The Tax Law Center NYU LAW

July 6, 2023

From Bad to Worse: Section 1202 and the House Tax Package

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Section 1202 was enacted in 1993 as an incentive for investments in small businesses, but the section has instead become an unnecessary subsidy for well-off taxpayers and VC funds investing in companies that would have launched with or without the benefit of section 1202. The proposed changes in the House tax package would only increase this subsidy without providing any additional incentive to invest in small businesses and would create some potentially serious new loopholes. Instead of expanding section 1202, the better approach would be to repeal the statute or, at a minimum, amend section 1202 to narrow the definition of a small business and repeal the $10 million gain exemption. These amendments would refocus section 1202 on its original purpose of incentivizing new investments in small businesses.

Introduction

The Small Business Jobs Act ("SBJA") (H.R. 3937) recently advanced by the House Ways and Means Committee contains several provisions that would expand the section 1202 exclusion of gain from the sale of qualified small business stock. These provisions would shorten the five-year holding period to three years, expand the section to include convertible debt, and extend the section to stock of an S corporation. Each of these provisions is a significant extension of section 1202 and, in combination, the three provisions would represent a substantial and unwarranted expansion of the statute.

These proposed modifications should be rejected for several reasons. The modifications are fundamentally inconsistent with the intended purpose of section 1202. The modifications also contain a number of provisions that would permit gain exclusion in inappropriate situations. Finally, as a general matter, any modification that expands the scope of section 1202 is inappropriate. Section 1202 was initially enacted to incentivize investments in small businesses, but the section has been neither an incentive to invest nor a benefit for small business. As a practical matter, the section has evolved into an unnecessary subsidy for well-off taxpayers and venture capital (VC) funds who invest in start-ups that would have been created with or without the benefit of section 1202. The revenue loss under the SBJA changes is estimated at about $2.5 billion annually by the end of the decade (when the full impact of the proposals on the budget would have become more evident).[1] Instead of expanding this unwarranted subsidy, Congress

[1] JCT estimates the cost of the proposal to be $11.6 billion over 2023 to 2033, but the annual cost rises steeply across the budget window. This is in part because, as discussed below, the proposed changes include an increase in the tax benefit for investments held for three years or longer, so the bulk of the budgetary impact of investments qualifying for that benefit would not start to be seen until the latter half of the decade. J. Comm. on Tax'n, JCX-27-

should repeal section 1202 or, at a minimum, amend the section to better implement the original intent of the section.

Current Section 1202 and Proposed Amendments

Section 1202, enacted as part of the Omnibus Budget Reconciliation Act of 1993, provides that a taxpayer (other than a corporation) can exclude a percentage of gain from the sale of qualified small business stock ("QSB stock"). QSB stock is defined as stock in a domestic C corporation whose aggregate gross assets (before and after the issuance of the stock) are less than $50 million. For this purpose, gross assets include cash and the adjusted basis (not fair market value) of other property held by the corporation. The corporation must also use at least 80 percent (by value) of its assets in the active conduct of a qualified trade or business during substantially all the seller's holding period in the stock. For this purpose, an active trade or business includes certain start-up activities.

To qualify for the exclusion, the seller must have acquired the QSB stock at original issue and held the stock for at least five years. The percentage of gain that can be excluded has varied over time, but for stock acquired after September 27, 2010 (the date of enactment of the Small Business Jobs Act of 2010), the gain exclusion percentage has been 100 percent. The total amount of excluded gain is limited to the greater of (i) $10 million (reduced by any amount excluded on a previous sale of stock in such corporation) or (ii) 10 times the taxpayer's aggregated adjusted basis in the stock. Seven percent of the excluded gain was originally subject to the alternative minimum tax ("AMT"), but for stock acquired after September 27, 2010, the gain is not an AMT preference item.

