

THE QUALIFIED SMALL BUSINESS STOCK EXCLUSION:
HOW STARTUP SHAREHOLDERS GET \$10 MILLION (OR
MORE) TAX-FREE

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INTRODUCTION

The IPO parade of 2019 is making the early shareholders of technology startups such as Uber, Lyft, Slack, and Pinterest (among others) staggeringly wealthy.¹ Now that these companies are publicly traded, equity owners can easily cash out at a huge profit.² As shares of stock, this profit would normally be taxed at long-term capital gains rates.³ But the qualified small business stock exclusion of section 1202 of the Internal Revenue Code, a provision whose ostensible purpose is to promote investment in small businesses, will result in many of these millionaires paying zero federal taxes on much of this sudden wealth.⁴

This Piece demonstrates that the loss in federal tax revenue due to section 1202 is far greater than previously estimated, with the provision almost exclusively benefitting the wealthy. Section 1202 represents flawed tax policy, with little connection between the statute's main beneficiaries and its putative goals. Even if catalyzing investment in small businesses is normatively desirable, the provision does little to promote that result. Though applicable to investors in "small businesses," most truly small businesses are precluded from using section 1202. Instead, tech startups with valuations in the billions are the common beneficiaries.

Part I of this Piece provides an overview of section 1202. Part II uses both IRS data and publicly available information from 2019 IPO filings to demonstrate that the true cost of the provision is likely far greater than previously estimated. Part III provides tax policy critiques of the provision, and Part IV suggests how the provision could be improved.

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1. See Stephen Grocer, Grant Gold & Erin Griffith, Who's Getting Rich when Uber, Slack and Other 'Unicorns' Go Public, N.Y. Times, <https://www.nytimes.com/interactive/2019/business/dealbook/ipo-investors.html> (on file with the *Columbia Law Review*) (last updated May 9, 2019).

2. See *id.*

3. Including the net investment income tax, the top long-term capital gains rate is 23.8%. See I.R.C. §§ 1, 1411 (2012).

4. I.R.C. § 1202.

I. SECTION 1202 AND QUALIFIED SMALL BUSINESS STOCK

Section 1202 allows taxpayers to exclude from all federal taxes \$10 million (or more) of profit from the sale of qualified small business stock (QSBS).⁵ As described in more detail below, QSBS is stock (1) issued by a C-corporation with less than \$50 million of gross assets that is engaged in an active trade or business and (2) held for at least five years.⁶ Although first enacted over twenty-five years ago, the provision has become especially valuable for the early equity holders of technology startups.

The original, 1993 iteration of the statute lacked the force of today's version.⁷ In 1998, the first year in which QSBS gain could be recognized, section 1202 excluded from tax only 50% of QSBS gain. Importantly, the 50% of QSBS gain that *was* still taxed was subjected to a top capital gains rate of 28%, resulting in an overall tax rate of 14% on QSBS gain.⁸ Given that the top capital gains rate was then only 20%, section 1202 gave taxpayers only a 6% savings relative to typical long-term capital gains.⁹ This benefit was further reduced to just 1% in May 2003, when the top capital gains rate was reduced to 15%.¹⁰ Additionally, a sizable portion of the excluded QSBS gain was treated as a tax preference item for alternative minimum tax (AMT) purposes, potentially subjecting the taxpayer to an increased AMT burden.¹¹

QSBS gain was fully excluded from federal income tax starting with the passage of the Small Business Jobs Act on September 27, 2010.¹²

5. I.R.C. § 1202(b)(1) states:

[A taxpayer's eligible qualified small business stock] gain . . . shall not exceed the greater of—(A) \$10,000,000 reduced by the aggregate amount of eligible gain taken into account by the taxpayer under subsection (a) for prior taxable years and attributable to dispositions of stock issued by such corporation, or (B) 10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.

Id.

6. See *id.* § 1202.

7. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312.

8. I.R.C. § 1(h)(5) (1998).

9. Although the top capital gains rate was reduced from 28% to 20% in 1998, any QSBS gain *not* excluded was still subject to the old, 28% rate. I.R.C. § 1(h).

10. Federal Capital Gains Tax Rates 1988–2013, Tax Found. (2013), https://files.taxfoundation.org/legacy/docs/cap_gains_1988-2013.pdf [<https://perma.cc/XQN6-VN25>].

