



## Code Section 1202: Let's Hope It Doesn't Expire

By StartUpAdmin on August 26, 2011



Lofty economic theories about economics and taxes are all the rage now-a-days. Plenty of people are chiming in with ideas on how to solve our economic woes. We've heard from, among others, Warren Buffett, Michael Arrington, Seattle's own Andy Liu (writing in GeekWire) and Mark Cuban recently. They all have opinions about how taxes can impact job creation and investment, but one big issue that nobody seems to be mentioning is Code Section 1202, the 100% exclusion of which is soon to expire and if given a chance, may have a significant impact on the job market.

### Startups, Taxes, and Job Creation

Obviously, there are many public policy concerns that animate these discussions (including, anger, envy, and all those other good human emotions!). But I think the primary public policy question we ought to ask is how can we create more jobs? I personally enjoyed the recent suggestion of Mark Cuban, billionaire owner of the Dallas Mavericks and Shark Tank judge, that we ought to just ask private companies to state how many jobs they could create with \$X number of dollars. He said:

“Seriously. Call me crazy (and I'm sure many of you will), but there is no reason why we can't quickly create a federal website that allows existing companies to say to the Federal Government how much money they need and how many jobs they can create



for that money and for what duration are they committing to maintain those jobs for the money.”

“Rather than having Dems and Republicans fight ideological battles about job creation, let’s get direct. Let’s just ask companies to tell us how many jobs they would create and how much they need and see what it all adds up to and go from there.”

Seattle’s own Andy Liu’s (CEO of BuddyTV) suggested that we needed to somehow encourage the wealthy to invest in startups because startups create jobs. As Andy said: “the “haves” [need] to step up and take risk and invest in a way that drives growth and jobs (something I believe the government cannot efficiently do and shouldn’t do).”

Section 1202 of the Internal Revenue Code is not exactly what Andy was describing, but it is similar. Section 1202 provides a capital gains tax break section for investments in qualified small business stock. The 100% exclusion under Section 1202 is set to expire at the end of this year, unless renewed. I hope Congress extends it.

## What is Code Section 1202?

Section 1202 is a federal tax provision designed to encourage investment in certain small businesses.

The way the tax break works is this—if you buy Section 1202 “qualified small business” stock and hold it for more than 5 years, you get a reduction in your capital gains tax rate. Currently, the reduction is to zero (!)—and this includes an exemption from the Alternative Minimum Tax (AMT) as well. There is a catch—but it is not a severe one—that you have an overall exclusion limitation of \$10M in gain. Not bad.

Whose idea was it to create such an inducement to invest in small businesses? Well, President Obama advocated for it, including in his State of the Union speeches, so we ought to give him substantial credit for it. He got this bill passed, and successfully advocated for its extension for another year (the original bill was set to expire at the end of 2010). We’ll see if he can work his magic again.

If the 100% exclusion component of the bill expires, the exclusion will revert to its historical amount—allowing investors in startups to exclude 50% of any gain from the sale or exchange of qualified small business stock held for more than five years. The trouble with this 50% exclusion is that it is not 50% of the 15% capital gains tax rate, but 50% of 28%, one of the intermediate capital gains tax rates that you may not have



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known even existed. So, before Obama, this break was only worth a reduction of the 15% tax rate to 14%. Not as exciting as zero.

In its current formulation as a complete exemption, the Section 1202 is a fantastic incentive for investors.

## **Allowing Code Section 1202 to Work**

### **How does Section 1202 work?**

First, the investment has to be in a C corporation with less than \$50M in gross assets, including the amount of the investment. Investments in LLCs or S corporations don't qualify.

Second, the business has to be a qualified small business. Generally speaking, high-tech, software, internet, mobile device and game companies qualify.

Third, the stock has to be held for 5 years. However, if the stock is not held for 5 years, you might be able to rollover your gain by buying other qualified small business stock, under Section 1045 of the IRC.

Other rules apply as well. You should consult with tax counsel to make sure a particular investment qualifies.

### **Does the benefit apply to founders?**

Yes, founders can take advantage of Section 1202, but only if they acquire C corporation stock on its original issue from the corporation. If they form as an S corporation, they won't be entitled to the benefit.

TIP: If you have formed as an LLC, you can convert to a corporation before the end of the year to qualify for the benefit. Again, these steps ought to be taken only in consultation with a qualified tax advisor.

### **Why is this good for startups?**

Section 1202 is good for startups because it encourages investments in them.



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## What's wrong with Section 1202?

Well, what is wrong with Section 1202 depends on your point of view, and what lofty economic/tax theory you subscribe to:

- From Buffett's point of view, you could say that the problem with Section 1202 is that it is coddles the wealthy, who perhaps ought to be paying more in taxes. This is because, for the most part, the only people who can invest in startups are "accredited investors"—who we typically think of as wealthy.
- From Mark Cuban's point of view—it won't do the job. He doesn't think that tax incentives for job creation work: "The Republicans/Tea Party are wrong that cutting taxes will result in more jobs."
- Section 1202 doesn't do what Andy described. But could it help? Could it cause some investors to invest in startups when they otherwise wouldn't? I think the answer to this question is yes. I think at the margins it is helpful.

Nothing is perfect. No solution is perfect. But we have Section 1202 on the books right now. I think we ought to keep it for now. I believe that we should keep experimenting with tax and other incentives and programs to create jobs until we find what works, especially in the areas of technology and software.

## For More Information About Code Section 1202 try:

- [New Tax Act Extends 100% Tax Exclusion For 1 Year](#)
- [Startup America Suggestion of the Day: Repeal Section 409A](#)
- [100% Exclusion From Tax on QSB Stock Bought Before End of Year](#)

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