The SBJA proposes three modifications to section 1202. First, the required holding period is shortened from five years to three years and a new schedule for the percentage of excluded gain is created: 50 percent of the gain is excluded for stock held at least three years, 75 percent of the gain is excluded for stock held at least four years, and 100 percent of the gain is excluded for stock held five years or more. Second, under a new tacking rule, if qualified convertible debt is converted to stock, the holding period of the stock includes the holding period of the converted debt. Finally, the section is expanded to include stock of an S corporation.

The SBJA Modifications are Inconsistent with the Intent of Section 1202

Section 1202 was enacted to incentivize long-term investments in the equity of small businesses. As the legislative history of the section indicates, the section was intended to provide "targeted tax relief for investors who risk their funds in new ventures, small businesses, and specialized small business investment companies" to "encourage the flow of capital to small business, many

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23, Estimated Revenue Effects of H.R. 3937, The "Small Business Jobs Act" (2023). Some research argues that JCT's estimates of the cost of the existing provision are conservative. *See* Manoj Viswanathan, *The Qualified Small Business Stock Exclusion: How Startup Shareholders Get $10 Million (Or More) Tax-Free*, 120 Colum. L. Rev. F. 29, 37 (2020) ("Assuming a private acquisition market comparable to that of the IPO market, the true cost of section 1202 would be ten times larger than that estimated by the JCT."). *See also* summary in Manoj Viswanathan, *Money for nothing: The Qualified Small Business Stock capital gains exclusion is a giveaway to wealthy investors, startup founders, and their employees* (June 8, 2023).

of which have difficulty attracting equity financing." This congressional intent is reflected in the statutory language: the gain exclusion is limited to investors who make an equity investment and hold the investment for at least five years.

Under the SBJA modifications, however, an investor would no longer need to make a long-term investment because they could receive a 50 percent gain exclusion after just three years. The investor would also no longer need to make even an equity investment. Under the qualified convertible debt provision, a lender could convert the debt to stock on the day before a sale, thereby removing any equity risk. In effect, a lender could make a three-year loan and, if the business significantly appreciated in three years, convert the debt, sell the stock, and receive a full or partial gain exclusion. If the business did not appreciate, the lender could simply hold the debt instrument and continue to receive any interest and principal repayments. The net result is a tax cut windfall for the lender on any profitable investments for no additional downside risk. Indeed, extending this tax break to short-term debt instruments makes these types of investments more attractive relative to the long-term equity investments that section 1202 was supposed to support.

The SBJA modifications would also expand section 1202 to include stock of an S corporation. The original decision to exclude S corporations from section 1202 was presumably made at least in part to avoid the inevitable problems that would be created by the interaction of section 1202 and Subchapter S. This decision was quite practical and sensible and should not be reversed.

For a quick example of the complexity created by the interaction of section 1202 and Subchapter S, suppose a shareholder contributes $1 million in cash to a C corporation. The corporation incurs $1 million of deductible expenses. The stock appreciates and the shareholder sells the stock for $10 million. The shareholder would have a net economic gain of $9 million ($10 million sale price - $1 million initial investment) and a corresponding tax gain of $9 million ($10 million sale price - $1 million basis in C corporation stock). The $9 million of gain would be excluded under section 1202. The amount of the gain exclusion would match the amount of the economic gain.

The result is quite different if the corporation is an S corporation. The $1 million deduction would be allocated to the shareholder under Subchapter S, reducing her stock basis from $1 million to $0. When the shareholder sells the stock for $10 million, she has the same $9 million economic gain ($10 million sale price - $1 million initial investment), but she now has a tax gain of $10 million ($10 million sale price - $0 basis in stock reduced by the expense allocation). The $10 million of gain would be excluded under section 1202. The amount of the gain exclusion would now exceed the amount of the actual economic gain, which is not the intent of section 1202.

The S corporation shareholder has effectively received two benefits: a deduction and a gain exclusion. The effect is the same as allowing a taxpayer a $1 million depreciation deduction on an asset and then excluding the gain on sale: all deduction; no gain. To avoid this result, $1 million of the gain would presumably need to be excluded from section 1202 and treated as taxable recapture gain. This would equalize the treatment of S corporation and C corporation shareholders, except of course for any timing or character benefit inherent in any recapture situation.