11. See IRS, Instructions to Form 6251 (1998) (requiring 42% of excluded QSBS gain to be included as an AMT tax preference item). Subsequent legislation decreased this percentage from 42% to 28%, then 7%, then zero in 2010. See I.R.C. § 1202(a)(4)(C); Small Business Jobs Act of 2010, Pub. L. No. 111-240, 124 Stat. 2504, 2554; Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752, 759 (amending the percentage to 7% in 2003); Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685, 800, 805 (amending the percentage from 42% to 28% in 1998).

12. Small Business Jobs Act of 2010, Pub. L. No. 111-240, 124 Stat. 2504.

QSBS gain from stock acquired after this date had an effective tax rate of zero. But the provision was temporary, and thus had little value for taxpayers desiring tax planning certainty.¹³ Section 1202 changed significantly in 2015 when the 100% exclusion from both capital gains and exclusion as an AMT preference item were made permanent.¹⁴ A taxpayer with QSBS gain from stock acquired after September 27, 2010 now enjoys a tax savings of 23.8% relative to garden-variety, non-QSBS long-term capital gains.¹⁵

To qualify for QSBS treatment, shares must be received directly from a “qualified small business” in exchange for either cash or services provided.¹⁶ Thus, stock sold to early investors as well as stock given to early employees in exchange for services both qualify. A “qualified small business” is a C-corporation engaged in an active trade or business with less than \$50 million of gross assets at the time of the shares’ issuance.¹⁷ This \$50 million gross-assets test is not equivalent to valuation—a company valued at billions could conceivably satisfy the gross-assets test. Additionally, QSBS maintains its status even if the company’s gross assets eventually exceed the \$50 million threshold.¹⁸

These requirements are easily satisfied by technology startups. Although most small businesses operate as pass-through entities, there are several reasons (other than the QSBS exclusion) why nascent tech companies elect C-corporation status.¹⁹ Technology startups also tend to have minimal physical assets, and can thus have less than \$50 million of gross assets and still be worth many times that. Lyft, for example, represented to investors that it was a qualified small business during its Series B funding round, yet had an estimated post-Series B valuation well in excess of \$50 million.²⁰ This is illustrative of technology startups; early

13. See Beckett G. Cantley, *The New Section 1202 Tax-Free Business Sale: Congress Rewards Small Businesses that Survived the Great Recession*, 17 *Fordham J. Corp. & Fin. L.* 1127, 1141 (2012).

14. *Protecting Americans from Tax Hikes Act of 2015*, Pub. L. No. 114-113, 129 Stat. 3040, 3054.

15. The top capital gains rate is 23.8% when the net investment income tax (NIIT) of section 1411 is taken into account. See I.R.C. § 1411. NIIT does not include QSBS gain. *Id.*

16. *Id.* § 1202(c).

17. *Id.* § 1202(d)(1).

18. *Id.* Once the \$50 million gross-assets threshold is exceeded, however, the company cannot issue additional QSBS. *Id.* § 1202(d)(1)(A).

19. See Gregg Polsky, *Explaining Choice-of-Entity Decisions by Silicon Valley Start-Ups*, 70 *Hastings L.J.* 409, 411 (2019) (noting that the startup business model preferences C-corporations over flow-through entities, such as administrative ease and tax asset valuation).

20. Lyft, *Amended and Restated Investors’ Rights Agreement 22* (June 27, 2018), <https://www.sec.gov/Archives/edgar/data/1759509/000095012318012262/filename4.htm> [<https://perma.cc/MGQ4-AKLW>]; Lyft, Inc., *Registration Statement (Form S-1) F-26* (Dec. 6, 2018), <https://www.sec.gov/Archives/edgar/data/1759509/000095012318012262/filename1.htm> [<https://perma.cc/XZC5-YDUV>]; Lyft Raises \$530M at \$2.5B Valuation,

investors in these companies, typically venture capital firms, and startup employees, who often receive restricted stock as part of their compensation packages, are the typical beneficiaries of the QSBS exclusion.²¹

