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The New Section 1202 Tax-Free Business Sale: Congress Rewards Small Businesses That Survived the Great Recession

Beckett G. Cantley*

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The New Section 1202 Tax-Free Business Sale: Congress Rewards Small Businesses That Survived the Great Recession*

Beckett G. Cantley

Abstract

On September 27, 2010, President Barack Obama signed the Creating Small Business Jobs Act of 2010 (“SBJA”) that contains a temporary amendment to Internal Revenue Code (“IRC”) §1202. The amendment permits original shareholders of eligible corporation stock to sell the stock without being taxed on the sale. The temporary amendment initially only applied to certain stock acquired after the enactment of the SBJA and before January 1, 2011, but the amendment was extended on December 17, 2010 for another year ending January 1, 2012. With the impending sunset of the 15% capital gains rate at the end of 2012, this 100% exclusion from both capital gains taxes and the alternative minimum tax (“AMT”), would be a very big financial windfall to business owners with qualified small business stock (“QSBS”). A qualified small business (“QSB”) is a C corporation with assets of \$50 million or less where at least 80% of its assets are used in the active conduct of a trade or business other than certain professional, entertainment, and hospitality services. In general, each QSB C corporation may exclude gain in the amount of the greater of \$10 million or 10 times the adjusted basis in the corporation. Victor Fleischer stated that the main purpose for enhancing the IRC §1202 exclusion is to encourage investment in certain new C corporation ventures and small businesses. Manufacturing, construction, and retail wholesaling industries appear to be some of the main areas promoted by the expanded exclusion, since the definition of “qualified trade or business” excludes many other major areas of industry. This Article provides an overview of the IRC Section §1202 tax-free business sale provision, the history behind the development of the IRC amendments, the apparent intent for enactment, the likelihood the Act will achieve its purposes, the statute’s ambiguities, and some policy implications of creating a tax-free business sale provision.

KEYWORDS: Small Business, Tax, IRC, Internal Revenue Code, Jobs Act, Shareholders, Qualified Small Business

*Beckett G. Cantley is an Associate Professor of Law at Atlanta’s John Marshall Law School. B.A., University of California, Berkley, 1989; J.D., cum laude, Southwestern University School of Law, 1995; LL.M. in Taxation, University of Florida, College of Law, 1997. Professor Cantley would like to thank Abigail Williams for her assistance as a Research Assistant on this Article.



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INTRODUCTION

On September 27, 2010, President Barack Obama signed the Creating Small Business Jobs Act of 2010 (“SBJA”)¹ that contains a temporary amendment² to Internal Revenue Code (“IRC”) § 1202.³ The amendment permits original shareholders of eligible corporation stock to sell the stock without being taxed on the sale.⁴ The temporary amendment initially only applied to certain stock acquired after the enactment of the SBJA and before January 1, 2011.⁵ The amendment was extended on December 17, 2010 for another year ending January 1, 2012.⁶

With the impending sunset of the 15% capital gains rate at the end of 2010⁷ (now extended to the end of 2012),⁸ this 100% exclusion from capital gains taxes,⁹ as well as the alternative minimum tax (“AMT”),¹⁰ would be a very big financial windfall to business owners with qualified small business stock (“QSBS”).¹¹ A qualified small business (“QSB”) is a C corporation¹² with assets of \$50 million or less where at least 80% of its assets are used in the active conduct of a trade or business other than certain professional services, athletics, performing arts, banking and financial enterprises, hospitality or restaurants.¹³ In general, each QSB C

1. Jeff Mason, *Obama Signs Small Business Bill into Law*, REUTERS, Sept. 27, 2010, available at <http://www.reuters.com/article/2010/09/27/us-usa-economy-obama-idUSTRE68Q4H22010092>.

2. Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2011, 124 Stat. 2504 (2010).

3. See I.R.C. § 1202 (2006).

4. Small Business Jobs Act § 2011(a).

5. *Id.* § 2011(a)(4).

6. Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 760(a), 124 Stat. 3296 (2010).

7. See Press Release, Treasury Dep’t, *Tax Relief in 2001 Through 2011* (May 2008), available at http://www.treasury.gov/press/releases/reports/taxrelief_20012011_052708.pdf; Small Business Jobs Act § 2011.

8. Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §§ 101-02, 124 Stat. 3296 (2010).

9. Small Business Jobs Act § 2011.

10. See I.R.C. § 1202(a)(4)(C) (2006); Small Business Jobs Act § 2011.

11. See I.R.C. § 1202(c).

12. A C corporation is any entity duly incorporated under state law that has not made an “S” election to be taxed as a pass-through entity.

13. I.R.C. § 1202(d)(1)(A), (e)(1)(A), (e)(3).

corporation may exclude gain in the amount of the greater of \$10 million or 10 times the adjusted basis in the corporation.¹⁴

Victor Fleischer stated that the main purpose for enhancing the IRC § 1202 exclusion is to encourage investment in certain new C corporation ventures and small businesses.¹⁵ Manufacturing, construction, and retail wholesaling industries appear to be some of the main areas promoted by the expanded exclusion, since the definition of “qualified trade or business” excludes many other major areas of industry.¹⁶

This Article provides an overview of the IRC Section § tax-free business sale provision,¹⁷ the history behind the development of the IRC amendments, the apparent intent for enactment, the likelihood the Act will achieve its purposes, the statute’s ambiguities and some policy implications of creating a tax-free business sale provision.

I. THE ORIGINAL IRC § 1202

The original IRC § 1202 was enacted¹⁸ during the Clinton administration¹⁹ as part of a larger bill²⁰ designed to reduce the accumulation of national debt.²¹ IRC § 1202’s original purpose was to spur investment in startup ventures²² by providing tax breaks on a

14. *Id.* § 1202(b)(1).

15. See Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137, 163 (2003).

16. *Significant Tax Incentives in Jobs Act; Not Limited to Small Business*, LARSONALLEN.COM (Sept. 29, 2010), available at [http://www.larsonallen.com/Tax/Sig nificant_Tax_Incentives_in_Jobs_Act_Not_Limited_to_Small_Business.aspx](http://www.larsonallen.com/Tax/Sig%20nificant_Tax_Incentives_in_Jobs_Act_Not_Limited_to_Small_Business.aspx).

17. Small Business Jobs Act § 2011.

18. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13113, 107 Stat 312 (1993). This legislation is also known as the Revenue Reconciliation Act and the Deficit Reduction Act of 1993.

19. *Biography – William J. Clinton*, CLINTONLIBRARY.GOV, <http://www.clintonlibrary.gov/bios-WJC.html> (last visited Nov. 3, 2012).

20. See Omnibus Budget Reconciliation Act § 13113.

21. 139 CONG. REC. E1477-03 (daily ed. June 10, 1993) (statement of Rep. Romano Mazzoli).

22. Joseph W. Bartlett & Robert S. Hartfield III, *IRC § 1202’s Advantage*, THE DEAL MAGAZINE (Oct. 28, 2011), available at <http://www.thedeal.com/magazine/ID/042392/commentary/irc-1202s-advantage.php>; *The Revenue Reconciliation Act of 1993: Hearing on H.R. 1960 Before the House of Representatives*, 103d Cong. H2245 (1993) [hereinafter *Revenue Reconciliation Act*]; 139 CONG. REC. H2245-05 (daily ed. May 4, 1993) (statement of Rep. Daniel Rostenkowski).

percentage of gain from the eventual sale of QSBS, which would ultimately raise the rate of return to owners of a profitable qualifying startup.²³ This Part of the Article focuses on the legislative bill responsible for the enactment of the original IRC § 1202, the 50% exclusion provided for in IRC § 1202 and the requirements for stock to be considered QSBS and for a corporation to be considered a QSB.²⁴ Other than the temporary raise of the exclusion percentage from 50% to 100%, the remainder of these discussed provisions remain relevant and in force currently.

A. REVENUE RECONCILIATION ACT OF 1993

President Clinton signed the Revenue Reconciliation Act (“RRA”) into law on August 10, 1993²⁵ after Congress very narrowly enacted the hotly contested bill.²⁶ The goals of the RRA included reducing the national deficit through an increase in taxes, the creation of jobs (increasing the number of taxpayers) and encouraging long-term economic growth (generating tax revenue).²⁷

As part of the RRA, Congress enacted IRC § 1202 as an incentive designed to promote long-term investments in small businesses and venture capital start-ups²⁸ by providing a partial exclusion of gain on the sale of the QSBS after the fifth year of operation.²⁹ The rationale of the tax break is to encourage entrepreneurs and investors to start and operate businesses that would generate economic activity and employment.³⁰ It is likely that the five-year holding period required to obtain the tax break exists to allow the tax system to recoup as much tax revenue from the business activity as possible, since the tax system may lose revenue

23. Omnibus Budget Reconciliation Act § 13113.

24. *Id.*

25. *Id.*

26. Janice M. Johnson, *The Revenue Reconciliation Act of 1993: who wins and who loses*, THE CPA JOURNAL ONLINE (Oct. 1993), <http://www.nysscpa.org/cpajournal/old/14522914.htm>.

27. 139 CONG. REC. E1477-03 (daily ed. June 10, 1993) (statement of Rep. Romano Mazzoli).

28. See Fleischer, *supra* note 15 at 163.

29. I.R.C. § 1202(a)(1) (2006).

30. See Alan D. Viard, *The Misdirected Tax Debate and the Small Business Stock Exclusion*, AM. ENTERPRISE INST. (Feb. 6, 2012), <http://www.aei.org/article/economics/fiscal-policy/taxes/the-misdirected-tax-debate-and-the-small-business-stock-exclusion/>.

from the eventual partial tax-free sale of the corporation.³¹ Of course, it is also possible that the portion that is excluded from taxation will be reinvested, thereby stimulating the economy further.

