Congress Proposes Legislation Limiting Section 1202's Gain Exclusion

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When Congress enacted Section 1202, it noted that the gain exclusion was intended to "encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing." When the percentage gain exclusion was increased to 100% in 2010, Congress noted that the "increased exclusion and the elimination of the minimum tax preference for small business stock will encourage and reward investment in qualified small business stock."

Proposed reduction in Section 1202's percentage gain exclusion

On September 13, 2021, the House Ways and Means Committee issued draft legislation, referred to as part of the "Build Back Better Act," that proposes to amend Section 1202(a) to eliminate the 75% and 100% gain exclusions for taxpayers whose adjusted gross income (AGI) equals or exceeds $400,000, or that is a trust or estate.[i] All stockholders would still be eligible for the 50% Section 1202 gain exclusion applicable to QSBS issued prior to February 18, 2009.

The various tax hikes included as part of the proposed legislation have been introduced as a way of funding President Biden's $3.5 trillion infrastructure spending bill. House Ways and Means Committee Chairman Richard Neal described the various proposed tax increases for high-income taxpayers as a way to "mitigate wealth inequality and strengthen the progressive power of our tax system by increasing the individual tax rate, increasing the top capital gains rate, and adding a modest surtax on the highest-income taxpayers."

Putting these various pieces together, it appears that the benefits of Section 1202's 100% gain exclusion, which was touted by Congress in 2010 as an accelerant for encouraging investment in venture start-ups, are outweighed in 2021 by the desire to source

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tax revenues and "mitigate wealth inequality."

The proposed legislation as currently written would be effective for sales and exchanges of qualified small business stock (QSBS) occurring on or after September 13, 2021, subject to a binding contract exception for contracts in effect prior to September 13, 2021.

The proposed legislation includes several additional tax increases targeting higher net worth and higher-income taxpayers. Of particular importance in connection with assessing the potential impact of the proposed reduction in Section 1202's percentage gain exclusion are the increase in the maximum capital gains rate from 20% to 25% and the addition of a new 3% surcharge imposed on a taxpayer's modified adjusted gross income in excess of $5 million. [ii]

Potential impact of the proposed changes

Under current Section 1202, a stockholder who has a $10 million gain from selling QSBS is generally entitled to $2,380,000 of federal income tax savings after claiming Section 1202's $10 million gain exclusion – the spread between the 20% capital gains rate plus the 3.8% investment income tax and a 0% tax rate, no investment income tax and no alternative minimum tax.[iii]

Under amended Section 1202, the same stockholder claiming the 50% gain exclusion would generally be entitled to $1,590,000 of federal income tax savings – the spread between the 25% capital gains rate plus the 3.8% investment income tax plus the additional 3% tax on income over $5 million and a 15.9% blended tax rate.[iv]

So, for a stockholder who has $10 million of QSBS gain and claims the 50% gain exclusion, there is approximately a $790,000 reduction in federal income tax saving resulting from the proposed legislation based on a rough comparison set out above.[v]

Factors to consider when making a choice of entity decision

Obviously, the proposed tax legislation reduces the potential tax savings associated with an investment in QSBS and likely reduces

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the incentive to invest in venture start-ups, but there continues to be significant benefits associated with selecting a C corporation instead of an S corporation or LLC/LP for venture start-ups. The House Ways and Means Committee's focus on increasing taxes for higher-income taxpayers may skew investment away from pass-through entities where taxpayers bear the annual burden of various higher rates and surcharges, towards operating through C corporations whose tax rate remains competitive, assuming that the business allows for revenues to be reinvested rather than distributed out as taxable compensation or dividends. A C corporation is generally an efficient business entity from a tax standpoint if revenues are reinvested into the business, thereby avoiding double taxation, and stockholders successfully reap the benefits of their investment through an eventual stock sale, particularly if Section 1202's gain exclusion is available.

At this early stage in the legislative process, remember that the path from the Ways and Means Committee draft legislation to enactment is unclear. Each of the proposed changes to the tax laws are subject to modification or abandonment during the legislative process. Finally, QSBS issued today must be held for five years before claiming Section 1202's gain exclusion. Over the years, Congress has made several changes to Section 1202's percentage gain exclusion and a reduction today in the percentage gain exclusion could be followed in the next administration by a return of the 100% gain exclusion.

We plan on following the proposed legislation as it works its way through Congress and will supplement this article to address additional developments and planning considerations.

More resources

In spite of the potential for significant tax savings, many experienced tax advisors are not familiar with Sections 1202 and 1045 planning. Venture capitalists, founders and investors who want to learn more about Sections 1202 and 1045 and related planning opportunities are directed to several articles on the Frost Brown Todd website:

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- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202

Contact Scott Dolson if you want to discuss QSBS issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[i] References to "Section" are to sections of the Internal Revenue Code.

[ii]The 20% rate is applicable for a single taxpayer's capital gains exceeding $445,850 and for married filing jointly taxpayers for capital gains exceeding $501,600.

[iii] This assumes that all Section 1202 eligibility requirements have been met and the stockholder is entitled to the 100% gain exclusion.

[iv] For purposes of simplifying the example, it is assumed that the $10 million in QSBS gain is the stockholder's only income. The calculation of taxes applying the proposed changes assumes that the 3.8% investment income tax will apply against the 50% of QSBS gain not excluded by Section 1202 and that the additional 3% proposed surcharge on high-income taxpayers applies to the $5 million of the $10 million of gain in the non-QSBS case but not in the case where the taxpayer claims the 50% gain exclusion. Section 1(h)(4) provides that the 50% portion of QSBS sales gain not excluded is taxed at a 28% rate. Also, the example doesn't take into account the fact that 7% of the excluded gain is an AMT preference item. Until legislation is passed, it won't be clear how the investment income tax and the AMT function with respect to the 50% of gain not excluded by Section 1202.

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[v] As noted generally in the preceding footnote, this comparison is a rough estimate for planning purposes and actual numbers will depend on how the tax legislation, if enacted, interacts with various provisions of the Internal Revenue Code not highlighted in the proposed legislation and a taxpayer's individual tax attributes and circumstances.

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