Taxpayers may exclude up to \$10 million of QSBS gain, with this exclusion applying per small business, meaning that shareholders of multiple small businesses may exclude up to \$10 million of gain from sales of *each* company's stock.²² A savvy investor with multiple lucrative investments may, therefore, exclude \$10 million of gain from each investment. Each partner of Andreessen Horowitz, a venture capital firm that made early investments in Lyft, Airbnb, and Pinterest,²³ could, for example, receive up to \$30 million of tax-free income selling stock from just these three companies. With approximately fifteen general partners, Andreessen Horowitz (the organization) could receive nearly half a billion dollars free from all federal tax.²⁴ Additionally, investors may also exclude up to ten times their cash investment from each tranche of QSBS stock sold, allowing for exclusions of at least, but possibly far in excess of, \$10 million.²⁵ For example, an investor purchasing QSBS for \$5 million in 2011 that sold for \$70 million in 2017 would receive \$50 million (rather than \$10 million) of the \$65 million profit completely tax-free.

II. THE TRUE COST OF SECTION 1202

The Joint Committee on Taxation's (JCT) estimate for the 2019 tax revenue lost from section 1202 ranges between \$1.1 billion and \$1.3 billion.²⁶ As the following analysis of IRS data and recent IPOs demonstrates, those estimates dramatically underestimate the true cost of the provision.²⁷

Pitchbook (Mar. 13, 2015), <https://pitchbook.com/newsletter/lyft-raises-530m-at-25b-valuation> [<https://perma.cc/8J4K-8FYQ>] (listing a \$109 million valuation); Lyft Funding Rounds, Valuation and Investors, Craft, <https://craft.co/lyft/funding-rounds> (on file with the *Columbia Law Review*) (last visited Oct. 25, 2019) (noting \$14.9 million raised by Lyft in its Series B funding round with a post-money valuation of \$147.7 million).

21. Employees making § 83(b) elections, which is common for employees at startups, are deemed to own their restricted stock and thereby start the required holding period. I.R.C. § 83(b), (f).

22. *Id.* § 1202(b)(1)(A).

23. See Erin Griffith, *These Silicon Valley Investors' Bets May Pay Off*, N.Y. Times (Mar. 31, 2019), <https://www.nytimes.com/2019/03/31/technology/silicon-valley-venture-capitalists.html> [<https://perma.cc/R5W8-MJJ9>].

24. With fifteen general partners each excluding \$30 million, the total amount excluded would be \$450 million. See Kate Clark, *Andreessen Horowitz Hires Its 15th General Partner*, TechCrunch (Mar. 4, 2019), <https://techcrunch.com/2019/03/04/andreessen-horowitz-hires-its-15th-general-partner/> [<https://perma.cc/K9YM-VUDD>].

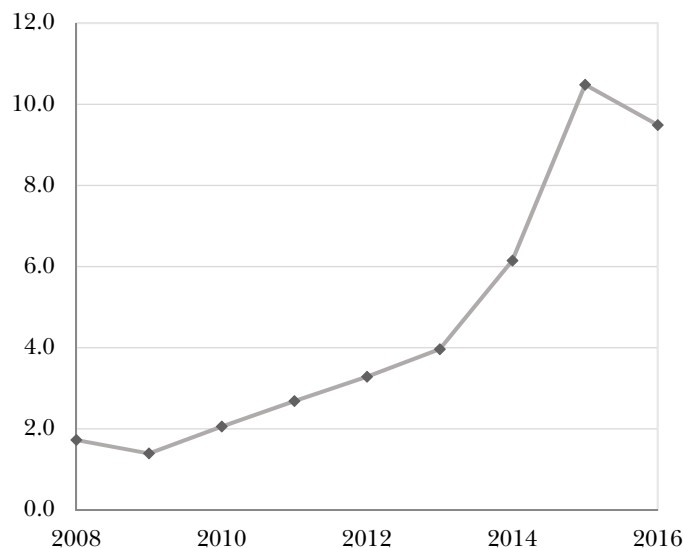
25. I.R.C. § 1202(b)(1)(B).

26. The JCT estimated the cost of Section 1202 for Fiscal Years 2015–2019, 2016–2020, 2017–2021, 2018–2022 to be \$1.1 billion, \$1.3 billion, \$1.3 billion, and \$1.3 billion, respectively. See Staff of J. Comm. on Taxation, 117th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2018–2022* (Comm. Print 2018); Staff of J. Comm. on Taxation, 116th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2017–2021*

A. IRS Data on Section 1202

Although QSBS gain is not an explicitly stated line item of publicly available IRS data (for which only tax years through 2016 are available), it is still possible to calculate baseline estimates of the tax revenue forgone due to section 1202. Because QSBS issued prior to September 27, 2010 constitutes an AMT tax preference item, 7% of the QSBS gain from this earlier-issued stock is listed on Form 6251, the form required for taxpayers potentially subject to the AMT. From this, the aggregate amount of QSBS gain for stock acquired prior to September 27, 2010, can be calculated.²⁸ As the chart below illustrates, pre-September 2010 QSBS gain for tax years 2008–2016 is steadily increasing.