B. 50% EXCLUSION

The original IRC § 1202 provided for the exclusion of 50% of all gain from the sale of QSBS that was held by non-corporate stockholders for a period of more than five years.³² IRC § 1202 also placed a cap on the amount of gain that could be excluded—limiting the exclusion to the greater of \$10,000,000 or 10 times the aggregate adjusted basis of the taxpayer's stock in the corporation.³³ The dollar limitation³⁴ is an issue that remains unclear to this day with no particular opinion prevailing.³⁵ An in-depth discussion of cap limit issues follows in Section IV below, entitled "Open Interpretations."

In general, gain from the sale of stock that has been held for a period of longer than one year will be dealt with as long-term capital gain ("LTCG").³⁶ An individual taxpayer's net long-term capital gains are generally taxed at a rate of 15 percent³⁷ and this is the pertinent tax rate for gain from the sale of QSBS. The exclusion provided for in IRC § 1202 has the effect of limiting the actual maximum tax rate (excluding Alternative Minimum Tax ("AMT"))³⁸ to 7.5%.³⁹ However, the sale of QSBS is also subject to an AMT rate of 28%⁴⁰ of annual alternative

31. 139 CONG REC. H6237-02 (daily ed. Aug. 5, 1993) (statement of Rep. Jolene Unsoeld).

32. I.R.C. § 1202(a)(1).

33. *Id.* § 1202(b)(1).

34. *See id.* § 1202(b).

35. Dan R. Ward et al., *The Fact and the Fantasy of I.R.C. § 1202: An Illustrative Overview and Analysis*, 8 ENTREPRENEURIAL EXEC. 39 (2003), available at http://golia.th.ecnext.com/coms2/gi_0198-494230/The-fact-and-the-fantasy.html.

36. I.R.C. § 1222(3).

37. *Id.* § 1(h)(1)(C).

38. *Id.* § 55(b)(2).

39. Half of the gain taxable at 15% would be excluded. This would result in an effective tax rate of 50% of 15%. $50\% \text{ of gain} \times 15\% \text{ LTCG rate} = 7.5\%$.

40. The applicable AMT rate for a non-corporate taxpayer is actually 26% on the first \$175,000 and a marginal rate of 28% on each dollar of alternative minimum taxable income thereafter. However, for the sake of simplicity of calculation, this paper will assume a rate of 28%. *See* I.R.C. § 55(b)(1)(A)(i).

minimum taxable income.⁴¹ Alternative minimum taxable income would include the 50% of gain not excluded from income under IRC § 1202.⁴² Furthermore, 7% of the gain excluded under IRC § 1202 would be considered a preference item and would thus be added back to alternative minimum taxable income.⁴³ An AMT rate of 28% would be applied towards 53.5%⁴⁴ of the gain recognized upon the sale of QSBS.⁴⁵ This translates to an effective AMT rate of 14.98%⁴⁶ on total gain from the sale of QSBS. Application of the AMT increases the effective tax rate on gain from the sale of QSBS—subject to the RRA limitations—from 7.5% to 14.98%.

C. QUALIFIED SMALL BUSINESS STOCK

In order to qualify for the IRC § 1202 tax exclusion, the stock must be considered QSBS by meeting several conditions.⁴⁷ First, the issuing corporation must be a C corporation.⁴⁸ Also, while the stock's original issue date must have occurred after August 10, 1993,⁴⁹ the existence of the five-year holding period requirement⁵⁰ made it so no stock was actually eligible for the gain exclusion until 1998.⁵¹ Moreover, the stock acquired by the taxpayer *must* be acquired at its original issue in exchange for (i) money, (ii) services performed and/or provided for the corporation, or (iii) other non-stock property.⁵² Thus, stock purchased in the secondary market generally cannot be QSBS. The issuing C

41. I.R.C. § 55(b)(1)(A). Gain from the sale of QSBS under the 1993 Act is generally includible in alternative minimum taxable income. *See generally* Small Business Jobs Act § 2011 (only offering exclusion as a preference item under I.R.C. § 57(a) for QSBS acquired after the enactment of the Creating Small Business Jobs Act of 2010).

42. I.R.C. § 1(h)(7).

43. *Id.* § 57(a)(7).

44. [50% included in income + (7% preference rate x 50% excluded from income)].

45. [28% (AMT)] x [50% (non-excluded gain)] + [50% x 7% (addition of the 7% preference on 50% of gain excluded under section 1202)] = 14.98%.

46. (28% non-corporate AMT rate x 53.5% total of gain from QSBS that is included in AMT taxable income).

47. I.R.C. § 1202(c).

48. *Id.* § 1202(c)(1).

49. *Id.*

50. *See id.* § 1202(a)(1).

51. T.D. 8749, 1998-1 C.B. 533.

52. *See* I.R.C. § 1202(c)(1).

corporation must be defined as a QSB corporation, meet the active business requirements and meet the gross assets test requirements.⁵³

D. QUALIFIED SMALL BUSINESS

In order to achieve QSB corporation status, the corporation: (i) must be a C corporation, and (ii) the corporation's aggregate gross assets prior to and immediately following the issuance of the stock cannot exceed \$50 million.⁵⁴

"Aggregate gross assets" are calculated by adding the amount of cash in the corporation with the aggregate adjusted basis of other property held by the corporation.⁵⁵ Property contributed to the corporation shall be determined—with regard to adjusted basis—as if the basis of the property being contributed were equal to its fair market value ("FMV") at the time of the contribution.⁵⁶ Furthermore, for the purpose of determining aggregate gross assets, corporations that are members of the same parent-subsiary shall be treated as one corporation.⁵⁷

IRC § 1202 also enumerates requirements pertaining to the period subsequent to the issuance of the stock.⁵⁸ If these post-issuance requirements are not satisfied, the stock may become disqualified and no longer be eligible for the IRC § 1202 exclusion.⁵⁹ If the QSBS issuing corporation purchases any of its stock from the taxpayer or a related person⁶⁰ at any time during the four-year period commencing two years prior to the stock issuance, the stock will become disqualified.⁶¹ Also, QSBS shall become disqualified if, during the two year period commencing one year prior to stock issuance, the QSBS issuing corporation purchased its own stock in excess of 5% of the aggregate value of the corporation's outstanding stock (at the beginning of the two year period).⁶² If the corporation meets the above requirements, the

53. *See id.* § 1202(c)(1)(A), (c)(2), (d)(2).

54. *See id.* § 1202(d).

55. *Id.* § 1202(d)(2).

56. *See id.*

57. *See id.* § 1202(d)(3)(A).

58. *Id.* § 1202(a)(1).

59. *See id.* § 1202(c)(2)(A).

60. *Id.* §§ 267(b); 707(b) (defining related person).

61. *Id.* § 1202(c)(3)(A).

62. *Id.* § 1202(c)(3)(B).

corporation's stock shall remain QSBS and gain from the sale of such stock will be eligible for IRC § 1202 exclusion.⁶³ If the QSBS becomes disqualified, the entire gain from the sale of such QSBS would be subject to the applicable rate, which would likely be the 15% tax rate currently applied to long-term capital gains.⁶⁴

There are also potential issues surrounding the \$50 million cap, especially when the founder has multiple corporations. However, there is no brother-sister corporation attribution for purposes of determining the \$50 million asset cap per corporation.⁶⁵ Thus, where more than one corporation is formed by the same owner(s) and all of the corporations are sold at the same time, there is no \$50 million cap on the entire group as long as each of the corporations alone does not exceed \$50 million.⁶⁶ Of course, as with any corporate transaction that has a significant tax benefit, there should be an independent business purpose for forming the corporation other than the reduction of income taxation.⁶⁷

E. ACTIVE BUSINESS REQUIREMENT

Exclusion of gain from the sale of QSBS is only available to "active businesses," which are defined as businesses that meet the requirements set forth under IRC § 1202(c).⁶⁸ First, the eligible corporation must use at least 80% of its assets in the active conduct of one or more "qualified trades or businesses."⁶⁹ Second, "qualified trade or business" refers to any trade or business that does not involve the performance of services pertaining to specifically excluded trades or businesses.⁷⁰ The list of trade and business activities that are excluded is ambiguous due to the extensive nature of what is *excluded*, and with little direction as to what is actually *included*. The qualified trade or business requirement will be discussed further in Section IV of this article, entitled "Open Interpretations." Lastly, in order to retain active business status, the corporation must meet the specified requirements

63. *Id.* § 1202(a)(1), (c)(2)(A), (c)(3)(A), (c)(3)(B).

64. I.R.C. § 1(h) (2006).

65. *See id.* § 1202(d)(1)(A), (d)(3).

66. *Id.* § 1202(d).

67. *See Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935).

68. I.R.C. § 1202(c)(2)(A), (e).

69. *See id.* § 1202(e)(1)(A).

70. *See id.* § 1202(e)(3).

during all periods.⁷¹ If the corporation satisfies the active business requirements as well as the other stipulations, the taxpayer will be eligible for an exclusion of gain.⁷²

Summarily, IRC § 1202 is one form of preferential tax treatment that was designed to encourage investment.⁷³ Although there have been changes to this section over the last few years, the overall goal of IRC § 1202 remains the same—to encourage investment in order to promote and aid qualified small businesses.⁷⁴ However, subsequent to the enactment of IRC § 1202 by the Revenue Reconciliation Act of 1993, taxpayers eventually discovered not only the erosion of the IRC § 1202 exclusion (due to the reduced LTCG rate and the application of the AMT), but also that the prescribed benefits were much less favorable than they seemed at first glance.⁷⁵

II. THE 2009 AMENDMENTS

As 2009 began, the ongoing recession that had been in effect since December of 2007 forced the U.S. government to discuss alternative measures for economic recovery.⁷⁶ With the foreclosure and unemployment rate increasing, Congress proposed a drastic measure aimed at stabilizing the economy: the American Recovery and Reinvestment Act of 2009 (“ARRA”).⁷⁷ President Obama signed the ARRA into law on February 17, 2009.⁷⁸ The immediate goals of the ARRA included: (i) the creation of new jobs while salvaging those in

71. *See id.* § 1202(c)(2)(A).

72. *See id.* § 1202(a)(1).

73. *See Viard, supra* note 30.

