Section 1202 Qualified Small Business Stock Exclusion & Entrepreneurship

Gregg Polsky
University of Georgia School of Law

Thesis

- Section 1202, which excludes gains realized by individuals on the sale of small business stock, is likely largely ineffective in achieving its intended goal
  - Main Street small businesses almost always still organized as pass-throughs
  - VC-backed start-ups, while idiosyncratically organized as C corporations, solicit much of their capital from non-U.S. individuals, who don't benefit from the provision
    - See also glut in VC dry powder
- Instead, the provision is a windfall for successful founders, angel investors, VC general partners

Section 1202 Basics

- Since 2015, section 1202 provides for an exclusion of gain for individuals from the sale of "qualified small business stock" (QSBS) that will be held for more than 5 years prior to disposition
- QSBS is (in general):
  - Stock of a C corporation
  - Is originally issued by the corporation
  - Satisfies a gross assets test (<$50M after issuance), and
  - Satisfies active business test
- QSBS may be held through flow-through entities
- Cap on excluded gain is greater of $10M or (10 x cost basis)
- Section 1045 allows for tax-free rollover of proceeds from sale of QSBS into other QSBS with tacked holding period
  - Example: Taxpayer sells QSBS stock A for $10M gain 3 years after purchase and (within 60 days of the sale) buys QSBS stock B with the proceeds. If QSBS B stock is sold 2 years later, gain is excluded (up to cap)

Statutory Purpose

- Stated legislative purpose of 1993 enactment was to provide "targeted relief for investors who risk their funds in new ventures [and] small businesses" and "to encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing"
- Expansion of QSBS exclusion in 2010 was to "encourage and reward investment in qualified small business stock"
- Statute benefits two types of individual investors
  - Sweat equity investors ("founder's stock")
  - Cash investors (angels, individual LPs in VC funds, individual VC fund managers)
  - Legislative history seems to focus on the latter cash investment
- Is the desired purpose to stimulate more entrepreneurial activity or to encourage greater investment in new/small businesses?
  - Goals seem to go hand-in-hand
  - More cash for equity investment in new businesses

History of section 1202

- 1993 through 2002: QSBS taxed at effective (federal) rate of 14.98%, compared to max LTCG rate of 20%
- 2003 through 2/17/09: QSBS taxed at effective rate of 14.98%, compared to max LTCG rate of 15%
- 2/17/09 through 9/27/10: QSBS taxed at effective rate of 8.47%, compared to max LTCG rate of 15%
- 9/27/10 onward: QSBS taxed at effective rate of 0%, compared to max LTCG rate of 15% (until 2013) or 23.8% (thereafter)

History of Complete Exclusion

- Legislation on 9/27/10—provided for complete exclusion for QSBS purchased on or before 12/31/10 (from effective 44% cut in LTCG rate)
- Legislation on 12/17/10—extended complete exclusion to 12/31/11
- Legislation on 1/2/13—extended complete exclusion (retroactively) from 1/1/12 to 12/31/13
- Legislation on 12/19/14—extended complete exclusion (mostly retroactively) from 1/1/14 to 12/31/14
- Legislation on 12/18/15—extended complete exclusion (partially retroactively) from 1/1/15 onward
- Absent extensions would have reverted back to 14.98% effective rate (compared to 15% or 23.8% rate)

Limited Periods of Proactive Exclusion

- An investor would be sure that complete exclusion would be available during these period
  - QSBS purchased between 9/27/10 and 12/31/11
  - QSBS purchased between 1/2/13 and 12/31/13
  - QSBS purchased between 12/19/14 and 12/31/14
  - QSBS purchased after 12/18/15

- Between 9/27/2010 and 12/18/15 (approximately 1,900 days), QSBS purchased would be eligible for complete exclusion
  - But only about 800 (approximately 40%) of those days was the exclusion actually available on the date of purchase (as opposed to retroactive application)
  - Longest lead time from legislation to expiration was about 1 year
    - From 12/17/10 to 12/31/11
    - From 1/2/13 to 12/31/13
  - Limited windows of opportunity
  - If the goal is to change behavior (stimulate new investment), then windows should be larger and there should be no retroactivity
  - Anecdotal evidence is that these windows were used to consider reclassification of existing businesses from flow-through status to C corporation status
    - “Check the box” tax planning that doesn’t affect investment behavior

Application to Main Street Business

- Main Street businesses usually are organized as flow-throughs
  - S corporations
  - LLCs taxable as partnerships
- Historically, the burdens of C corporation status clearly outweighed the potential 1202 benefits
- 2018 corporate tax rate cut has caused some thinking (but apparently not a lot of acting)
- Leaving aside 1202 (and 1014 SUB at death) corporate status is generally still disfavored, though in some situations it may provide a slight benefit
  - See Knoll (2019)
  - Risk of corporate rate hikes makes conversion scary
  - Flow-through status preserves optionality; C corp status eliminates optionality

