

Alert

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House Ways and Means Committee Proposes Reduction of QSBS Exclusion

On September 15, 2021, the House Ways and Means Committee approved its draft tax legislation that was released on September 13, 2021, as part of the “Build Back Better” budget reconciliation program. Included in the draft legislation is a proposal to reduce the Section 1202 gain exclusion on the sale of qualified small business stock in a C corporation (QSBS).

The draft legislation reduces the favorable 75 percent and 100 percent exclusion rates to 50 percent for gain recognized on the sale of QSBS acquired after February 18, 2009, for taxpayers with an adjusted gross income (AGI) equal to or exceeding \$400,000 or taxpayers that are trusts and estates, which would likely apply to most individuals cashing in QSBS. The 75 percent exclusion applies to QSBS acquired prior to September 28, 2010. The proposal would apply to all sales of QSBS made on or after September 13, 2021, with an exception provided for sales made pursuant to a written binding contract that was in effect on September 12, 2021.

In general, under current law, Section 1202 allows a non-corporate taxpayer to potentially exclude up to 100 percent of the amount of eligible gain realized from the sale or exchange of QSBS held for five years. The amount of gain eligible for exclusion is subject to an annual limitation equal to the greater of either: (i) \$10 million (reduced by eligible gain taken into account by the taxpayer in prior years with respect to the disposition of QSBS of the corporation) or (ii) 10 times the aggregate adjusted tax basis of the QSBS disposed of by the taxpayer. Among other requirements, in general QSBS must be originally issued before a corporation has \$50 million or more in gross assets, a cut off that generally includes investors in early rounds of capital raises.

Along with the proposed amendments to Section 1202, the draft legislation includes various other tax increases that may affect any potential gain recognized from the sale of QSBS. In particular, the draft legislation would increase the top long-term capital gains rate from 20 percent to 25 percent for capital gains recognized on or after September 13, 2021. Similar to the transition rules related to Section 1202, any capital gain recognized on or before September 13, 2021, or pursuant to a written binding contract in effect on or before September 13, 2021, will be subject to the 20 percent tax rate.

Additionally, the draft legislation introduces a new high-income surcharge. The high-income surcharge provision would impose a new 3 percent tax on a taxpayer’s modified AGI in excess of \$5 million (or in excess of \$2.5 million in the case of a married individual filing separately) and in excess of \$100,000 in the case of a trust or estate. For purposes of the high-income surcharge, modified AGI is equal to a taxpayer’s AGI reduced by any deduction for investment interest.

For example, under current law, if a taxpayer acquired Section 1202 stock in 2012, and at least five years later, disposed of the QSBS recognizing a gain of \$20 million, 100 percent of the taxpayer’s gain would be excluded under Section 1202, resulting in federal tax savings of \$4.76 million (\$4 million of capital gains tax at the 20 percent rate and \$760,000 of Net Investment Income Tax (NIIT) at a 3.8 percent rate). Under the proposed change to Section 1202, only 50 percent of the taxpayer’s \$20 million of gain would be excluded under Section 1202, resulting in federal tax savings of \$3.18 million (\$2.5 million of capital gains tax at the new capital gains rate of 25 percent, \$380,000 of NIIT at a 3.8 percent rate, and \$300,000 of high-income surcharge tax at a 3 percent



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rate).

Based on the proposed changes, a taxpayer's sale of \$20 million of QSBS would result in an additional \$1.58 million of federal income tax liability. While the draft legislation is still pending approval, taxpayers should consider the impact of the legislation when determining the benefits of investing in QSBS and the appropriate entity choice for their future investments. Taxpayers should also be mindful in materially amending contracts entered into prior to the retroactive effective dates of the QSBS and capital gain provisions.