FIGURE 1: PRE-SEPTEMBER 2010 QSBS GAIN (BILLIONS)



The Figure above underestimates total QSBS gain from recent years in two significant ways. First, only QSBS gain from stock acquired prior to September 27, 2010 is an AMT preference item. QSBS gain from stock acquired after that date is not only completely excluded from federal income tax, but is also free of any AMT consequences and therefore not included in the Form 6251 data or the above chart. Therefore tax years start-

(Comm. Print 2018); Staff of J. Comm. on Taxation, 115th Cong., Estimates of Federal Tax Expenditures for Fiscal Years 2016–2020 (Comm. Print 2017); Staff of J. Comm. on Taxation, 114th Cong., Estimates of Federal Tax Expenditures for Fiscal Years 2015–2019 (Comm. Print 2015).

27. In a future piece I will discuss other examples of the JCT underestimating tax expenditure costs, and what could and should be done about it.

28. On file with the *Columbia Law Review*.

ing in 2015 will also contain QSBS gain that, unlike the pre-September 2010 gain, is completely free of federal tax. Second, the Form 6251 data only capture QSBS gain from the roughly 7% of total taxpayers filing Form 6251. The QSBS gain from the approximately 93% of taxpayers not filing Form 6251 is not captured by any publicly available IRS data.²⁹

Pre-September 2010 QSBS gain has been steadily increasing since 2008, with pre-September 2010 QSBS gain in 2015 and 2016 equal to approximately \$10 billion. If this number just stays constant, the forgone tax revenue in 2019 from just pre-September 2010 QSBS gain is approximately \$1 billion, or nearly all of the JCT's estimate.³⁰ If post-September 2010 QSBS gain, which is completely excluded from tax, is equal to pre-September 2010 QSBS gain, the 2019 forgone tax revenue then becomes nearly triple JCT's estimates, or \$3.4 billion.³¹ But as shown below, there is ample evidence to indicate that post-September 2010 QSBS gain is actually much greater.

B. 2019 IPO Data

Although data on privately held companies are limited, estimates of the 2019 tax revenue lost from section 1202 can be estimated by analyzing tech companies with current-year IPOs. Before going public, the ownership of technology startups is largely held by two groups: investors and employees.³² Investors, typically angel investors and venture capital firms, contribute cash to startups in exchange for equity.³³ Assuming at least a 10x return on investment, the first \$50 million of capital invested will return an exclusion of at least \$500 million for these investors.³⁴ This assumes that when total funding in a company exceeds \$50 million, the gross-assets threshold of section 1202 (which looks to cash and adjusted

29. Given that higher-income taxpayers are likely to have QSBS gain, the 7% of taxpayers filing Form 6251 likely have significantly more than 7% of total QSBS gain. But they do not have it all.

30. The top capital gains rate is 23.8%, meaning that pre-September 2010 QSBS gain is taxed an effective rate of 23.8% minus half of 28%, or 9.8%.

31. \$10 billion of post-September 2010 QSBS gain results in 23.8% of forgone tax revenue, or \$2.4 billion.

32. Founders are a subset of employees and typically retain a significant portion of equity. Victor Fleischer, *Taxing Founders' Stock*, 59 *UCLA L. Rev.* 60, 62 (2011) ("Founders of a start-up usually receive common stock as a large portion of their compensation for current and future labor efforts.").

33. Seth C. Oranburg, *Bridgefunding: Crowdfunding and the Market for Entrepreneurial Finance*, 25 *Cornell J.L. & Pub. Pol'y* 397, 403 (2015) ("Startups raise money from 'angels' and 'venture capitalists' (or 'VCs') primarily by selling preferred stock to these two types of investors.").