Another potential problem is that Subchapter S, unlike Subchapter K, does not have any provisions dealing with built-in gain at the S corporation level. Any gain or loss of the S corporation is simply allocated to the shareholders pro rata. This pro rata rule could easily create undesirable results in combination with section 1202. For example, suppose A forms a new S corporation. The S corporation develops an intangible asset with a basis of $0 and a value of $10 million. The S corporation sells the asset. The $10 million gain is allocated to A and is not eligible for section 1202 because it is gain from the sale of an asset, not gain from the sale of stock.

Now assume B contributes $10 million to the S corporation for a 50% interest before the asset sale. The $10 million of gain from the sale of the asset would be allocated equally to A and B. A's basis in her stock would be increased from $0 to $5 million, and B's basis would be increased from $10 million to $15 million. The fair market value of A and B's stock, however, is still $10 million each. A and B then sell their stock. A has a gain of $5 million, but this gain would be excluded under the SBJA modifications to section 1202. (There are provisions in current section 1202(i) that would reduce the gain exclusion for certain built-in gains and losses, but these provisions apply only to property contributed to a corporation and A has not contributed any property to the S corporation.) B recognizes a $5 million loss on the stock sale.

From an economic position, B's contribution has had no impact. A's stock was worth $10 million before the contribution, and she sells the stock for $10 million. B contributed $10 million and sold her stock for $10 million – effectively getting her money back. From a tax perspective, however, B's contribution has a big impact: it has the practical effect of reducing the gain on the sale of the S corporation asset from $10 million to $5 million. Before the contribution by B, a sale of the S corporation asset would have resulted in $10 million of taxable gain allocated entirely to A. After the contribution, the asset sale itself still creates $10 million of taxable gain, but the net taxable gain for A and B from the combination of the asset sale and the stock sale is only $5 million: (i) $5 million of taxable gain for A on the asset sale and $5 million of excluded section 1202 gain on the sale of her stock and (ii) $5 million of taxable gain for B on the asset sale and $5 million of loss on the sale of her stock. If section 1202 had not applied to A's sale of her S corporation stock, A would have recognized $5 million of taxable gain on the sale of the stock, thereby bringing the total net gain for A and B back to the correct $10 million.

In effect, extending section 1202 to S corporations in these situations would convert the current timing mismatch created by the Subchapter S pro rata rule into a permanent exclusion of gain on the sale of corporate assets. Of course, while most taxpayers in B's situation might not prefer the timing disadvantage of an early gain and a later loss, there are undoubtedly situations where, depending on a taxpayer's particular circumstances, a taxpayer would prefer a gain today and a loss in a later year. At any rate, this effective exclusion of 50 percent of the gain on the sale of the S corporation's asset is presumably not the type of incentive that section 1202 was intended to provide.

In addition to problems created by the pro rata allocation rule, there may be problems created by the basic fact that, unlike C corporation stock, the basis of S corporation stock is adjusted for the shareholder's share of the S corporation's income and loss. There might even need to be a new "section 1202 basis" for S corporation stock, in addition to the normal basis for the stock, to avoid any problems and ensure that section 1202 operates as intended. Designing statutory rules to prevent these and other types of potential problems that may be created by extending section 1202 to S corporation stock would be difficult at best and may still allow for inappropriate results. It would also add further complexity to the section 1202 regime that was supposed to be for small start-up businesses, rather than for those who have (or whose investors have) access to the sophisticated tax advice needed to navigate such rules. The better approach would be to avoid these results (as well as any other similar potential problems) by simply not extending section 1202 to S corporation stock at all.

