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The Future of Section 1202 and the Qualified Small Business Stock Exclusion: Planning Around Potential QSBS Repeal

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On September 13, 2021, accountants, attorneys, and financial advisors woke up to startling news regarding the qualified small business stock (QSBS) exclusion as defined under §1202.[1] The night before, Chairman of the House Ways and Means Committee, Richard Neal (D-MA) had released a new set of tax proposals under the Congressional budget reconciliation process. Among other changes, Chairman Neal proposed to repeal the 100% exclusion available for QSBS received on or after September 28, 2010, and held for five years.[2]

Chairman Neal's proposal sent shockwaves through Silicon Valley and beyond.[3] QSBS has become an integral tax planning tool for many founders, early employees, and investors in the startup and VC worlds. Few taxpayers in the startup world had expected that tax increases under the American Jobs Plan and the American Families Plan would implicate QSBS. In fact, the Biden administration's proposed budget explicitly indicated that "the exclusion under current law for capital gain on certain small business stock would also [continue to] apply."[4] Thus, many taxpayers, who assumed they would continue to be able to exclude 100% of the gain on the sale of their QSBS even under Democrat tax increases, have spent the last few weeks nervous they will lose the QSBS exclusion.

OVERVIEW OF QUALIFIED SMALL BUSINESS STOCK

In general, §1202 allows non-corporate taxpayers, who invest in certain types of businesses, to exclude up to $10 million of gain or 10 times their basis in the stock, provided they have held the shares for five years.[5] For the QSBS benefits, a shareholder must receive shares from a domestic C corporation[6] either in exchange for money (or other property) or as compensation for services.[7] In addition, shares issued within one year prior to or subsequent to a major company

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[1] All section references are to the Internal Revenue Code of 1986 (the "Code"), as amended, and the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] Section 138150 of Amendment in the Nature of a Substitute to the Concurrent Resolution on the Budget for Fiscal Year 2022 (proposing to add§1202(a)(5)(A)). *See* https://waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/NEAL_032_xml.pdf.

[3] On October 27, 2021, Senate Finance Committee Chair Ron Wyden (D-OR) released the Elimination of Deferral for Applicable Taxpayers which entirely repeals the QSBS exclusion for taxpayers with income exceeding $100 million for three consecutive years or assets in excess of $1 billion. *See* https://www.finance.senate.gov/imo/media/doc/Billionaires%20Income%20Tax.pdf. Such a change would have little impact on most taxpayers holding QSBS.

[4] General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals, p. 63.

[5] §1202(b).

[6] S corporations and businesses taxed as partnerships cannot issue QSBS. §1202(c)(1), §1202(e)(4).

[7] A taxpayer generally cannot purchase shares from a preexisting shareholder and still obtain the QSBS benefits.

stock buyback may not qualify as QSBS.[8] So founders, who receive founder's shares in a Delaware corporation through a restricted stock purchase agreement, or venture capitalists (and their LPs) investing through a limited partnership in a newly converted DE corporation as part of a funding round, are normally entitled to the §1202 benefits.

AGGREGATE GROSS ASSETS TEST

The shareholder must acquire the shares before the company has more than $50 million of "aggregate gross assets," meaning the company's cash on hand (and raised through funding rounds), plus the adjusted basis of the company's assets.[9] The aggregate gross assets test does not involve the enterprise value or fair market value of the company.[10] Rather, it is a snapshot test of the company's book value, including cash and the adjusted basis of the company's assets. Thus, founders and early investors (for example LPs whose fund invests in a series seed, A, B, or — sometimes — C funding round) normally get their shares before the company has surpassed the $50 million aggregate gross assets test.[11]

QUALIFIED TRADE OR BUSINESS TEST

Finally, shares are only QSBS if, for substantially all the taxpayer's holding period, the company uses 80% of its assets in a "qualified trade or business."[12] To be considered a "qualified trade or business," the company cannot be engaged in roughly 20 specified businesses, including the performance of services in the fields of health, law, financial services, brokerage services, as well as any banking, insurance, financing, leasing, investing, or similar businesses.[13] Importantly, the IRS has issued four favorable private letter rulings (PLRs) since 2014 regarding the "qualified trade or business" limitation.[14] In each of the four rulings, the IRS determined that the company was a qualified trade or business even though it was in one of the listed fields.[15]

The PLRs read in the aggregate appear to show that where a company's "activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers," such a company can be a qualified trade or business even if listed at §1202(e)(3).[16] In addition, the recently released PLR 202114002, which limited the scope of "brokerage services" simply to "a mere intermediary facilitating a transaction between two parties," helps confirm that shares of fintech and insurtech companies are likely privy to QSBS benefits, expanding the exclusion's applicability to a wider range of Silicon Valley startups.