74. *Id.*

75. *See generally* Ward et al., *supra* note 35.

76. *See* WSJ Staff, *NBER Makes it Official: Recession Started in December 2007*, WALL ST. J. ECONOMICS BLOG, Dec. 1, 2008, <http://blogs.wsj.com/economics/2008/12/01/nber-makes-it-official-recession-started-in-december-2007/>.

77. *See* American Recovery & Reinvestment Act of 2009, Pub. L. No. 111-5, § 1241, 123 Stat. 115 (2009) [hereinafter ARRA]; *see also* 155 CONG. REC. E529-02 (daily ed. Mar.3, 2009) (statement of Rep. Lucille Royball-Allard), *available at* 2009 WL 529786.

78. Macon Phillips, *Signed, Sealed, Delivered: ARRA*, WHITEHOUSE.GOV (Feb. 17, 2009), <http://www.whitehouse.gov/blog/09/02/17/signed-sealed-delivered-arra/>.

peril of being lost, and (ii) to encourage investment that would boost economic activity.⁷⁹

The pertinent ARRA provisions related to IRC § 1202 were aimed at stimulating and stabilizing the economy (particularly the unemployment rate) by encouraging investment in small businesses that would potentially create more jobs.⁸⁰ Specifically, the ARRA provided a temporary amendment to IRC § 1202, which increased investor incentives for investing in startup ventures.⁸¹

A. 75% EXCLUSION

The ARRA temporarily increased the IRC § 1202 gain exclusion from the sale of QSBS, from 50% to 75%.⁸² For example, prior to the ARRA amendment, if a taxpayer had \$1 million in gain from the sale of QSBS, the taxpayer would be eligible to exclude \$500,000 (\$1 million X 50%) of that gain from taxation. However, with the enactment of the ARRA and the temporary amendment⁸³ to IRC § 1202, the taxpayer would be eligible to exclude \$750,000 (\$1 million x 75%).

The portion of gain that is not excluded from income (25%) is taxed at the lower of (i) the ordinary income rate⁸⁴ or (ii) the current 15%⁸⁵ LT CG rate.⁸⁶ Consequently, the increase in the percentage of gain eligible for exclusion has the effect of setting the maximum tax on the entire gain realized from the sale of QSBS at 3.75% (15% maximum tax rate x 25% of gain included in income). To continue our example, assuming the LT CG rate is lower, the \$250,000 (\$1 million x 25%) included in income is taxed as follows: \$1 million gain x 25% included

79. 155 CONG. REC. H1090-05 (daily ed. Feb. 10, 2009) (statement of Rep. Michael E. Capuano).

80. 155 CONG. REC. H1307-03 (daily ed. Feb. 12, 2009) (statement of Rep. David Obey).

81. ARRA § 1241.

82. *Id.*

83. *Id.*

84. The ordinary income tax rates range from 15% to 39.6%, based upon the level of individual income. *See* I.R.C. § 1(a), (b), (c), (d), & (e).

85. *See* Carole Feldman, *Taxes: Individual, Capital Gains Rates Unchanged for 2012*, USA TODAY: MONEY (Jan. 20, 2012), available at <http://www.usatoday.com/money/perfi/taxes/story/2012-01-20/taxes-capital-gains-individual-rates/52705032/1>.

86. The tax imposed upon a net capital gain shall not exceed the sum of a tax computed at the rates and in the same manner as if the capital gains tax had not been enacted. *See* I.R.C. § 1(h)(1)(A) (2006).

in income x 15% tax rate = \$37,500. However, the sale of QSBS is also subject to an AMT rate of 28% of annual alternative minimum taxable income.⁸⁷ Alternative minimum taxable income would include the 25% of gain not excluded from income under IRC § 1202.⁸⁸ Furthermore, 7% of the gain excluded under IRC § 1202 would be considered a preference item and would thus be added back to alternative minimum taxable income.⁸⁹ Thus, as 7% of 75% is 5.25%, now the AMT rate of 28% would be applied towards 30.25%⁹⁰ of the gain recognized upon the sale of QSBS. This translates to an effective AMT rate of 8.47%⁹¹ on total gain from the sale of QSBS. Application of the AMT increases the effective tax rate on gain from the sale of QSBS—subject to the ARRA—from 3.75% to 8.47%.⁹²

B. SHORT PERIOD

The increase in the amount of gain that may be excluded is constrained by the small window of time in which the increased exclusion may be used.⁹³ The 75% exclusion only applied to stock acquired *after* February 17, 2009, but *before* January 1, 2011.⁹⁴

87. The applicable AMT rate for a non-corporate taxpayer is actually 26% on the first \$175,000 and a marginal rate of 28% on each dollar of alternative minimum taxable income thereafter. However, for the sake of simplicity of calculation, this Paper will assume a rate of 28%. *See id.* § 55(b)(1)(A). Gain from the sale of QSBS under the 1993 Act is generally includible in alternative minimum taxable income. *See generally* Small Business Jobs Act § 2011 (only offering exclusion as a preference item under I.R.C. § 57(a) for QSBS acquired after the enactment of the Creating Small Business Jobs Act of 2010).

88. *See* I.R.C. § 1(h)(7).

89. A taxpayer may face taxation under the AMT where the taxpayer's regular taxable income plus any adjustments and *preference items* exceed the AMT exemption amount. *See id.* § 55(b)(2)(B).

90. 25% is non-excluded gain and thus included in AMT taxable income. *See id.* §§ 55(b)(2)(B), 1(h)(7). 75% of the gain is excluded, but is considered an AMT preference item to the extent of 7% of the gain excluded. *See id.* § 57(a)(7). Preference items are added back to AMT taxable income. *See id.* § 55(b)(2)(B). [25% + (7% x 75%)] → 25% + 5.25% = 30.25%.

91. [28% (AMT Rate under I.R.C. § 55(b)(1)(A)(i)(II)) x 30.25% (the percentage of QSBS gain includable in AMT taxable income)] = 8.47%.

92. *See generally* I.R.C. §§ 1(h)(1)(A); 1(h)(7), 55(b)(1)(A), 55(b)(2)(B); 57(a)(7) (2006); ARRA § 1241.

93. *See generally* ARRA § 1241.

94. *Id.*

Congress subsequently amended these provisions again, effective on the date of the subsequent amendment (see below). However, the 2009 Amendments still apply for QSBS acquired after February 17, 2009, but before the September 27, 2010 effective date of the 2010 Amendments.⁹⁵

C. PURPOSE OF THE 2009 AMENDMENTS

The ARRA was designed to combat the severe economic issues that have affected the nation and continue to plague the American economy since the beginning of the recession.⁹⁶ Congress introduced the ARRA as a solution to rising unemployment rates, which were estimated to have reached their highest level since the Great Depression.⁹⁷ Congress proposed the increase in the percentage of gain eligible for exclusion to temporarily incentivize investment in new businesses and keep those businesses active for an extended period of time.⁹⁸ Presumably, if the business is active for five years (as required by IRC § 1202), the business is likely to have some employees, pay some taxes and generally have some positive economic activity—all of which would normally stimulate the economy.

Congresswoman Lucille Roybal-Allard (D-Cal.), a proponent of the ARRA, believed that the bill would stabilize the economy and assist Americans that had been affected by the recession.⁹⁹ Advocates urged members of Congress to support the bill based on the need for immediate action and the ability of the ARRA to bring about swift results.¹⁰⁰ In enacting the ARRA, Congress' intention was to promote investment in specific areas that would counter the rising unemployment rate and would have a long-term effect. The ultimate objective of Congress was to combat the effects of the recession and put measures

95. See Small Business Jobs Act § 2011; ARRA § 1241.

96. 155 CONG. REC. E529-02 (daily ed. Mar. 3, 2009) (statement of Rep. Lucille Roybal-Allard).

97. *Id.*

98. See generally I.R.C. § 1202(a)(1), (a)(4)(A) (2006); Bartlett & Hartfield, *supra* note 22.

99. 155 CONG. REC. E529-02 (daily ed. Mar. 3, 2009) (statement of Rep. Lucille Roybal-Allard).

100. *Id.*

into place that would have a long-term positive effect on the economy and those affected by it.¹⁰¹

III. THE 2010 AMENDMENTS

A. CREATING THE SMALL BUSINESS JOBS ACT

With the economy still in a fragile state, Congress and President Obama were once again forced to consider alternatives to insure that the country did not slip back into the recession.¹⁰² Representative Barney Frank (D-Mass.) first introduced the SBJA to the House of Representatives on May 16, 2010.¹⁰³ After being approved by the House, the bill was passed on to the Senate where Senator Max Baucus¹⁰⁴ (D-Mont.), the Chairman of the Senate Finance Committee, championed the bill.¹⁰⁵ As previously stated, the bill proposed amending the IRC to allow a 100% exclusion of gain from the sale of QSBS.

On September 16, 2010, Congress approved the SBJA, which sought to stabilize the economy by providing unprecedented incentives to small businesses and investors to invest in small businesses.¹⁰⁶ The SBJA contains a temporary amendment to IRC § 1202, allowing for a 100% exclusion of no more than \$10 million of gain from the sale of eligible QSBS.¹⁰⁷ The enhanced exclusion aims to increase small business investments, which will allow small businesses to create new jobs.¹⁰⁸

101. *Id.*

102. *See* Mason, *supra* note 1; 156 CONG. REC. E1780-01 (daily ed. Sept. 29, 2010) (statement of Rep. Janice D. Schakowsky).

103. Small Business Jobs Act § 2011.

104. Press Release, United States Senate Comm. on Fin., Baucus Hails Passage of Small Business Job Creation Bill (Sept. 16, 2010) [hereinafter *Baucus Hails Passage of Small Business Bill*], available at <http://finance.senate.gov/newsroom/chairman/release/?id=a65886f1-6a7e-4934-a070-b35f5ce0596e>.

105. *See* Press Release, United States Senate Comm. on Fin., Baucus, Landrieu Unveil Bill to Create Jobs and Help Small Businesses Grow (June 29, 2010) (on file with author).