34. The gain of any tax-exempt investors (such as a pension fund) is largely exempt from tax. Emily Cauble, *Harvard, Hedge Funds, and Tax Havens: Reforming the Tax Treatment of Investment Income Earned by Tax-Exempt Entities*, 29 *Va. Tax Rev.* 695, 701 (2010) ("Tax-exempt entities are generally not subject to U.S. federal income tax.").

basis of assets held) is exceeded.³⁵ This is a conservative assumption since funding from previous rounds can be spent on employee salaries and assets immediately expensed, resulting in zero accumulation of basis.³⁶

This estimate of excluded gain could be conservative since these investors might instead obtain a greater benefit from the \$10 million per investor exclusion. Angel investors, for instance, typically invest less than \$1 million, making the per-investor exclusion more valuable than the ten-times-basis exclusion.³⁷ Uber, for instance, raised \$1.3 million from approximately twenty-nine different investors during their angel round of funding.³⁸ If these twenty-nine investors are individuals, their \$1.3 million investment could result in \$290 million of excluded gains.

VC funds might benefit more from the ten-times-basis exclusion. VC funds are typically structured as pass-through entities, such as a partnership, with general partners (GPs) making investment decisions (and investing relatively little of their own money) and limited partners (LPs) contributing capital and making no investment decisions.³⁹ GPs typically charge a flat management fee as well as taking a percentage of total profit.⁴⁰ Depending on the amount of capital invested in the startup, and the mix of investors in the VC fund,⁴¹ the ten-times-basis exclusion might be larger than the \$10 million per individual exclusion. If, say, the initial \$50 million of startup funding is provided by VC firms with more than 50 GPs total (across all participating VC funds), more than \$500 million of profit could be excluded.

35. See *supra* note 18.

36. See, e.g., I.R.C. § 179 (2017) (allowing up to \$1 million of immediate expensing of certain property used in a trade or business); *id.* § 168(k) (permitting immediate expensing of certain business property).

37. See John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 *Ariz. St. L.J.* 861, 878 (2005) (“A typical early-stage angel financing is in the \$100,000 to \$1 million range, with six to eight angels participating.”).

38. See *Uber Angel Funding Round*, Crunchbase, https://www.crunchbase.com/funding_round/uber-angel-c76f9429#section-investors (on file with the *Columbia Law Review*) (last visited Oct. 24, 2019).

39. See Maxwell Gawley, *Note, Closing the Carried Interest Loophole and the Impacts on Venture Capital*, 68 *DePaul L. Rev.* 671, 677 (2019) (“Currently, when a venture capital firm establishes a new fund, it typically opts to treat the fund as a partnership for tax purposes.”).

40. The standard business practice is the “two and twenty” model. The “two” refers to a two percent management fee and the “twenty” refers to twenty percent share of the VC fund’s future profits. Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 *N.Y.U. L. Rev.* 1, 3 (2008).

41. If, for instance, the VC fund has many tax-exempt LPs, their gain would be largely excluded from tax. See *supra* note 34.

For example, Uber's Series A and Series B funding rounds consisted of approximately three individuals and at least thirteen VC firms.⁴² These rounds raised \$11 million and \$37 million, respectively, keeping Uber under the \$50 million gross-assets test.⁴³ The total number of general partners at these VC firms over these two rounds plus the three individual investors could easily exceed fifty, resulting in more than fifty total individual (as opposed to organizational) investors. The section 1202 exclusion available to these individuals could thus easily be greater than \$500 million.

Tech startups also award equity-based compensation to employees.⁴⁴ The equity award schedule varies between companies, but Sam Altman, chairman of the seed accelerator Y Combinator, has stated that giving 10% of a company's equity to the first ten employees, 5% to the next twenty employees, and 5% to the next fifty employees is reasonable.⁴⁵ Assuming that vesting for these employees occurs prior to exceeding the gross-assets limit, any company with an IPO market cap of \$10 billion (or more) will result in \$800 million of excluded QSBS gain.⁴⁶

There are seven technology companies whose value (or estimated value) at their 2019 (or potential 2019) IPO exceeds \$10 billion.⁴⁷ As of September 23, 2019, there are twenty-one additional companies that have already had 2019 IPOs.⁴⁸ Using valuations at time of IPO or esti-

42. See Series A-Uber, Crunchbase, https://www.crunchbase.com/funding_round/uber-series-a-7fb4f6a6#section-overview (on file with the *Columbia Law Review*) (last visited Oct. 10, 2019); Series B-Uber, Crunchbase, https://www.crunchbase.com/funding_round/uber-series-b-5b1dc73e#section-overview (on file with the *Columbia Law Review*) (last visited Oct. 10, 2019).