NEAL PROPOSAL

The Neal proposal is not a change to the §1202 benefits. Rather, it simply repeals the 75% exclusion benefit under §1202(a)(3)[17] and 100% exclusion ben-

[8] Section 1202(c)(3)(B) and Reg. §1.1202-2(b) provide that a "significant redemption" potentially triggering QSBS disqualification occurs when the redeemed shares have an aggregate value exceeding 5% of the total value of all the company's shares tested one year before the redemption (the beginning of the two-year period). A separate four-year redemption taint can occur if the company buys back more than 2% of the shares held by any particular shareholder. §1202(c)(3)(A); Reg. §1.1202-2(a). Both the redemption taints do not apply where the stock buyback occurs pursuant to a shareholder's termination, death, disability, or divorce. Reg. §1.1202-2(d).

[9] §1202(d)(1).

[10] However, where a shareholder contributes property (e.g., a patent or IP) in exchange for shares of QSBS, that property is tested at fair market value for purposes of the $50 million aggregate gross assets test. §1202(d)(2)(B).

[11] Section 1202(d)(1)(B) provides that shares received as part of a funding round where the investment pushes the company over the $50 million aggregate gross assets test are not QSBS.

[12] §1202(c)(2), §1202(e)(1)(A). After a two-year working capital safe harbor, no more than 50% of the total fair market value of the company can be cash. §1202(e)(6). The balance of the value must be IP or some other asset that is used in the company's trade or business. Taxpayers can use §409A valuations or (better) the pre-money value of the company as part of a funding round to establish the value of the underlying IP or other assets.

[13] §1202(e)(3). In addition, no more than 10% of the value of the company can be composed of real estate or stock and securities. §1202(e)(5), §1202(e)(7).

[14] PLR 201436001 involves a consulting business in the pharmaceutical industry; PLR 201717010 involves a genetic testing company; PLR 202114002 describes an insurance business and the application of brokerage services; PLR 202125004 involves a medical device manufacturer.

[15] *See, e.g.,* PLR 202125004 stating: "Although the Products produced by Taxpayer are associated with the health industry, we conclude that for the purposes of §1202(e)(3), Taxpayer is not in the trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees."

[16] PLR 201436001. The single Tax Court case providing guidance on the §1202(e)(3) qualified trades or business standard, *Owen v. Commissioner*, T.C. Memo 2012-21, appears to reach essentially the same conclusion: "the principal asset of the companies was the training and organizational structure; after all, it was [the Taxpayers] in their commission sales hats, who sold the policies that earned the premiums, not [their] personal capacity."

[17] The American Recovery and Reinvestment Tax Act of 2009, Pub. L. No. 111-5, added §1202(a)(3) which increased the gain exclusion for QSBS to 75% for shares acquired after February 17, 2009, and before September 28, 2010.

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efit under §1202(a)(4)[18] for taxpayers with adjusted gross income (AGI) of $400,000 or more.[19] There is a safe harbor for any sale of shares made "pursuant to a written binding contract which was in effect on September 12, 2021," which is not later materially modified.[20] In short, the Neal proposal simply puts most taxpayers back in the same place they were when §1202 was first enacted.[21] Under the proposed change, most taxpayers will only be able to exclude 50% of gain for the sale of QSBS.[22]

However, under the general §1202(a)(1) rules, the tax benefit for QSBS is not an exact 50% exclusion. Rather, the taxable gain portion of QSBS is taxed at the 28% collectibles gain rate[23] and 7% of the QSBS excluded gain is an alternative minimum tax preference.[24] Given these special rates, gain on the sale of QSBS under the Neal proposal would be taxed at an effective rate of 16.88% including the 3.8% net investment income tax (NIIT).[25]

It is noteworthy that the Obama administration added the QSBS exclusion benefits to the I.R.C. in 2009 and 2010.[26] In this respect, it is surprising that taxpayers may lose the 100% QSBS exclusion during another Democratic administration.[27]