106. *See* *Baucus Hails Passage of Small Business Bill*, *supra* note 104.

107. I.R.C. § 1202(b)(1)(A) (2006).

108. *Id.*

B. 100% EXCLUSION

The pertinent provisions of the SBJA allow for the exclusion of 100% of all gain from the sale of QSBS.¹⁰⁹ The amount of gain eligible for exclusion will remain capped at the greater of \$10 million or 10 times the adjusted basis of the shareholder's QSBS.¹¹⁰ Furthermore, gain from the sale of QSBS, excluded under the SBJA, will not be treated as a preference item for purposes of calculating the AMT.¹¹¹ Therefore, the benefits of the SBJA amendment to the IRC § 1202 exclusion are not limited by the application of the AMT.¹¹² Promoters of the bill contend that the exclusion of 100% of all gain from the sale of qualified stock¹¹³ will be a huge incentive for investors and will result in a large, long-term increase in investments, which will bolster the weakened economy.¹¹⁴

C. SHORT PERIOD

The 100% exclusion of gain is restricted by the narrow time period in which gain from recently acquired stock may be excluded.¹¹⁵ The pertinent SBJA section provides that the 100% exclusion of gain only applies to stock acquired on or after September 27, 2010, and *prior* to January 1, 2011.¹¹⁶

The previously mentioned requirements of the original IRC § 1202 will still apply.¹¹⁷ Mirroring the ARRA, this bill merely creates a temporary increase in the amount of gain eligible for exclusion.¹¹⁸

109. *Id.*

110. *Id.*

111. *Id.* § 1202(a)(4)(C) *amending* I.R.C. § 57(a)(7).

112. *See generally* I.R.C. §§ 55(b)(2), 57(a)(7), 1202(a)(4)(C) *amending* I.R.C. § 57(a)(7).

113. Small Business Jobs Act § 2011(a).

114. *See* Small Business Jobs Act § 2011(a); Mason, *supra* note 1; 155 CONG. REC. E529-02 (daily ed. Mar. 3, 2009) (statement of Rep. Lucille Roybal-Allard).

115. Small Business Jobs Act § 2011; I.R.C. § 1202(a).

116. Small Business Jobs Act § 2011.

117. *See generally* I.R.C. § 1202; Small Business Jobs Act § 2011.

118. *See* I.R.C. § 1202(a)(3), (a)(4).

D. PURPOSE FOR 100% IRC § 1202 EXCLUSION

One of the principal purposes of expanding the IRC § 1202 exclusion is to further encourage new investment in certain start-up C corporation ventures and small businesses.¹¹⁹ Manufacturing, construction and retail wholesaling industries are likely the focus of such encouragement given that the definition of “qualified trade or business” excludes nearly every other industry from issuing QSBS.¹²⁰ The federal government hoped to help stabilize the American economy by subsidizing—and thereby resuscitating—the moribund US manufacturing industry through these C corporation investment incentives.¹²¹

119. Fleischer, *supra* note 15, at 104.

120. To be considered QSBS, the company must be considered to be engaged in a “qualified trade or business.” The definition of “qualified trade or business” excludes many major industries, including: health services, legal services, architecture, engineering, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, insurance, farming, mining, any business of operating a hotel, motel, restaurant, or similar business, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees. See I.R.C. § 1202(e)(3); *Significant Tax Incentives in Jobs Act*, *supra* note 16.

121. Congresswoman Jackie Speier (R-Cal) specifically touts the SBJA’s impact on the U.S. manufacturing industry. Congresswoman Speier believes “[W]e need to see the words Made in America more often . . . We can lead the world in manufacturing if we make the choices and investments now to rebuild our broken manufacturing industry . . . That’s also why Speier worked with her colleagues in the 111th Congress to pass the Small Business Jobs Act - to increase much needed lending to millions of small businesses, and offer 8 new tax incentives to companies, so that they may expand, hire, and fuel our economy.” See Press Release of Congresswoman Jackie Speier, Economy & Jobs, available at http://speier.house.gov/index.php?option=com_content&view=article&id=392&Itemid=38. Furthermore, other provisions of the SBJA are extremely favorable to the manufacturing sector in practice. For instance, prior to the SBJA, general business credits—most notably the R&D tax credit—were subject to the AMT, which drastically limited the benefit of the R&D tax credit to many start-up manufacturers. After the SBJA, the benefits of the R&D tax credit, as applied to sole proprietorships, partnerships, and non-publicly traded corporations with \$50 million or less in average annual gross receipts for the prior three years, are not limited by the AMT. See Mark Lauber and Karim Solanji, *Small Business Jobs Act: A Windfall for Small to Mid-sized Manufacturers*, MATERIAL HANDLING INDUSTRY OF AMERICA (Sept. 29, 2010), available at <http://www.mhia.org/news/industry/10065/small-business-jobs-act--a-windfall-for-small-to-mid-sized-manufacturers>.

1. *Small Business Growth Targeted*

In written testimony to the House committee on small business, US Treasury Secretary Timothy Geithner supported the small business benefits of expanding IRC § 1202 exclusions.¹²² The focus on small business is likely due to the great importance placed on small businesses as job creators.¹²³ Commentators have called small businesses the backbone of the American economy.¹²⁴ In fact, statistics show that small businesses created roughly 70% of the jobs created over the last decade.¹²⁵ According to Geithner, small businesses are a critical element to economic recovery.¹²⁶ He claims that as small businesses go, so goes America.¹²⁷ In a speech to a group of small business owners, President Obama stated, “I will continue to do everything in my power to ensure that [small business owners] have the opportunity to contribute to your community, to our economy, and to the future of the United States of America.”¹²⁸

2. *Small Business Tax Increases*

Although the Obama Administration claims that the expansion of the IRC § 1202 exclusion is meant to incentivize investment and subsidize small businesses,¹²⁹ the administration has simultaneously supported other tax policies that would disincentivize small business investment.¹³⁰ Amidst the launch of President Obama’s 2012 re-election

122. Press Release, U.S. Dep’t of Treasury, Written Testimony by Treasury Secretary Timothy F. Geithner Before the House Comm. on Small Business (June 22, 2011), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg1214.aspx>.

123. See *id.*; *Baucus Hails Passage of Small Business Bill*, *supra* note 104.

124. *Baucus Hails Passage of Small Business Bill*, *supra* note 104; Phillip Elliott, *Obama Details Plan to Aid Small Businesses*, THE NETWORK JOURNAL, Mar. 16, 2009, available at <http://www.tnj.com/obama-details-plan-to-aid-small-businesses%20>.

125. Elliott, *supra* note 124.

126. See Press Release, Written Testimony by Treasury Secretary Timothy F. Geithner, *supra* note 122.

127. *Id.*

128. Elliott, *supra* note 124.

129. Press Release, Written Testimony by Treasury Secretary Timothy F. Geithner, *supra* note 122.

130. Tino Sanandaji & Arvid Malm, *Obama’s Folly: Why Taxing the Rich is No Solution*, THE AMERICAN (Aug. 16, 2011), available at <http://www.american.com/archi>

campaign, President Obama promised not to raise taxes on 98 percent of the population.¹³¹ Instead, Obama plans to narrow the budget deficit through increased taxes on the wealthiest 2% of taxpayers.¹³² Obama's deficit reduction plan proposes to raise the top two income tax rates back to 39.6% and 36%, up from 35% and 33% today, while simultaneously reducing the value of itemized deductions and personal exemptions.¹³³ Obama's proposal would effectively end certain tax breaks for individuals earning at least \$200,000 and couples earning in excess of \$250,000.¹³⁴

The increased tax rate on the top two marginal tax brackets is significant because many small businesses are organized as "pass-through" entities, which cause the business owners to be taxed on net business profits at the relevant individual marginal tax rate.¹³⁵ In the last 30 years, the number of "pass-through" entities, such as partnerships, S corporations, and limited liability companies, has nearly tripled from 10.9 million to 30 million entities.¹³⁶ Because of this growing trend towards "pass-through" tax entities, more business income is now taxed under the individual income tax code than the traditional corporate code.¹³⁷ The IRC § 1202 exclusion is only applicable within the corporate code since the 1202 exclusion only applies to gain from qualified small business *stock*.¹³⁸

Furthermore, wealthy individuals, who are subject to the top two marginal individual tax rates and the AMT rates, own a disproportionate percentage of "pass-through" small business entities.¹³⁹ A study recently

ve/2011/august/obamasfollytaxingtherich/; Jeanna Sahadi, *Tax the Rich! Ok, But Then What, Mr. President?*, CNN MONEY, Apr. 13, 2011, http://money.cnn.com/2011/04/12/news/economy/national_debt_taxes_obama/index.htm; *Distribution of Business Income by Statutory Marginal Tax Rate*, TAX POLICY CENTER (Table T10-0186, 2011), available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?DocID=2783>.

131. Sahadi, *supra* note 130.

132. *Id.*

133. *Id.*

134. *Id.*

135. Scott A. Hodge, *Don't Raise Taxes on Job Creators*, CNN OPINION, Sep. 17, 2010, http://articles.cnn.com/2010-09-17/opinion/hodge.taxes.business_1_business-tax-s-tax-cuts-business-income?_s=PM:OPINION; Sahadi, *supra* note 130.