Quantifying the “Net” 1202 Benefit

- A major benefit of flow-through status is the ability to, in an exit, give the buyer a stepped up basis in the assets, particularly goodwill
  - Goodwill is amortized ratably over 15 years
  - Flow-through status means only one tax on seller
  - SUB should result in a premium purchase price
    - Or put differently, a stock purchase price should be discounted to reflect lack of SUB
- Example: assume business has 1 asset: Goodwill worth 100 (zero basis in the asset and in the owner’s equity)
  - Buyer would pay 100 for in an asset deal
  - What’s the equivalent purchase price for a stock deal?
  - Assuming 25% corporate tax rate and 8% discount rate, Buyer should pay only about 85

Quantifying the “Net” 1202 Benefit

- With LLC, seller sells assets for 100 and is left with 76.2 after tax
- With Corporation & full section 1202 exclusion
  - Seller sells stock for 85 and is left with 85 after-tax
  - (Could alternatively sell assets for 100 and be left with 75 after corporate tax; 1202 shelters shareholder tax on liquidation)
- Under these facts, 1202 benefit is paying 15% “tax” (loss of SUB premium) rather than 23.8% actual tax, not paying 0% tax
- Other distinctions
  - 1202 only benefits individual owners (not corporate/tax-exempt shareholders); SUB available to all who don’t require a blocker corp
  - 1202 has other restrictions (original issuance, gross asset test) that don’t apply to SUB
  - 1202 benefit is capped; SUB is uncapped
  - SUB requires buyer to actually pay premium (and the expectation of future taxable income)
  - 1202 can be replicated by 1014 SUB at death and thus may be duplicative, while SUB premium & 1014 benefit can be cumulative

Bottom Lines for Main Street Businesses

- Flow-throughs historically clearly preferred
- Choice of entity analysis a bit tougher now
- But still flow-throughs should prevail
  - Benefits of corp are at best modest
  - Risk of corp tax rate changes
  - Flow-throughs preserve optionality
- 1202 benefit is not as large as it appears—23.8% tax down to 15% implicit tax--once SUB considerations are taken into account

Start-Ups

- Start-ups (defined as those businesses who solicit funding from VC firms) have idiosyncratically preferred corporate form
  - Choice has been the subject of much academic debate
  - I've previously argued that the preference is mostly due to tax compliance & administrative hassle/cost concerns
- Therefore section 1202 is clearly in play in the start-up context
- Threshold question of whether there is suboptimally low levels of supply of start-up equity financing
- VC firms had about $276 billion of dry powder in 2019, up from $119 billion in 2015, and nearly triple the amount in 2012
  - Vastly increasing dry power suggests that there is plenty of supply (and it is growing fast)

Start-Ups

- Start-up players
  - VC investors
  - “Angel” investors
  - Founders
  - Individual VC fund managers
- Investors: VC investment is funded to large extent by taxpayers who don’t benefit from 1202
  - 2017 Prequin Report identified 100 most active VC investors
    - 75 were ineligible for 1202 (pension funds, endowments, sovereign wealth funds, etc…)
    - Another 19 were funds of funds
      - Ultimate investors could be individuals or ineligible taxpayers
- Angel investors are individuals and could be influenced by 1202
  - Relative small potatoes
  - Often have social & reputational reasons to invest, not strictly financial
  - Hard to imagine that they would be significantly influenced by 1202
    - Is mass substitution into public equity realistic?
  - Even if they are, seemingly could be replaced by VC funds with all their dry powder

Start-Ups

- Founders are individuals and could be influenced by 1202
  - Like angels, have social/reputational reasons to start/join companies
  - Extremely high failure rate of early stage start-ups means that founders are likely not focused on potential tax rates if they are successful
  - Other tax avoidance techniques if they end up hitting a grand slam
    - 1014 SUB
    - Charitable gifting
- VC GPs likewise are individuals and could be influenced by 1202
  - Via carried and the GP's capital commitment (usually 1-3% of the fund's)
  - But their day job is investing in start-ups; substitution is unclear
  - Plenty of VC activity before 2015 when 1202 complete exclusion was permanent and proactive

Conclusions

- Despite its stated legislative goals, 1202 doesn't seem designed to stimulate investment in new/small businesses
- Main Street businesses are simply not eligible due to entity form
- The vast majority of VC investment is from investors who don't care about U.S. taxes
- Angels & founders & VC GPs will benefit
  - But unlikely to influence their behavior very much, if at all