Section 1202:

The Qualified Small Business Stock (QSBS) Exemption

INNOVATOR Alliance
EMPOWERING INNOVATION THROUGH STRATEGIC TAX POLICY

THE ISSUE:

Section 1202 of the U.S. tax code, known as the Qualified Small Business Stock (QSBS) exemption, allows investors in certain small startups and growth businesses to exclude part or all of the capital gains they earn from selling stock in these businesses, if the stock is held for at least five years.

QSBS drives capital and talent to small, high-risk companies, particularly in industries like technology and healthcare. Angel and venture capital investors invest in these risky, early-stage startup companies, the majority of which never see a major liquidity event. Employees take a risk to help build a company. These investors and employees become the owners that help turn a concept into a company. These companies create jobs, drive innovation, and give the U.S. its competitive edge, producing household names such as Apple, Google, Home Depot, and Amazon, which have fueled job and GDP growth over the past five decades. Without the next generation of these startups, our economy would lack the dynamism, productivity, and innovation that has set us apart to date.

To qualify for QSBS tax treatment, the shares must be:

- Issued by a U.S. C-corp with <$50 million in gross assets
- Issued by a company operating in a qualified trade or business
- Acquired directly from the company
- Held for at least five years prior to liquidation

IMPACT ON INNOVATION:

Created under President Obama and supported and expanded under Presidents Bush and Obama, QSBS is designed to promote innovation and entrepreneurship by providing tax incentives for investing in certain small businesses. While many startups fail, it is also these businesses that drive the bulk of net new job creation, economic opportunity, and innovation. QSBS incentivizes long-term investment in high-growth, but risky enterprises that are building for the long-term. It benefits employee owners who are willing to help startups build and helps both investors and employee owners optimize their gains and recycle that capital back into the ecosystem.

QSBS can do more to bolster the innovation ecosystem. Startups and growth businesses often use various corporate structures beyond C-corporations, but this does not make their contributions any less critical. Further, many companies raise capital through alternative structures such as a convertible notes. Policy should reflect this evolving practice and affirm eligibility for this alternative financing instrument as well as start the five year clock at that time. Moreover, the $50M gross asset limit appropriately tailors support to small businesses, but a moderate increase could maintain this focus while extending benefits to more employee owners.

REQUESTED ACTION:

We respectfully urge Congress to preserve and bolster Section 1202 of the Internal Revenue Code to further drive capital and talent to the startups and growth businesses by:

- *Maintaining the current 100% exclusion on QSBS*
- *Elevating the gross asset threshold for QSBS qualification to $150 million*
- *Expanding the QSBS benefit to include business entities beyond C-corporations, such as LLCs*
- *Clarifying that key financing arrangements such as convertible notes and Simple Agreement for Future Equity (SAFEs) are eligible for QSBS*

The Innovator Alliance is dedicated to empowering innovation through strategic tax reform. Our mission is to preserve and expand the innovation ecosystem while promoting the value of ownership. We believe that forward-thinking tax policy is key to driving the innovation economy forward, ensuring it remains a powerful engine for job creation, technological breakthroughs, and economic growth.