43. See *supra* note 42.

44. This equity-based compensation is typically stock options, restricted stock, or restricted stock units. John F. Coyle & Gregg D. Polsky, *Acqui-Hiring*, 63 *Duke L.J.* 281, 297 (2013).

45. Sam Altman, *Employee Equity*, Sam Altman Blog (Apr. 18, 2014), <https://blog.samaltman.com/employee-equity> [<https://perma.cc/24F4-7SBG>] (noting that "[i]n practice, the optimal [equity award] numbers may be much higher").

46. With the equity award estimations described above, employees 31–80 will each own 0.1% of the company, or \$10 million of a \$10 billion company, with earlier employees owning more.

47. The companies with 2019 IPOs or potential 2019 IPOs are (with approximate IPO values in parentheses) Uber (\$82 billion), Airbnb (\$38 billion*), The We Company (\$25 billion*), Lyft (\$24 billion), Slack (\$23 billion), Pinterest (\$10 billion), and Palantir (\$11 billion*). Asterisks indicate estimates. John Divine, *10 Major Upcoming IPOs to Watch in 2019*, U.S. News (Sept. 6, 2019), <https://money.usnews.com/investing/stock-market-news/slideshows/best-stocks-ipo-this-year> [<https://perma.cc/QYR7-5WGW>]; Alex Wilhem & Sophia Kunthara, *Here's Who Has Gone Public in 2019 (So Far)*, Crunchbase News (Aug. 22, 2019) <https://news.crunchbase.com/news/heres-who-has-gone-public-in-2019-so-far/> [<https://perma.cc/AQ4D-PGPD>]; Alex Wilhem, *What's Palantir Worth?*, Crunchbase News (Feb. 1, 2019), <https://news.crunchbase.com/news/whats-palantir-worth/> [<https://perma.cc/U35Z-QQWH>].

48. These companies are Cloudflare, SmileDirectClub, 9F, InMode, Dynatrace, Health Catalyst, Livongo, Medallia, Phreesia, DouYu, The RealReal, Change Healthcare,

mated IPO valuations, as applicable, the estimated profit completely excluded from tax is approximately \$19 billion, which results in forgone tax revenue of approximately \$4.5 billion, more than three times the JCT's estimate.⁴⁹

These estimates of forgone tax revenue are extremely conservative. The calculations only include technology startups with plans to go public in 2019. Although QSBS gain is easily obtained by shareholders of technology companies, there are likely many shareholders from the dozens of other companies also going public in 2019 that will take advantage of section 1202. Additionally, the estimates above do not take into account private acquisitions, of which there are dozens in any given year. For example, many shareholders of Ring, which was acquired by Amazon in 2018 for over a billion dollars,⁵⁰ likely excluded much of their profit via section 1202. 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.⁵¹

III. TAX POLICY CRITIQUES OF SECTION 1202

When enacted in 1993, section 1202 was trumpeted as necessary to catalyze investment in small businesses.⁵² Even if the direct beneficiaries of the provision are generally wealthy—investors and early employees of startups—to the extent section 1202 actually promotes investment in small businesses, it is arguably performing as intended. But only stock in specific businesses, C-corporations, are eligible for the exclusion. In con-

Cambium Networks, Chewy, Fiverr, CrowdStrike Holdings, Luckin Coffee, Fastly, Beyond Meat, Yunji, Zoom, and PagerDuty. Wilhem & Kunthara, *supra* note 47.

49. This assumes that companies with valuations of \$10 billion or more have VCs excluding \$500 million, and employees excluding \$800 million. Companies valued at less than \$10 billion are conservatively assumed to have zero VC exclusion, and an employee exclusion calculated with reference to the valuation at IPO. These data are on file with the *Columbia Law Review*.

50. Laura Stevens & Douglas MacMillan, Amazon Acquires Ring, Maker of Video Doorbells, *Wall St. J.* (Feb. 27, 2018), <https://www.wsj.com/articles/amazon-acquires-ring-maker-of-video-doorbells-1519768639> (on file with the *Columbia Law Review*).