136. Hodge, *supra* note 135.

137. *Id.*

138. See I.R.C. § 1202(a)(1) (2006).

139. "Pass-through" income is most commonly reported on schedules C, E, and/or F of IRS Form 1040. In the below-referenced study, the sections "Tax Units Reporting

conducted by the Tax Policy Center showed that wealthy individuals¹⁴⁰ account for 60.07%¹⁴¹ of positive business income from “pass-through¹⁴²” entities.¹⁴³

In addition, 74.2% of taxpayers in the highest tax bracket report schedule C, E and/or F income.¹⁴⁴ Also, 65.7% of taxpayers in the second highest tax bracket report schedule C, E, and/or F income.¹⁴⁵ However, only 23.2 % of all filing taxpayers report schedule C, E and/or

Business Income” and “Tax Units Reporting Positive Business Income” relate to tax units reporting income on a “pass-through” basis on schedules C, E, and/or F. There are a total of 36,026,000 tax units reporting business income, according to the below-referenced study conducted by the Tax Policy Center. There are a total of 2,854,000 tax units in the 26% AMT, 28% AMT, 36%, and 39.6% brackets reporting business income (*i.e.*, the top two marginal tax brackets, including AMT rates). Therefore, taxpayers in the 26% AMT, 28% AMT, 36%, and 39.6% brackets represent 7.92% (2,854,000/36,026,000) of the tax units reporting business income (*i.e.*, receiving pass-through income). However, taxpayers in the 26% AMT, 28% AMT, 36%, and 39.6% brackets represent only roughly 3.2% (4,965,000/155,368,000) of the overall taxpaying population. Thus, taxpayers in the top two marginal tax brackets, including AMT rate brackets, disproportionately report “pass-through” business income. *See* Distribution of Business Income by Statutory Marginal Tax Rate, *supra* note 130.

140. For the purpose of analyzing these findings, “wealthy individuals” includes those taxpayers in the top two marginal tax brackets [36% and 39.6%] and taxpayers subjected to the AMT [26% AMT and 28% AMT]. However, these wealthy individual business income statistics may also include lawyers, authors, public speakers, etc., which may not employ others and are thus not the typical small business entities sought to be incentivized under the SBJA. *See generally* Distribution of Business Income by Statutory Marginal Tax Rate, *supra* note 130.

141. Taxpayers subject to the 39.6% tax rate reported \$388.2 billion on schedules C, E and F. Taxpayers subject to the 36% tax rate reported \$39 billion on schedules C, E and F. Taxpayers subject to the 28% AMT rate reported \$113.5 billion on schedules C, E and F. Taxpayers subject to the 26% AMT rate reported \$37.5 billion on schedules C, E and F. All taxpayers combined to report \$962.5 billion on schedules C, E and F. $(388.2 + 39 + 113.5 + 37.5) = 578.2$. \$578.2 billion is 60.07% of \$962.5 billion. *See generally* Distribution of Business Income by Statutory Marginal Tax Rate, *supra* note 130.

142. Schedule C reports profit or loss from sole proprietorships. Schedule E reports supplemental income and loss from partnerships, S corps, real estate rentals, royalties, estates, trusts, etc. Schedule F reports profit or loss from farming activities. Many small business owners report income in a “pass-through” manner by filing schedule C and E sole proprietorship returns and supplemental income returns, respectively.

143. *See* Distribution of Business Income by Statutory Marginal Tax Rate, *supra* note 130.

144. *Id.*

145. *Id.*

F income.¹⁴⁶ The top two tax brackets also have a disproportionate percentage of taxpayers who garner more than 50% of their adjusted gross income from schedule C, E, and/or F income; 32.5% and 26.2%, respectively.¹⁴⁷ However, only 6.4% of the American population at large draws more than 50% of their adjusted gross income from schedule C, E and/or F income.¹⁴⁸

As such, the individuals who make up the vast majority of all U.S. private business income generated will be paying substantially higher taxes. Therefore, when the Bush era tax cuts end for the top two marginal tax brackets, the increased tax burden will be significant in the small business community because small businesses earn a vastly disproportionate percentage of income.¹⁴⁹ Such a tax increase is likely to reduce the incentive for potential small business owners to invest in new businesses because the return on their investment for taking the risk is reduced.

3. Trade Off for Small Business Investors

The temporary exclusion from gain creates a trade-off for the small business community. Small business taxpayers obtain the exclusion of gain from the sale of QSBS in exchange for organizing as a C corporation that pays double taxation at both the corporate and shareholder levels.¹⁵⁰ The 35% corporate level tax rate is simply the price that an eligible taxpayer must pay in order to obtain the benefits of the IRC § 1202 exclusion.¹⁵¹ The decision of whether to make a QSBS investment is very difficult for any taxpayer who, in the absence of IRC § 1202, would otherwise organize as a “pass-through” entity.¹⁵² The taxpayer would have to analyze the tax implications of organizing as a

146. *Id.*

147. *Id.*

148. *Id.*

149. *See* Hodge, *supra* note 135.

150. *See generally* I.R.C. §§ 1(h); 301; 316 (2006).

151. David F. Levy & Nickolas Gianou, 2011: A Boom Year for the Qualified Small Business?, CORP. BUS. TAX'N MONTHLY, Apr. 2011, at 43, available at <http://www.skadden.com/insights/2011-boom-year-qualified-small-business>.

152. *See* Douglas A. Schaaf & Erika B. Mayshar, *New Law Creates Zero Percent Effective Tax Rate For Certain Qualified Small Business Stock*, PAUL HASTING: STAY CURRENT, Oct. 2010, at 1, available at <http://www.paulhastings.com/assets/publications/1740.pdf>; Levy & Gianou, *supra* note 151, at 49.

“pass-through” entity (i.e. currently including all business income on the individual owner’s schedule C, E or F) against the tax implications for organizing as a QSB C corporation (incurring taxation on business income at the corporate level, but excluding all capital gain from the sale of QSBS at the shareholder level).¹⁵³ In general, the life cycle of a successful corporation includes incurring start-up expenses and losing money in the first few years of operation, while eventually becoming cash-flow positive after a few years once the corporation has a substantial customer base or other source of stable revenue. As such, a corporation under a typical growth pattern may be able to write off some of its start-up expenses and business losses during the first few years after formation, and will be able to potentially monetize its increase in value by selling after the fifth year without incurring tax on the sale. At least one commentator has determined that the tax-free sale could serve in this type of scenario as a potential hedge against the corporation’s appreciation.¹⁵⁴

4. *Intended Benefits Likely to be Limited*

Even though the expansion of IRC § 1202 purports to incentivize investment in small business, most small businesses are either ineligible for the exclusion by definition,¹⁵⁵ or unable to realize an economic benefit from the exclusion because of the corporate tax trade-off (described above) required to seek IRC § 1202 exclusion.¹⁵⁶ Of course, those who would have organized as C corporations regardless of the 1202 exclusions received a surprise benefit, making it even more enticing for them.¹⁵⁷ Taxpayers who generally would have formed C corporations regardless of the exclusion may include those who incur high start-up costs over the initial five-year period but expect capital

153. Levy & Gianou, *supra* note 151.

154. *Id.*

155. Most small businesses are not C corporations and, of those that are C corporations, many are excluded from the definition of “qualified trade or business” under I.R.C. § 1202(e). *See* I.R.C. § 1202(e)(3) (2006) (excluding legal services, health services, financial services, brokerage services, insurance, engineering, architecture, performing arts, consulting, athletics, farming, mining, any business of operating a hotel, motel, restaurant, or similar business, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees).

156. *See generally* I.R.C. § 1202; Levy & Gianou, *supra* note 151.

157. Levy & Gianou, *supra* note 151.

appreciation thereafter.¹⁵⁸ Entities generally incur high start-up costs because of large expenses for research and development, marketing and/or advertisement.¹⁵⁹ Such entities may include those engaged in high-tech or manufacturing industries. These industries are often risky and high-yield, meaning that while start-up costs are relatively high, appreciation has the potential to be immense.¹⁶⁰

Of course, some entities that would elect C corporation status absent the IRC § 1202 exclusion are not truly small businesses and thus would not be eligible to receive the exclusion anyway.¹⁶¹ For instance, large, publicly traded corporations, which would likely fail to meet the \$50 million aggregate asset limitation of I.R.C. § 1202(d), may nonetheless require C corporation status for purposes of obtaining financing.¹⁶² Furthermore, small personal service corporations, which would likely fail to meet the definition of a “qualified trade or business” under I.R.C. § 1202(e), may prefer taxation as a C corporation since the personal service corporation may oftentimes evade the C corporation double taxation system by paying large salaries to the corporation’s

158. *Id.*

159. The theory is that a taxpayer incurring high start-up costs would prefer C corporation taxation because the start-up costs may be amortized over the valuable life or even currently deducted, in the case of certain R&D costs, under I.R.C. § 174. Furthermore, if capital appreciation is expected thereafter, the corporate form would be preferable to “pass-through” entity form since corporate dividends and share appreciation would face taxation at currently preferable capital gains tax rates, rather than at ordinary income tax rates. The tax benefits of § 1202 exclusion of gain on QSBS would even further incentivize the use of C corporations by these taxpayers. *See generally* Annette Nellen, *Tax Consideration for High-Tech Startups*, SAN JOSE STATE UNIVERSITY COLLEGE OF BUSINESS (2001), available at http://www.cob.sjsu.edu/nellen_a/Startup.pdf; Amanda Webber, *Estimating Startup Costs for a New Business*, STARTUPNATION.COM, <http://www.startupnation.com/business-articles/1248/startup-costs-new-business.asp/> (last visited Mar. 27, 2012).

160. ROSS DEVOL & PERRY WONG, *AMERICA’S HIGH-TECH ECONOMY: GROWTH, DEVELOPMENT AND RISKS FOR METROPOLITAN AREAS* (Milken Inst. 1999); Mark Davis, *Driving Growth in High Tech*, DELOITTE DEBATES, available at http://www.deloitte.com/view/en_US/us/Insights/Browse-by-Content-Type/deloitte-debates/225748664f75b210VgnVCM2000001b56f00aRCRD.htm (last visited Mar. 27, 2012).

161. *See* I.R.C. § 1202(d) (2006) (dictating a \$50 million aggregate asset limit).

162. Joe Wallin, *Top Reasons to Choose a C Corporation*, STARTUP LAW BLOG (June 2, 2009), available at <http://www.startuplawblog.com/2009/06/02/top-reasons-to-choose-a-c-corporation/>.

owners in lieu of dividends.¹⁶³ Thus, some entities that would elect C corporation status regardless of tax subsidies would not be eligible for IRC § 1202 exclusions for failing to satisfy the aggregate asset and “qualified trade or business” limitations.