Section 1202 Should Not Be Extended, But Should Instead Be Repealed or Amended

Section 1202 was intended to provide an incentive for long-term equity investments in small businesses in ways that have broad benefits for the economy, but as a practical matter, the section has fallen far short of its intended goal. As the non-partisan Congressional Research Service's review of section 1202 concludes:

> While a case can be made on economic grounds for a tax subsidy such as the Section 1202 gains exclusion, it is more difficult to build a case for the subsidy on the basis of its efficacy. There are no apparent indications that the provision has greatly increased the flow of equity capital to eligible small firms. In the 24 or so years since QSBS owners were first able to take advantage of the exclusion (August 12, 1998), little research has been done on Section 1202's impact on the cash flow, capital structure, employment, and investment of companies issuing the stock.

The history of section 1202 suggests that a large part of its value, rather than efficiently supporting investments in new technologies, flows as a windfall to investors in corporations that already have a very large market value and easy access to equity capital. Most of these corporations have been concentrated in the technology sector. Instead of expanding this subsidy, section 1202 should be repealed or at least amended to correct the current flaws in the statute.

The reason why the benefits of section 1202 have been primarily limited to corporations in the tech sector appears to be a quirk of history. Under current law, section 1202 applies only to the sale of stock in a domestic C corporation. Given the corporate-level tax on C corporations and the tax benefits of operating as a flow-thru entity, the vast majority of small businesses are not formed as C corporations. These small businesses operate as sole proprietorships, partnerships, or S corporations and therefore cannot take advantage of section 1202.

There is, however, one curious exception to this general rule: start-ups who intend to seek equity funding from VC funds have historically been formed as C corporations. The reasons for this preference are opaque at best, but the preference clearly exists.[2] As a result, the benefits of section 1202 have generally been limited to the individuals involved in these C corporation start-ups: the founders and early employees of the business, initial "friends and family" investors, angel investors who make regular early investments in start-ups, and the general partners of VC funds who participate in the capital investment and receive a carried interest for their services.

Of course, benefiting these start-ups would be entirely consistent with the purpose of section 1202 if the start-ups were indeed small businesses and if there were a need to incentivize investments in these businesses. Many of the start-up companies that have benefitted from section 1202, however, are not small businesses under any reasonable definition.[3] Nor is there any evidence of a shortage of VC financing for start-ups, and indeed there is a consistently high level of potential financing ("dry powder") held by VC funds for such investments.[4] As a practical matter, the investments made in these start-up companies would have been made with or without the benefit of section 1202, making it an inefficient windfall rather than a cost-effective subsidy.

Allowing S corporations to qualify for section 1202 would only make this problem worse. Not only would the extension provide little or no additional incentive to invest, but it would allow investors to receive the additional benefits that come from S corporation status, such as the flow-through of losses. These additional Subchapter S benefits, on top of the current gain exclusion, would simply be another windfall that would not provide any additional incentive to invest.

Given the lack of incentive provided by section 1202 and the types of entities that have benefitted from the gain exclusion, the more appropriate approach would be to repeal section 1202. An alternative would be to adopt the proposals in the Build Back Better bill to reduce the 100% exclusion to 50% for individuals with AGIs in excess of $400,000.[5] If section 1202 is not repealed or the benefits capped, the section should be amended to eliminate some of the more egregious problems caused by the current statute. Most of these problems arise from the statutory definition of a qualified small business and the operation of the $10 million gain limitation. The best approach to solve these problems would be to narrow the definition of small business and eliminate the $10 million gain exclusion.

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[2] *See* Gregg Polsky & Ethan Yale, *A Critical Evaluation of the Qualified Small Business Stock Exclusion*, 42 Virginia Tax Review 353, 384 (2023) and sources cited therein for an excellent discussion of this issue and an in-depth critique of section 1202.

[3] *See* Manoj Viswanathan, *The Qualified Small Business Stock Exclusion: How Startup Shareholders Get $10 Million (Or More) Tax-Free*, 120 Columbia Law Review Forum 29 (2020) for an overview of the size of corporations potentially eligible for section 1202 treatment.

[4] *See* Nat'l Venture Cap. Assoc. 2023 Y.B. 13 (2023) ("Venture funds hit a fundraising record in 2022, with the industry sitting on a record $312 billion in dry powder.").

