** Both the original and replacement stocks must meet all QSBS tests except for the five-year hold..
- ✓ **Complexity and Evidence:** Investors must carefully document all aspects of both original and replacement investments.

Key Benefits of Section 1045 (2025 Update)

Key Benefits of Section 1045:

- ✓ **Investment Flexibility:** Allows serial or strategic reinvestment into new qualifying companies without triggering immediate capital gains tax.
- ✓ **Preserves Tax-Advantaged Compounding:** When utilized in conjunction with 1202, 1045 lets retail investors ride multiple startup success stories before ultimately claiming an exclusion.
- ✓ **Bridge Across Market Events:** Enables smart liquidity in response to secondary offers, M&A events, or the need to rebalance portfolios—protecting capital from near-term tax drag.

Considerations and Risks of Section 1045

While deferring taxes, the investor remains exposed to risks including:



Timing Risk: You must find a new qualifying QSBS within the 60-day window, which can be challenging.



Business Risk: Reinvesting in another small business comes with the inherent risks associated with startups and small companies.



Complexity: The rules governing QSBS and Section 1045 are complex, and failing to meet all requirements can result in the loss of tax benefits.



Investment loss: QSBS investments also come with substantial risks, including the possibility of total loss.

You should work closely with tax, accounting and legal professionals who can help you review the qualifications of both the original and new stock to ensure they meet the criteria for QSBS under Sections IRC 1202 and 1045.

State-Level Tax Treatment of QSBS Sections 1202 and 1045 (2025 Update)

When considering investing in micro-cap and small-cap stocks with the intent to utilize Qualified Small Business Stock (QSBS) tax benefits under IRS Sections 1202 and 1045, it is essential for investors to understand that state-level tax treatment can significantly impact their overall tax savings. While the federal benefits of QSBS are well-known, the availability of similar state tax benefits varies across states.

Federal-State Conformity Overview

Most states either fully conform or do not conform to federal QSBS exclusions. State treatment determines whether retail investors owe state income tax on QSBS gains or 1045 deferrals.

Full Conformity States

Over 30 states—including Connecticut, Massachusetts, Texas, New York, Virginia, and Washington—follow federal rules, granting parallel QSBS benefits at the state level. However, as of July 2025, California, Alabama, Mississippi, New Jersey, and Pennsylvania do not conform.

Partial Conformity States

Hawaii and Massachusetts conform only in part; investors should check for current-year specific limitations.

No State Income Tax:

Alaska, Texas, Florida, South Dakota, Wyoming, Nevada, and Washington residents have no state income tax, making QSBS state treatment irrelevant for such investors.

Legislative Environment is Dynamic:

Investors must review state-level conformity annually; many high-tax states face pressure to close QSBS “loopholes” as adoption expands.

Note: The tax landscape can change, so it is crucial to check the latest state-specific tax rules or consult with tax, accounting and legal professionals for current informatio

Why QSBS Tax Benefits Are Worthy of Consideration

Investors considering micro-cap and small-cap stocks as part of their portfolio should carefully evaluate the federal-level and possible state-level tax treatment of QSBS under Sections 1202 and 1045.

In summary, QSBS Sections 1202 and 1045 can offer significant advantages:

- 1. Tax Efficiency for Enhanced Returns:** Ability to exclude or defer capital gains at both federal and state levels can dramatically increase after-tax, long-term compounding and risk-adjusted returns.
- 2. Stacking Exclusions:** In full-conformity states, combined state and federal exclusions may eliminate tax on all eligible gains, potentially dropping overall tax burden to zero for investors meeting relevant criteria.
- 3. Long-Term Investment Strategy:** The structure of QSBS benefits aligns with patient, long-term investing and creates meaningful incentives for holding and re-investment versus short-term speculation.
- 4. Support for Small Business Growth:** Direct investment in small businesses underpins job creation and innovation, societal benefits supported by modern public policy.

Risks and Considerations:

It is crucial for investors to be aware of and consider the associated risks:

1. Compliance Complexity:

Ensuring both the original and new investments qualify as QSBS under Sections 1202 and 1045 requires careful planning and adherence to complex tax rules.

2. State Law Variability:

Investors in non-conforming states face significant state tax on gains, potentially altering after-tax outcomes unless residency changes or legal structures are deployed.

3. Market and Business Risk:

Despite advantageous tax laws, small-cap and micro-cap issuers can fail or become illiquid, risking total loss even if investor actions comply with all tax provisions.

4. Transition and Trapping Provisions:

Pre-July 5, 2025 QSBS remains eligible only under old rules; careful timing, acquisition planning, and legal/tax counseling are essential to realize new law advantages.



Best Practices Before Pursuing Investments in QSBS

The following important considerations and actions are recommended for investors seeking to maximize the benefits of investing in Qualified Small Business Stock (QSBS) under IRS Sections 1202 and 1045:

- ✓ Consult specialized tax, legal, and accounting professionals for transaction design, documentation, and compliance.
- ✓ Rigorously track acquisition/issuance dates, company asset status, and all holding periods across new and rolled investments.
- ✓ Analyze state-level conformity and consider relocation or entity planning as necessary to maximize post-tax proceeds.
- ✓ Stay informed about annual changes in both federal and state treatment.
- ✓ Recognize that full benefits require careful adherence to IRS rules and timely rollovers under Section 10145 if interim liquidity or exit events occur.

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