IV. OPEN INTERPRETATIONS

Several provisions of IRC § 1202 have been the subjects of much debate since the time of IRC § 1202’s original enactment in 1993.¹⁶⁴ The per-issuer limitation (see section IV(A) below, *infra*),¹⁶⁵ the treatment of appreciated property (see section IV(B) below, *infra*)¹⁶⁶ and the definition of activities that meet the requirements of a “qualified trade or business” (see section IV(C) below, *infra*),¹⁶⁷ are issues that have been discussed but have yet to be clarified by the IRS.¹⁶⁸

A. PER-ISSUER LIMITATION

1. *The Two Interpretations*

While IRC § 1202 provides for the exclusion of 50% of gain from the sale of qualified stock, it also places a dollar amount limitation on the gain that may be excluded on a per-issuer basis.¹⁶⁹ The ambiguity of

163. A corporation may deduct salaries paid as an ordinary and necessary business expense. *See generally* I.R.C. § 162(a). Thus, salaries are deducted from the gross income of the corporation and only subject to taxation upon the employee/owner as ordinary income. *See generally* Comm’r v. Glenshaw Glass Co., 348 U.S. 426 (1955) (holding that income is an “accession[] to wealth, clearly realized, and over which the taxpayers have complete dominion.”). *See also* IRC § 64 (stating “‘ordinary income’ includes any gain from the sale or exchange of property which is neither a capital asset nor property described in IRC § 1231(b).”). Personal service corporations are the most apt corporations to take advantage of salary deductions since the profits are largely obtained from personal services, which usually entail the payment of salary. Furthermore, the employees of personal service corporations are often the owners who are able to control salary and dividend policies.

164. 139 CONG. REC. S7662-02 (daily ed. June 23, 1993) (statement of Sen. John Kerry); Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat 312 (1993).

165. I.R.C. §1202(b) (2006).

166. *See id.* § 1202(i).

167. *See id.* § 1202(e)(3).

168. *See generally* Ward et al., *supra* note 35, at 42.

169. *See* I.R.C. § 1202(a)(1), (b).

IRC § 1202(b) has resulted in two very distinct interpretations of the previously noted language that limits the amount of gain eligible for exclusion to the greater of \$10 million *or* 10 times the aggregate adjusted basis of QSBS issued by the corporation.¹⁷⁰

The first (and more restrictive) approach interprets the code as limiting the excludable amount to the greater of 50% of \$10 million (\$5 million total amount eligible for exclusion) or 50% of 10 times the adjusted basis (5 times the adjusted basis eligible for exclusion).¹⁷¹ This approach actually limits the amount of gain eligible for exclusion to the greater of \$5 million total or 5 times the adjusted basis.¹⁷²

Alternatively, the second approach interprets the code as allowing for a maximum exclusion of the greater of \$10 million or 10 times the adjusted basis.¹⁷³ This approach is less restrictive, and allows for the exclusion of more gain. As a result of neither Congress nor the IRS issuing an opinion regarding this clause, taxpayers currently use both approaches.¹⁷⁴

2. *The Restrictive Approach is More Consistent*

The more restrictive approach appears to be the better of the two interpretations. Since the limitation is framed statutorily as “*the greater of*” the two options, it appears to be more consistent to approach the limitations in a manner that provides the highest benefit to the taxpayer. After all, the intent of the statute is to incentivize potential business owners to make the investment.¹⁷⁵ As such, it would seem to be much more in keeping with the spirit and intention of the statute to give the investor the greatest possible incentive by expanding the cap more than the less restrictive interpretation.

In addition, a statutory interpretation that operates with consistency is more plausible than one that is inconsistent in application. If the exclusion is calculated by reducing a full \$10 million sales price by 50% (the “General Rule”), the cap is easily calculable. If “10 times the adjusted basis” is a replacement for the General Rule, then it is easy to

170. Ward et. al, *supra* note 35, at 42.

171. *Id.* at 2.

172. *Id.*

173. *Id.*

174. *Id.* at 42.

175. *Baucus Hails Passage of Small Business Bill*, *supra* note 104.

calculate the new result.¹⁷⁶ However, if the replacement cap is defined by “50% of 10 times the adjusted basis,” then the result will actually be “5 times the adjusted basis.”¹⁷⁷ If the statutory cap is actually intended to be “5 times the adjusted basis,” it would seem to be far more consistent to directly define things this way.¹⁷⁸

B. TREATMENT OF APPRECIATED PROPERTY

1. *Transfers of Appreciated Property*

Property is frequently contributed in exchange for stock in start-up corporations, including QSBS.¹⁷⁹ In general, a transfer of *appreciated* property (other than by gift or inheritance) results in the transferor’s recognition and realization of gain in the amount of the excess of the value received for the property over the transferor’s tax basis in the property.¹⁸⁰ An exception to this general rule exists where property is contributed to a corporation in exchange for a controlling interest¹⁸¹ in the corporation—an IRC § 351 transaction.¹⁸² In support of a clear public policy favoring the corporate form, IRC § 351 was enacted to remove one of the main obstacles to business incorporation—the recognition of taxable gain upon contribution of appreciated property to the corporation.¹⁸³

Essentially, IRC § 351(a) authorizes non-recognition (deferral until a subsequent recognition event) of built-in gain existing in appreciated property received in exchange for stock under an IRC § 351 exchange.¹⁸⁴ Since corporations and shareholders are independent taxpayers, built-in gain would cease to be directly recognizable by the

176. Ward et al., *supra* note 35, at 42.

177. *Id.*

178. *See id.* at 42.

179. *See generally id.* at 42.

180. *See* I.R.C. § 1001(a) (2006).

181. A controlling interest is generally defined as the ownership of stock representing at least 80% of: 1) the total combined voting power and 2) the total number of shares of all classes of corporate stock. *See id.* § 368(c).

182. *Id.* §§ 351(a), 368(c).

183. *See* William J. Rands, *Incorporation Under the Federal Tax Laws*, 22 LOY. L.A. L. REV. 985, 987-990 (1989); I.R.C. § 351(a).

184. *See generally* I.R.C. § 351(a); Craig L. Rascoe & William M. Richardson, *Opportunities and Pitfalls Under Sections 351 and 721*, William & Mary Annual Tax Conference, Paper 58, 1 (2007), available at <http://scholarship.law.wm.edu/tax/58>.

shareholder following the application of IRC § 351 non-recognition provisions.¹⁸⁵ Instead, the built-in gain on appreciated property transferred in an IRC § 351 exchange is preserved for subsequent recognition by the transferee corporation through the use of a carry-over basis.¹⁸⁶ The transferring shareholder would receive an initial basis in the stock received equal to the transferring shareholder's adjusted basis in the property exchanged.¹⁸⁷ In addition, the transferring shareholder's basis in stock would not be adjusted to reflect any subsequent gain or loss recognized by the corporation upon sale of the appreciated property following the IRC § 351 exchange.¹⁸⁸ Therefore, a C corporation shareholder would face no tax consequences from either: (1) the IRC § 351 exchange of appreciated property, or (2) the C¹⁸⁹ corporation's subsequent sale of the appreciated property at a gain.¹⁹⁰ However, the built-in gain is reflected in the initial basis of stock received by the shareholder in the IRC § 351 exchange.¹⁹¹

An IRC § 351 transfer of appreciated property to a C corporation could face double gain recognition since: (a) the C corporation would face direct taxation on the then-existing capital gain recognized upon a subsequent disposition of the property by the C corporation, and (b) the shareholder could face recognition of gain from the sale of the IRC § 351 stock for an amount in excess of the shareholder's carry-over basis in the stock—an indirect preservation of built-in gain within the shareholder's stock basis.¹⁹² In the loss context, Congress enacted IRC § 362(e)(2) restricting the potential for the same economic loss to be recognized following a shareholder's contribution of appreciated

185. Rascoe & Richardson, *supra* note 184, at 5.

186. A carry-over basis means that the corporation's basis in the property is the same as the contributor's adjusted basis in such property at the time of contribution. The carry-over basis would essentially defer realization of any gain or loss that had occurred from the time in which the contributor originally acquired the property to the date of contribution. *See* Ward et al., *supra* note 35 at 42; I.R.C. § 358(a).

187. *See* I.R.C. § 355(a)(5)(C).

188. Rascoe & Richardson, *supra* note 184, at 5.

189. On the other hand, a shareholder's IRC § 351 transfer of built-in gain property to an S corporation would cause the shareholder to recognize some gain upon the S corporation's subsequent sale since an S corporation's recognition of gains and losses results in pro-rata adjustments to the basis of all outstanding shares. *See* Rascoe & Richardson, *supra* note 184, at 5-6.

190. *Id.* at 5.

191. *See id.* at 5-6.

192. *Id.* at 6.

property as part of an IRC § 351 exchange.¹⁹³ However, Congress has not taken similar action to restrict the recognition of double gain upon such a transaction. Given Congress' action to prevent the recognition of double loss from a shareholder's IRC § 351 transfer of appreciated property to a C corporation, Congress' failure to prevent the recognition of double gain arguably implies Congressional approval of such a result.¹⁹⁴

2. *Potential Disparate Basis Treatment for Contributions of Appreciated Property Made Pursuant to IRC §§ 351 and 1202*

IRC § 1202(i) provides that a shareholder taxpayer who contributes property (other than money or stock) to a QSB in exchange for QSBS, would possess a basis in the QSBS in the hands of the contributing taxpayer that "in no event [would] be less than the fair market value of the property exchanged on the date of such exchange."¹⁹⁵ In the case of a contribution of built-in loss property, IRC § 1202(i) would still produce a carry-over basis in the QSB.¹⁹⁶ However, in the case of built-in gain (appreciated) property, IRC § 1202(i) would produce a fair market value basis in the QSB in the hands of the contributing shareholder.¹⁹⁷

It is conceivable that a taxpayer would seek non-recognition of gain on an IRC § 351 transfer of appreciated property in exchange for a controlling interest in a QSB. Therefore, the basis provisions of IRC §§ 351 and 1202 transactions could face simultaneous application. However, the basis provisions of IRC §§ 355(a)(5)(C) and 1202(i) produce inconsistent results with respect to contributions of *appreciated* property. IRC § 355(a)(5)(C) essentially calls for a shareholder to maintain a carry-over basis in stock acquired in exchange for appreciated property.¹⁹⁸ On the other hand, IRC § 1202(i) calls for a basis in stock of no less than the fair market value of the property contributed.¹⁹⁹ The interplay between the basis provisions applicable to IRC §§ 351 and 1202 transactions remains unsettled. If Congress wants to maintain a double tax benefit prevention policy in the context of

193. I.R.C. § 362(e)(2).

194. *See generally id.*

195. *Id.* § 1202(i)(1)(B).