51. Based on National Venture Capital Association and Pitchbook data from 2006 through the first half of 2019, the value of VC exits via IPO is only about 13% larger than exits via acquisitions and buyouts. NVCA & PitchBook, PitchBook-NVCA Venture Monitor 28 (2019), https://nvca.org/wp-content/uploads/2019/08/2Q_2019_PitchBook_NVCA_Venture_Monitor.pdf [<https://perma.cc/NW6C-3U93>]; NVCA & PitchBook, The 2Q 2019 PitchBook-NVCA Venture Monitor Data Pack, https://nvca.org/wp-content/uploads/2019/08/Final_PitchBook_NVCA_2Q_2019_Venture_Monitor_Summary_XLS.xlsb.xlsx [<https://perma.cc/5P2B-M4CD>] (last visited Oct. 11, 2019).

52. David H. Benz & Lisa Donn Sergi, Section 1202's Gain Exclusion for Qualified Small Business Stock—Yes, It's Still Relevant, 29 *J. Tax'n & Reg. Fin. Institutions*, Sept.–Oct. 2015, at 23, 23 (“Originally enacted in 1993, section 1202 was intended to encourage investment in small businesses by providing a 50 percent exclusion of gain resulting from the sale of ‘qualified small business stock’ (QSBS) held for more than five years.”).

trast, more than 90% of small businesses (defined by the Treasury Department as having less than \$10 million in annual revenue) operate as something *other* than C-corporations.⁵³ Because most small businesses operate either as sole proprietorships or pass-through entities such as LLCs and S-corporations, and not C-corporations, investors in these enterprises get zero benefit from section 1202.⁵⁴

Section 1202 can also be criticized on distributional grounds. As discussed previously, the two main beneficiaries of section 1202's munificence are early employees of startups (software engineers) and early investors in startups (angel investors and venture capitalists). Both categories of beneficiaries are generally wealthy, with average starting salaries of software engineers approaching six figures.⁵⁵ For example, the taxpayers filing Form 6251 and listing QSBS gain are generally rich, with data indicating the average amount of QSBS gain is approximately \$430,000.⁵⁶ These shareholders are arguably least in need of a multi-million dollar exclusion.

Additionally, there is no evidence that section 1202 is encouraging investment that would not have occurred in its absence.⁵⁷ What results is an unnecessary subsidy for early investors in and early employees of tech startups. There is no shortage of funding opportunities in Silicon Valley; startups have been awash in venture capital for years.⁵⁸ Even assuming that investing in these companies does indeed have social value, giving these investors a tax-free return on their investment is simply paying for something that likely would have happened anyway, at a cost far in excess of what was originally estimated by the JCT. Similarly, the lure of obtain-

53. Richard Prisinzano, Jason DeBacker, John Kitchen, Matthew Knittel, Susan Nelson & James Pearce, Dep't of the Treasury, Office of Tax Analysis Technical Paper 4 (Update), November 2016: Methodology to Identify Small Businesses tbl.2a (2018), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/TP4-Update.pdf> [<https://perma.cc/6AYR-HL3K>].

54. Kyle Pomerleau, Tax Found., An Overview of Pass-Through Businesses in the United States 2, 10 (2015).

55. Michelle Robertson, The Average Starting Salaries at San Francisco Tech Companies, SFGATE (Mar. 21, 2018), <https://www.sfgate.com/technology/article/Starting-salaries-at-SF-tech-companies-10970396.php> [<https://perma.cc/7PRV-FALL>] (reporting that as of 2018, the average starting salary for a software engineer at San Francisco's top tech companies was \$91,738).

56. IRS Statistics on Income, 2003–2016 (on file with the *Columbia Law Review*). Again, this figure only takes into account pre-September 2010 QSBS gain; the true amount of QSBS gain (which would include post-September 2010 QSBS gain) is likely much higher.

57. Ben Steverman, Silicon Valley Wins Big with Tax Break Aimed at Small Businesses, Bloomberg Tax (June 10, 2019), <https://news.bloombergtax.com/daily-tax-report/silicon-valley-wins-big-with-tax-break-aimed-at-small-businesses> (on file with the *Columbia Law Review*).

58. Erin Griffith, \$100 Million Was Once Big Money for a Start-Up. Now, It's Common., N.Y. Times (Aug. 14, 2018), <https://www.nytimes.com/2018/08/14/technology/venture-capital-mega-round.html> [<https://perma.cc/L5QU-4KYN>].

ing valuable equity in a startup is incentive enough for startup employees to provide their services;⁵⁹ there is no need for the tax code to provide additional inducement.