FUTURE QSBS CONSIDERATIONS IN THE FACE OF TAX REFORM

It is not clear whether Neal's QSBS proposal will be picked up as part of the final reconciliation. However, even if the Neal changes become law, QSBS will remain a valuable planning tool for founders, early employees, and investors. The Democrats are almost certain to raise the long-term capital gains rate, potentially to 25% under the Neal proposal[28] or to ordinary income tax rates under the Biden budget.[29] Thus, taxpayers will still enjoy at least a 12% savings even if QSBS is taxed at an effective rate of 16.88%.[30]

In addition, taxpayers with significant holdings of QSBS will still want to leverage the §1202 exclusion, even if it is not 100%. This is particularly true for shareholders who hold QSBS in excess of $10 million. For these shareholders, there are a number of methods to stack the QSBS exclusion in excess of $10 million. As a general matter, §1202 allows each "taxpayer" to exclude gain[31] and the statute provides a number of avenues to create additional taxpayers who can exclude gain.

GIFTING QSBS

First, §1202(h)(2) allows taxpayers to gift shares of QSBS and the donee is considered a separate taxpayer

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[18] The Creating Small Business Jobs Act of 2010, Pub. L. No. 111-240, added §1202(a)(4) which further increased the QSBS exclusion to 100% for shares acquired after September 27, 2010.

[19] *See* proposed §1202(a)(5)(A). Importantly, whether a taxpayer has exceeded the $400,000 AGI limitation is calculated and determined by taking into account all income including the full amount of gain from QSBS sold in a particular year. *See* H. Rep. 117-137, Report from the Committee on the Budget to Accompany H.R. 5376, the "Build Back Better Act," 117th Cong., 1st Sess. (2021). Note, as well, that under the proposal, any taxpayer which is a trust or estate cannot receive the 75% or 100% exclusion benefit regardless of AGI. *See* proposed §1202(a)(5)(B).

[20] Section 138150(b) of Amendment in the Nature of a Substitute to the Concurrent Resolution on the Budget for Fiscal Year 2022.

[21] As referenced in Note 3, above, §23 of the Elimination of Deferral for Applicable Taxpayers, introduced by Senator Ron Wyden on October 27, 2021, would also add (a different) §1202(a)(5)(A) to the I.R.C. disallowing any QSBS exclusion benefits for the roughly 700 U.S. taxpayers with more than $1 billion in assets or more than $100 million in income in three consecutive years. The author believes that such an amendment would have almost no impact on the vast majority of founders and investors holding QSBS. Only a small fraction of VCs holding QSBS through their funds would lose the QSBS exclusion.

[22] In fact, taxpayers who received shares of QSBS before February 18, 2009 (i.e., before the 75% or 100% exclusion benefits) should see no major impact from the Neal proposal.

[23] §1(h)(4), §1(h)(7).

[24] §57(a)(7).

[25] By way of example, $10 million of QSBS gain would be taxed: ($5,000,000 [50% of the taxable gain] + (7% of $5,000,000 [50% of the excluded gain])) × 28% [collectibles rate] = $1,498,000 + (3.8% of $5,000,000 [NIIT]) = $1,688,000.

[26] For example, S. Rep. No. 208, 68, 112th Cong., 2d Sess. (2012), states that the "increased exclusion and the elimination of the minimum tax preference for small business stock gain will encourage and reward investment in qualified small business stock." Prior to 2016, the 100% exclusion was subject to sunset provisions. The Protecting Americans from Tax Hikes Act, Pub. L. No. 114-113, made the 100% exclusion permanent.

[27] Chairman Neal does not appear to be concerned. According to a Ways and Means Committee Democratic aide, Chairman Neal "wholeheartedly rejects the notion that stock sales taxed at this rate would have any effect on innovation and investment. . . . He believes that Silicon Valley millionaires making these disingenuous arguments are among the extremely wealthy people who should be contributing more, not less, to support investments in critical infrastructure and services that make success in this country possible." Ben Steverman and Kaustuv Basu, *Tech Millionaires Fear Their Favorite Tax Break Will Be Chopped*, Bloomberg Wealth (Sept. 21, 2021), https://www.bloomberg.com/news/articles/2021-09-21/silicon-valley-fears-the-end-of-qsbs-every-tech-millionaires-favorite-tax-break.