[5] Build Back Better Act, H.R. 5376, 117th Cong. § 138149 (as reported by the Committee on the Budget, Nov. 3, 2021) (including proposed section 1202(a)(5)).

Under current section 1202(d)(1), a "qualified small business" is any C corporation whose aggregate gross assets do not exceed $50 million. For this purpose, "aggregate gross assets" means cash and the aggregate adjusted basis of other property. Using basis to define the size of a business is a simple approach, but it is often a very poor indication of the actual value of a business. For example, suppose A contributes zero-basis Intellectual Property (IP) to a start-up corporation. The value of the company then increases, but the basis of corporate assets is still $0 (assume no income and all expenses have been deducted or expensed). A VC fund contributes $50 million for a 10 percent interest. The implied value of the C corporation would be $500 million, but it is still considered a qualified small business because the total of the cash contributed ($50 million) plus the adjusted basis of corporate assets ($0) is not greater than $50 million. Under any reasonable definition, this business should not have qualified as a small business at the time of the VC contribution.

A more sensible approach would be to base the $50 million test on the fair market value of the corporation at the time of the VC investment. Any problems in valuing the corporation should be mitigated because the VC contribution provides an implied value of the corporation at the time of contribution. An even better approach would be to define a small business by reference to the gross annual revenue or the gross annual receipts of the corporation, similar to how section 448 limits the use of the cash method of accounting to corporations and partnerships with annual gross receipts of $25 million or less.

In addition to the problems caused by the definition of a small business, the current $10 million gain limitation can lead to some surprising and troubling results. The most egregious problem is probably the so-called "stacking" technique. To illustrate this problem, suppose an individual holds QSB stock with a basis of $0 and a value of $20 million. If the shareholder sells her stock, only $10 million of the $20 million gain is excluded. The shareholder instead transfers $10 million of her stock by gift to a relative or a family trust. The transferee steps-into-the-shoes of the transferor under section 1202(h)(1). On the sale of the stock, the transferor and transferee each recognize $10 million of gain, all of which is excluded under section 1202, resulting in the entire $20 million of gain being excluded.

There does not appear to be a limit on the number of potential gifts that could be made by the original shareholder. For example, if a shareholder sold stock with a basis of $0 and a value of $100 million, she would be able to exclude only $10 million of her $100 million gain. But if she made a gift of $10 million of the stock to each of nine transferees, each transferee would apparently also have a $10 million gain exclusion. The entire $100 million gain would have been excluded.

The most efficient way to eliminate this problem and other similar inappropriate results would be to eliminate the $10 million gain exclusion. A shareholder's gain would then be limited to 10 times its basis. Under this rule, if the shareholder in the previous example made the nine gifts contemplated, the gifts would not result in a larger gain exclusion because the shareholder and each transferee had no basis in the stock. If the shareholder had basis in her stock, the gifts would still not result in an increased gain exclusion because the shareholder's initial basis would simply be divided among the nine transferees. A gain limitation based on stock basis would have the added benefit of preventing general partners in a VC fund from excluding gains on their carried interests because such interests have a basis of zero on issuance. At a minimum, if the $10 million gain exclusion is retained, the section could be amended to eliminate the step-into-the-shoes rule for transferees and limit the exclusion to the original holder of the QSB stock.

In addition to this stacking problem, section 1202 applies on a per-issuer basis and thereby provides an exclusion of up to $10 million for each corporation sold by an investor. This can result in an inappropriately large benefit for some investors. For example, if an individual entrepreneur contributes zero-basis IP to her corporation, she is limited to a one-time exclusion of $10 million for her investment. If an individual is a general partner in a VC fund that invests in ten different businesses, however, the general partner is potentially eligible for $100 million of excluded gain over time. Section 1202 presumably was not intended to disproportionately advantage VC general partners over the actual founders of small businesses. This result could be avoided by applying the $10 million exclusion on a per-taxpayer basis and not a per-issuer basis, thereby limiting an individual taxpayer to one $10 million lifetime exclusion for all sales of QSB stock.