Section 1202 QSBS Reforms

Because start-ups take investment capital to build a novel product and hire out a new workforce, they are generally not yet profitable. While they start small, their goal is significant growth – though the possibility of failure, given the intricacies of advanced science and groundbreaking innovation, is ever-present. Because this type of investment is high-risk and long-term, the economics must work for people to invest in start-up and early-stage innovators. Without a tax structure that encourages this activity, our innovators and entrepreneurs will be placed at a disadvantage at a time when the rest of the world is doing everything it can to compete with our leadership.

First and foremost, we believe that maintaining the permanent 100% exemption of gains on investments in Qualified Small Business Stock under IRC Section 1202, passed under the Protecting Americans from Tax Hikes (PATH) Act of 2015, is vital to encourage the early-stage investment necessary to spur groundbreaking innovation. We applaud lawmakers for retaining this incentive in tax reform.

This exclusion makes a real difference in investing in start-ups – and because many individual angel investors tend to re-invest their gains back in additional new companies, it leads to more capital for more start-ups. Now that the 100% exclusion has been made permanent, Section 1202 has the potential to be one of the most powerful federal policies for encouraging an expansion of entrepreneurship across the country. The fact is that many growing companies in the middle of the country – outside of coastal VC hubs – are simply too small for significant traditional institutional investment, so tax incentives like Section 1202 can drive local investors to these start-ups. QSBS is a powerful policy to encourage individuals in these communities to invest in their local entrepreneurs. In fact, we believe that Congress should build on this success by simplifying and expanding QSBS so it can encourage more investment in start-ups across the country.

Changes that would make 1202 more efficient include:

- ***Raise the maximum gross assets threshold for QSBs***. The existing gross assets test in Section 1202 limits the universe of QSBs to companies with gross assets below $50 million. The high costs of innovative research, coupled with valuable intellectual property and successive rounds of financing, often push growing innovators over the $50 million gross assets limit and thus out of the QSB definition. Raising the gross assets threshold to $100 million, and indexing the threshold to inflation, would drive investment to capital-intensive small businesses conducting groundbreaking research and creating high-quality jobs across the country.

- Because QSBs must meet certain financial and operational requirements, we believe Congress should ***direct the IRS to adopt reporting obligations for companies that make it clear to the investor whether the company is a QSB***. These can take the form of check the box certification on annual or quarterly corporate tax filings similar to REIT certifications. This would also allow Congress and the IRS to track data about the use and benefits of Section 1202 and assure investors of their ability to appropriately utilize the exemption.

- Related to the reporting recommendation, we believe the ***requirement that a QSB adhere to the 80 percent value test for "substantially all" of the shareholder holding period should be updated to an annual test of quarterly averages for each year of an investor's required holding***

period. Currently, there is no guidance on what "substantially all" means. This proposal would simplify and clarify the requirement. In addition, the 80 percent test should be revised to apply only during the required holding period. Once the holding period is met, the policy objective of encouraging investment into early stage companies is achieved and the testing for that investment should no longer be required, regardless of how long the investor holds the stock after the requisite holding period is achieved.

- ***Allow investors to count up to four years of the time they held LLC interests which are then converted into C Corporations into the five-year holding period***. Many early-stage companies are started as LLCs and then later converted to C Corporations when they want to attract VC or other institutional capital. Allowing investors to count the time during which they held LLC interest (provided they otherwise satisfy the QSB requirements) to meet the five-year hold period is consistent with the policy objective to encourage investments in early stage businesses.

- ***Increase the time to rollover gains in QSBS***. Currently Section 1045 allows taxpayers to rollover their gain from the sale of QSBS if the holding period has not been achieved, but Section 1045 only allows 60 days for the rollover to occur. This is an artificial and unrealistically short time frame; it not only limits investors' ability to avail themselves of the benefit, but it also deprives other QSBs of a prime source of potential growth capital. To fulfill the policy objective of Section 1045, we recommend revising the rollover period to the later of 180 days or the end of the investor's tax year in which the sale occurred. This allows for more reasonable amount of time to seek a suitable rollover investment using good start-up investment practices and provides for flexibility within a tax year thus reducing the need to amend or modify a prior return.

- ***Shorten the ban on redemptions from 4 years to 2 years.*** A common complication of a start-up's QSBS eligibility is caused by the excessive length of the ban on redemptions. The four-year limitation can inadvertently trip up many growth companies, thus triggering uncertainty about the viability of the benefits of QSBS. A two-year ban would still provide a safeguard against abuse in a more reasonable timeframe.