196. *See generally id.* § 1202(i).

197. *See generally id.*

198. *See id.* § 355(a)(5)(C).

199. *See id.* § 1202(i).

appreciated property contributions to a C corporation, then it would be advisable for Congress (or the IRS) to resolve this issue by acting to maintain the double taxation of IRC § 351 transfers of appreciated property—perhaps by limiting the stepped-up basis accorded to transfers of appreciated property in exchange for QSBS under IRC § 1202(i).

C. QUALIFIED TRADE OR BUSINESS DEFINITION

The IRC § 1202 subsection that defines the type of business that may qualify as a “qualified trade or business” appears to be somewhat ambiguous since the purportedly exclusive list provided by the subsection offers several broad categories that are open to interpretation.²⁰⁰ The definition provided is exclusive.²⁰¹ The subsection states that:

[A] ‘qualified trade or business’ means any trade or business other than those involving: . . . the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees, any banking, insurance, financing, leasing, investing, or similar business, any farming business (including the business of raising or harvesting trees), any business involving the production or extraction of products of a character with respect to which a deduction is allowable under § 613 or 613A, and any business of operating a hotel, motel, restaurant, or similar business.²⁰²

The exclusionary language of the active business requirement tends to favor those taxpayers and business owners who would create new, high-value jobs and, in so doing, boost the economy.²⁰³ Since the term “qualified trade or business” is defined primarily through exclusion, the resulting ambiguity surrounds which activities are actually *included* in

200. *See id.* § 1202(e)(3). Examples of broad categories include: 1) “any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees” and 2) “any business of operating a hotel, motel, restaurant, or similar business.” *See id.* § 1202(e)(3)(A), (E).

201. *See id.* § 1202(i).

202. *Id.* § 1202(e)(3)(A)–(E).

203. 139 CONG. REC. S7662-02 (daily ed. June 23, 1993) (statement of Sen. John Kerry).

the term's definition.²⁰⁴ For example, the term "restaurant" also covers other "similar" business, so presumably that would cover businesses that operate food services that may be eaten in the establishment. However, there are plenty of businesses that are predominately in operations not included on the above list of exclusions, but which sell food that can be eaten onsite, such as mini-marts, bookstores with snacks, buildings that have a cafeteria dining area or numerous other combination business sites. An aggressive IRS might interpret some or all of these businesses as similar to a restaurant, while a less enforcement-minded IRS would likely not do so. To date, there has been no significant clarification on which activities actually *do* qualify. As such, individuals are left to muddle through the list of what is excluded and determine whether their business meets the description of any activity listed (and therefore excluded), and if not, they may then assume that their trade or business qualifies.

V. POLICY CONSIDERATIONS

A. ECONOMIC CONDITIONS LEADING TO THE SBJA

The SBJA and the prior acts dealing with IRC § 1202 were aimed at encouraging investments in "key" types of small businesses.²⁰⁵ The goal was to stimulate the economy through certain types of investments.²⁰⁶ The purposes of the SBJA included: (i) increasing exports in order to reduce the trade deficit; (ii) reducing the number of outsourced American jobs; and (iii) creating new domestic jobs.²⁰⁷ The SBJA was intended to incentivize job creation in industries that will make America more competitive in the global economy, such as manufacturing and technological development.²⁰⁸ In addition to the IRC

204. See generally I.R.S. Priv. Ltr. Rul. 2005-21021 (May 27, 2005), 2005 WL 1254485 (stating that a manufacturing company may be considered to be engaged in a qualified trade or business).

205. Jesse Lee, *President Obama Signs Small Business Jobs Act – Learn What's In It*, WHITEHOUSE.GOV (Sept. 27, 2010), <http://www.whitehouse.gov/blog/2010/09/27/president-obama-signs-small-business-jobs-act-learn-whats-it>.

206. *Id.*

207. 156 CONG. REC. S7102 (daily ed. Sept. 15, 2010) (statement of Sen. Cardin), available at 2010 WL 3582757 (Westlaw).

208. 139 CONG. REC. S7662-02, (daily ed. June 23, 1993) (statement of Sen. John Kerry); see also 156 CONG. REC. S7102 (daily ed. Sept. 15, 2010) (statement of Sen. Ben Cardin), available at 2010 WL 3582757 (Westlaw).

§ 1202 exclusions, the SBJA also provides several other economic growth incentives.²⁰⁹

The passage of the SBJA illustrates that Congress has taken note of the severely difficult economic environment for starting up and maintaining a small business. Of course, anytime the business community faces a prolonged economic slowdown, reduced availability of credit, and expanding regulation, it will make the productive conduct of business more difficult. Furthermore, America is less appealing to manufacturing investment because of problems such as America's crumbling transportation infrastructure, an unfavorable currency exchange rate, lack of enforcement against overseas piracy of American intellectual property, proposed "cap and trade" environmental policies, lack of consumer demand and lack of suitable financing.²¹⁰ These market and regulatory issues have caused one-time American jobs to be outsourced, which has caused a huge disparity in America's trade deficit and threatened America's relative economic standing in the global economy.²¹¹

Congress turned to small businesses for help in solving these economic problems because small businesses have historically been the engine of the American economy, and the sector that creates the most jobs in an economic recovery.²¹² For example, some reports have shown that small businesses may account for (i) up to two-thirds of all new American jobs created over the last 15 years, (ii) 50% of America's

209. These incentives include the double deduction of start-up costs, bonus depreciation, and increased availability of cheap financing for large-scale projects requiring land, buildings and heavy equipment. *See* 156 CONG. REC. E1777 (daily ed. Sept. 23, 2010) (statement of Rep. Earl Pomeroy); CONG. REC. E1765-02 (daily ed. Sept. 23, 2010) (statement of Rep. Laura Richardson).

210. *See* Edward Alden, *Why Companies are Leaving the United States, and How to Get Them Back*, RENEWING AMERICA (Mar. 6, 2012), available at <http://blogs.cfr.org/renewing-america/2012/03/06/why-companies-are-leaving-the-united-states-and-how-to-get-them-back/>; 156 CONG. REC. E1777 (daily ed. Sept. 23, 2010) (statement of Rep. Earl Pomeroy).

211. *See* 156 CONG. REC. S7144-02 (daily ed. Sept. 16, 2010) (statement of Sen. George Voinovich).

212. *See* Press Release, Written Testimony by Treasury Secretary Timothy F. Geithner, *supra* note 122; *Baucus Hails Passage of Small Business Bill*, *supra* note 104; Elliott, *supra* note 124.

current private sector employment, (iii) 44% of the total United States' payroll, and (iv) a whopping 97% of America's exports.²¹³

To illustrate the effectiveness of small business job creation, consider that during the last economic expansion, companies with less than 20 employees accounted for 40% of the job growth, while accounting for only 25% of all jobs.²¹⁴ American small businesses have struggled in the current recession, and there have been calls to reduce regulatory and tax burdens, which prohibit small businesses from creating American jobs and spurring growth of the American economy.²¹⁵

The above economic policy goals are the backdrop for the provisions of the SBJA, including the increased tax benefits of the temporarily revised IRC § 1202. This section of this Article focuses on the policy reasons behind two important provisions of IRC § 1202, and uses such policy reasons to illustrate the connection between the goals of the SBJA and IRC § 1202. The relevant policy provisions of amended IRC § 1202 are: (i) the 100% tax-free business sale and (ii) the five-year holding requirement.

B. POTENTIAL EFFECT OF THE 100% TAX-FREE BUSINESS SALE

Proponents of these amendments believe that IRC § 1202 and other parts of the SBJA will encourage the type of investment in small business needed to boost the economy.²¹⁶ In theory, the incentive may cause more potential business start-ups to commence because the owners who take the risk of starting and running a business will have a tax-free sale at the end of the line.²¹⁷ Of course, for the potential business owner to make this decision, the entire business venture must be a sensible tax decision.

213. 156 CONG. REC. E1765-02 (daily ed. Sept. 23, 2010) (statement of Rep. Laura Richardson).

214. 156 CONG. REC. E1777 (daily ed. Sept. 23, 2010) (statement of Rep. Earl Pomeroy).

215. See Press Release, Written Testimony by Treasury Secretary Timothy F. Geithner, *supra* note 122.

216. *Baucus Hails Passage of Small Business Bill*, *supra* note 104.

217. *Id.*; I.R.C. § 1202(a)(4) (2006).

1. The Decision to Start the Business

A potential business owner would likely consider several factors in deciding whether to start an IRC § 1202 compliant corporation, most notably the income tax rate on the business income that would be earned during at least the first 5 years of operation. A C corporation's income is taxed twice—once at the C corporation level and a second time when the C corporation pays the income out to the owner.²¹⁸ The payment to the owner can be taken by way of compensation or as a dividend out to the shareholders.²¹⁹

The income tax rates on upper income earners and the dividend tax rates have both been artificially low since the tax cuts enacted during President George W. Bush's term ("Bush Tax Cuts").²²⁰ President Obama has repeatedly proposed ending the Bush Tax Cuts, at least for households that earn at least \$250,000 per year.²²¹ Obviously, if this were to occur, the resulting tax rate increases²²² would affect the overall return a business owner would receive from starting up and running a new C corporation business.²²³ To some degree, the policies of the Obama Administration may end up working counter to each other with regard to helping potential future business owners to decide to start a new business.