[28] Section 138202 of the Amendment in the Nature of a Substitute to the Concurrent Resolution on the Budget for Fiscal Year 2022.

[29] The Biden administration has proposed to tax long-term capital gains of taxpayers with adjusted gross income of more than $1 million at ordinary income tax rates (40.8% including NIIT). General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals, p. 62.

[30] 28.8% (Neal proposed capital gains rate with NIIT) − 16.88% (QSBS effective rate at 50% exclusion) = ~12%.

[31] §1202(a), §1202(b).

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entitled to her own $10 million exclusion. The donee is treated as having received the shares in the same manner as the donor (i.e., in exchange for cash or compensation for services) and the donee's holding period tacks to the donor's holding period (i.e., if the donor has held the shares for four years, the donee only needs to hold for another year to reach the five-year exclusion threshold).[32] Founders often use §1202(h)(2) to multiply their exclusions.

For example, it is relatively common for founders to establish nongrantor irrevocable trusts for the benefit of their children. The nongrantor trust is considered a separate taxpayer.[33] Each trust is funded with enough QSBS so that when it sells, the gain is roughly $10 million.[34] Ideally the founder can fund the trusts when the value of the QSBS is still relatively low since the gift must be reported and a gift tax return filed.[35] But, with adequate planning, a founder with three children should be able to exclude $40 million of QSBS.[36]

$20 MILLION QSBS EXCLUSION FOR MARRIED FILING JOINTLY SPOUSES

Second, §1202(b)(3) appears to allow spouses who file jointly to exclude $20 million of QSBS. There are a number of situations in the I.R.C. and IRS administrative guidance where spouses are treated as separate taxpayers[37] and §1202 does not explicitly limit married filing jointly couples to a single $10 million exclusion.[38] Indeed, the legislative history to §1202 appears to support the $20 million married filing jointly position when it states "the $10 million limitation on eligible gain is applied on a shareholder-by-shareholder basis."[39]

Consider two unmarried founders who form a company and each receive shares of QSBS. Later they marry and elect to file jointly. From a policy standpoint, does it make sense to limit these founders to a single $10 million exclusion? Such a position seems like a flagrant marriage penalty since, absent the marriage, each founder would be entitled to his or her own $10 million exclusion. The legislative history to §1202 supports the idea that these two founders are each shareholders of QSBS and they are separate taxpayers.[40] Thus, because §1202 allows a $10 million exclusion on a per taxpayer, rather than a per tax return basis, it appears that such spouses should be able to exclude a total of $20 million of QSBS on a joint return.

CONCLUSION

The reconciliation process will inevitably create tax changes, including potential increases to capital gains rates and the repeal of the 100% QSBS exclusion. However, §1202 remains a complex but powerful tool for taxpayers. As rates rise, the value of the QSBS exclusion (in whatever form it ultimately takes) will continue to provide significant benefits.

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[32] §1202(h)(1).

[33] §641, *et seq*. A nongrantor trust files its own tax return (Form 1041, *U.S. Income Tax Return for Estates and Trusts*), and must obtain its own EIN.

[34] It appears that the recently proposed "Billionaire's Income Tax," entitled Elimination of Deferral for Applicable Taxpayers, would disallow QSBS benefits for a nongrantor trust selling QSBS in excess of $10 million. Taxpayers would need to plan so not to trigger this threshold. See Notes 3 and 27, above for more information on the proposed Elimination of Deferral for Applicable Taxpayers.

[35] With the Neal proposal set to lower the estate and gift tax exemption from $11,700,000 (married couples $23,400,000) to $6,020,000 effective as of January 1, 2022, founders have additional incentive to make gifts of QSBS.

[36] The founder's own $10 million plus three trusts with $10 million each.

[37] For example, TAM 9853002 provides that spouses should not be treated as one taxpayer for purposes of the $5,000,000 applicable threshold under §453A on installment obligations.

[38] Section 1202(b)(3)(A) does limit married couples who file separately to $5 million exclusion each. But taxpayers should not necessarily infer that a restriction on married filing separately couples extends to couples filing jointly.

[39] H. Rep. No. 103-213, p. 527, 103d Cong., 1st Sess. (1993).

[40] *Nell v. Commissioner*, T.C. Memo 1982-228: "It is a long recognized legal maxim that a husband and wife are separate and distinct taxpayers notwithstanding the fact that they have filed joint Federal income tax returns."

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