Lastly, the December 2017 Tax Cuts and Jobs Act (TCJA)⁶⁰ further promotes the extent to which wealthy taxpayers benefit from section 1202. The TCJA significantly reduced the number of taxpayers affected by the AMT.⁶¹ As a result, wealthy taxpayers who might have paid some tax via the AMT on their pre-September 2010 QSBS gain will likely not be required to do so now. Additionally, by reducing the top corporate tax rate to 21%,⁶² the TCJA gives new companies even more reason to select C-corporation status over another business form, allowing them to also benefit from section 1202.

IV. THE FUTURE OF SECTION 1202

Given the failings of section 1202, what should be done about it? The tidiest solution, of course, would simply be to repeal the provision. However, that seems unlikely given the difficulties of the legislative process. But actions short of repeal could promote progressivity while still providing some incentive to invest in new businesses. Limiting the excludable ceiling (from \$10 million to \$1 million, say) would still give a tax break to investors without conferring an unnecessarily large windfall on startup venture capitalists. Similarly, capping the QSBS exclusion each individual could take in aggregate would reduce the extent to which section 1202's benefits concentrate in the pockets of small numbers of investors.

Section 1202 could also be changed to more precisely target small businesses. Because most small businesses are S-corporations and LLCs, these entities should also count as section 1202 “qualified small businesses.” Although these entities are pass-throughs, investors in these businesses could be permitted to exclude any capital gains resulting from sales of their ownership stakes. Additionally, changing the \$50 million gross-assets threshold to a more appropriate standard, such as the \$10

59. Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?*, 2019 Colum. Bus. L. Rev. 107, 121–22 (“[I]ndividuals historically chose to work at high-risk startups for a modest cash salary with significant stock option grants, in the hopes that they could cash out for a large sum of money after an IPO of the startup’s stock.”).

60. The official name is “An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018.” Pub. L. No. 115-97, 131 Stat. 2054 (2017).

61. Robert McClelland, *Fixing The TCJA: How Should Congress Treat the Alternative Minimum Tax?*, Tax Policy Ctr.: TaxVox (Mar. 19, 2019), <https://www.taxpolicycenter.org/taxvox/fixing-tcja-how-should-congress-treat-alternative-minimum-tax> [https://perma.cc/9D48-CERU].

62. Briefing Book: Some Background, Tax Policy Ctr., <https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-business-taxes> [https://perma.cc/8628-J4RU] (last visited Oct. 24, 2019).

million annual revenue test the Treasury already uses to identify small business,⁶³ could more accurately focus section 1202 on its intended beneficiaries.

Additionally, states need not double-down on federal tax policy mistakes. Although most states defer to federal definitions of income out of administrative convenience, this is not required.⁶⁴ California, which does not provide a preferential income tax rate on capital gains, assesses state income taxes on QSBS gain, even if such gain is excluded for federal income tax purposes.⁶⁵ By so doing, California residents claiming the exclusion still pay up to 13.3% in taxes on their QSBS gain. Other states could act similarly.

CONCLUSION

Helping small businesses attract funding is a laudable goal. But the section 1202 QSBS exclusion is a clumsy, ineffective way of doing so that results in massive windfalls for rich investors and early employees in technology startups. The TCJA has compounded these mistakes, helping to make the provision much costlier than previously estimated. In the absence of full repeal, Congress should at least modify section 1202 so that the provision's intended beneficiaries—small businesses—actually benefit.

63. See *supra* note 53 and accompanying text.

64. Erin Adele Scharff, *Laboratories of Bureaucracy: Administrative Cooperation Between State and Federal Tax Authorities*, 68 *Tax L. Rev.* 699, 703 (2015) (“All states imposing a comprehensive personal income tax rely on federal law definitions of income, though the extent of this reliance varies.”).

65. See Cal. Rev. & Tax. Code § 18152 (2019); *Saving Tax Dollars with Qualified Small Business Stock (QSBS)*, Sandhill (Aug. 2, 2017), <https://www.sandhillglobaladvisors.com/blog/saving-tax-dollars-with-qualified-small-business-stock-qsbs/> [https://perma.cc/FL2S-88WF].

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