2. The Decision to Use a C Corporation

The potential end of the Bush Tax Cuts will impact many small businesses because a significant amount of small businesses choose entities, such as limited liability companies ("LLC") and S corporations, that involve "pass-through" taxation.²²⁴ Entities with "pass-through" taxation are only taxed once at the shareholder level.²²⁵ A significant

218. See generally I.R.C. §§ 11, 301.

219. *Id.* §§ 64, 301.

220. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (2003); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, 4853 Pub. L. No. 111-312, 124 Stat. 3296 (2010) (extending Bush tax rates for 2 years).

221. Sahadi, *supra* note 130.

222. *Id.*

223. See generally I.R.C. §§ 11, 64, 301, 302 (2006).

224. Hodge, *supra* note 135.

225. I.R.C. § 701.

number of US households earning \$250,000 a year or more include small business owners.²²⁶

The IRC § 1202 exclusion only applies to C corporations, which are double-taxed entities.²²⁷ So, while it is possible that the Obama administration is correct that the end of the Bush Tax Cuts will only affect 2% to 3% of Americans,²²⁸ it is conceivable that the majority of small businesses will be financially impacted. Such a negative result may actually cause an overall loss in job creation from the market segment that has historically been the engine of American growth, rather than entice investors to start businesses.

3. *The Past is Prologue: the CARS Example*

It is entirely possible that the IRC § 1202 amendments will not have the intended effect of increasing small business start-ups, increasing economic activity and reducing the January 2011 9.4% unemployment rate.²²⁹ The incentives for creating the “Cash for Clunkers” or Car Allowance Rebate System (“CARS”) of 2009 were similar to the incentives for the IRC § 1202 exclusion. Reference to the CARS program will help illustrate the possible future effects of the IRC § 1202 exclusion.²³⁰

In addition to certain environmental goals,²³¹ CARS was designed to stimulate new car sales in an effort to save auto-manufacturing

226. Wealthy individuals account for 60.07% of business income from “pass-through” entities (see section III(D)(3) above, *infra*). See *Distribution of Business Income by Statutory Marginal Tax Rate*, *supra* note 130.

227. I.R.C. § 1202(c).

228. Christi Parsons & Lisa Mascaro, *Geithner Urges Ending Tax Cuts for the Wealthy*, L.A. TIMES, July 26, 2010, <http://articles.latimes.com/print/2010/jul/26/nation/la-na-geithner-tax-cuts-20100726>; *Distribution of Business Income by Statutory Marginal Tax Rate*, *supra* note 130.

229. See Charles Hurt, *Prez’s Big Biz Lesson for “Hire” Education*, N.Y. POST, Jan. 8, 2011, http://www.nypost.com/p/news/national/prez_big_biz_lesson_for_hire_education_1FavgpKz021zmkGSyotIzM.

230. Randolph Heaster, *Study Says ‘Cash for Clunkers’ Impact was Underestimated*, MCCLATCHY, Mar. 10, 2010, <http://www.mcclatchydc.com/2010/03/10/90110/study-says-cash-for-clunkers-impact.html>.

231. The environmental goals included replacing inefficient gas guzzlers with new, more fuel-efficient automobiles. See Gwen Ottinger, *When ‘Clunkers’ Are Greener*, WASH. POST, Aug. 4, 2009, <http://www.washingtonpost.com/wp-dyn/content/article/2009/08/03/AR2009080302220.html>.

jobs.²³² The effects of purchase credits offered by the U.S. to spur new car purchases by consumers produced a large number of sales for dealerships in July and August of 2009.²³³ Consumers traded in their obsolete vehicles for vouchers valued between \$3,500 and \$4,500 to be used towards the purchase of a new vehicle.²³⁴

Critics contend that the program failed to stimulate the economy.²³⁵ The increase of new car purchases under CARS was followed by a subsequent dearth of sales.²³⁶ As such, it is likely that CARS merely caused consumers who were likely to make purchases in the near future to buy new cars while the program was in effect. Therefore, these purchases may not actually produce *additional* car sales.

It is possible that the incentives in the amendments to IRC § 1202 will have a similar effect on new business start-ups as CARS had on new auto sales. Rather than entice people to start new businesses, the incentives will instead only provide a tax break to start-up owners who would already have started the business anyway. Perhaps it will entice some people to start their business earlier than otherwise, but that may only end up causing a drop-off in business start-ups after the sunset date for the tax-free temporary amendment.

The Obama Administration has proposed making the 100% IRC § 1202 exclusion permanent.²³⁷ Perhaps making these amendments permanent would have a better chance of testing whether the tax-free business sale is enough to incentivize long-term business formation and operations. Unlike CARS, a permanent extension would provide the time to tell whether IRC § 1202 will spur job creation and/or economic growth as hoped.

C. RATIONALE FOR THE FIVE-YEAR HOLDING PERIOD

Another policy question regarding the recent amendments to IRC § 1202 is whether the five-year holding period is a proper incentive, *or*

232. Heaster, *supra* note 230.

233. *Id.*

234. *Id.*

235. *Cash For Clunkers: Let's Have a \$4500 Subsidy For Everything*, WALL ST. S.J., Aug. 2, 2009, <http://online.wsj.com/article/SB10001424052970204313604574326531645819464.html>.

236. *Id.*

237. *Startup America: Obama Administration Commitments*, WHITEHOUSE.GOV, <http://www.whitehouse.gov/issues/startup-america-public> (last visited Mar. 29, 2012).

whether it is so restrictive that it actually defeats the purpose of the exclusion. The holding period serves the purpose of granting the tax-free sale treatment *exclusively* to investors who provide long-term benefits to the economy.²³⁸

The decision by Congress to limit the exclusion of gain to stock held for *at least five years* was in no way arbitrary.²³⁹ As previously mentioned, the ARRA was designed to not only provide incentives for those willing to take the risk associated with investing in small businesses, but also to lower the overall budget deficit.²⁴⁰ Supporters of the original IRC § 1202 passed in 1993 argued that the five-year requirement would promote “patient capital,”²⁴¹ as well as encourage those that were willing to hold onto their stock for a prolonged period and take a risk at job creation.²⁴² The ARRA amended IRC § 1202 to provide for increased tax benefits. Therefore, the underlying policy surrounding the enactment of the original IRC § 1202 in 1993 likely applies to the enactment of the ARRA amendments to IRC § 1202.

Critics of the five-year holding period contend that it is too long.²⁴³ In particular, the five-year holding period’s commercial unreasonableness impairs the ability to raise capital²⁴⁴ and runs counter to the goal of encouraging investment.²⁴⁵ For example, venture capital firms that finance small businesses may be dissuaded from doing so. Venture capital firms desire to sell out of the venture at whatever time is

238. See *Targeted Capital Gains Tax Relief for Small Companies Before the H. Comm. On Ways and Means*, 105th Cong. (Mar. 17, 1997) (testimony of J. Morton Davis, Chairman of D.H. Blair Investment Banking Corp.).

239. See generally 139 CONG. REC. S7662-02 (daily ed. June 23, 1993) (statement of Sen. John Kerry).

240. See generally 139 CONG. REC. S1593-01 (daily ed. Feb. 16, 1993) (statement of Sen. Dale Bumpers).

241. See generally *id.*

242. 139 CONG. REC. S1593-01S7662-02 (daily ed. June 23, 1993) (statement of Sen. John Kerry).

243. See *Opportunity in Proposed Change to Tax Incentive for Small Business Investment*, Community Development Venture Capital Alliance (Apr. 2010), http://www.cdvca.org/index.php?option=com_content&view=article&id=274:small-biz-investment&catid=31:news&Itemid=101; *Targeted Capital Gains Tax Relief for Small Companies Before the H. Comm. On Ways and Means*, *supra* note 238.

244. *Opportunity in Proposed Change to Tax Incentive for Small Business Investment*, *supra* note 243.

245. *Targeted Capital Gains Tax Relief for Small Companies Before the H. Comm. On Ways and Means*, *supra* note 238.

most opportune, in order to free up the capital again for other prospective small business investments. Therefore, the existence of a five-year holding period may inhibit the normal course of a venture capital firm's business financing decisions.²⁴⁶ It is likely that other financiers of start-up businesses may have similar issues with making an assessment of the exclusion's value on their financing decisions.

CONCLUSION

With the enactment of the SBJA, Congress and President Obama hoped to stimulate the economy through incentives for long-term investment and job creation.²⁴⁷ The temporary exclusion of all gain from the sale of QSBS is aimed specifically at small business investment with the hope that an increase in investment will free up capital, and allow businesses to expand and hire new employees.²⁴⁸

The temporary amendment is a huge opportunity for investors and QSBS business owners. With the somewhat stringent (and often ambiguous) requirements of the original IRC § 1202 still in place, investors that are willing to take risks and invest long term will be rewarded by Congress for their persistence through significant tax breaks.²⁴⁹ Congressional intent surrounding the SBJA (and former amendments to IRC § 1202) is to promote the stabilization and stimulation of the economy.²⁵⁰ The coming months will serve as an important indicator of the success of the 2010 IRC § 1202 amendments enacted to incentivize and reward businesses that survive the Great Recession.

246. *Opportunity in Proposed Change to Tax Incentive for Small Business Investment*, *supra* note 243.

247. Small Business Jobs Act § 2011.

248. See 156 CONG. REC. S7102 (daily ed. Sept. 15, 2010) (statement of Sen. Ben Cardin).

249. 156 CONG. REC. S7102 (daily ed. Sept. 15, 2010) (statement of Sen. Ben Cardin); 139 CONG. REC. S1593-01 (daily ed. Feb. 16, 1993) (statement of Sen. Dale Bumpers).

250. See generally 156 CONG. REC. S7102 (daily ed. Sept. 15, 2010) (statement of Sen. Ben Cardin); 139 CONG. REC. S1593-01 (daily ed. Feb. 16, 1993) (statement of Sen. Dale Bumpers).