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Silicon Valley Wins Big With Tax Break Aimed at Small Businesses

By Ben Steverman Jun 10, 2019

Early investors and employees at Uber Technologies Inc., Lyft Inc., and other tech companies are getting a double reward this year: a wave of initial public offerings that puts billions of dollars in their pockets, and a quirk in the law that means some of that money will be tax-free.

Photographer: Josh Freydkis for Bloomberg Businessweek

Entrepreneurs, venture capital firms, and early startup employees are using the Qualified Small Business Stock, or QSBS, provision to partially or totally wipe out their tax bills. “It’s an awesome way to mitigate tax,” says Richard Scarpelli, head of financial planning at First Republic Private Wealth Management. Of all the strategies that investors and business owners use to lower capital-gains taxes, he says, “this is by far the best.”

Shares are eligible for QSBS if they’re issued when a company has gross assets of $50 million or less. If you hold on to the stock for at least five years, you can avoid taxes on $10 million of any gains when you sell. But that $10 million is only a minimum—the law says you can instead shield as much as 10 times your initial investment, or basis, in the corporation. So a venture firm that put $10 million in an early startup could reap $100 million in tax-free gains. And QSBS’s benefit can be multiplied several-fold with clever planning.

The incentive was created after the recession of the early 1990s and expanded during the financial crisis that began in 2008. It’s supposed to help young companies attract capital. The congressional Joint Committee on Taxation says the provision costs the U.S. Treasury $1.3 billion a year. “There is no evidence that these sorts of breaks do anything to help the economy in the long run,” says Steve Wamhoff, director of federal tax policy at the left-leaning Institute on Taxation and Economic Policy. “Even in the short run, they are likely to reward investments that would have happened anyway.”

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The vast majority of small businesses aren't eligible for the break because they're organized as pass-throughs, which have their income reported on owners' individual tax returns. Only C-corporations, which file their own corporate returns, qualify for QSBS. The tech industry is the prime beneficiary. Venture-backed companies tend to be organized as C-corporations, and in the past decade hundreds of tech startups have seen the sort of rapid growth that makes QSBS so lucrative.

Lobbyists for the industry defend the provision. "Folks are doing quite well at some of these IPOs, but they're creating real value in the economy," says Justin Field, senior vice president of government affairs at the National Venture Capital Association. By targeting companies smaller than $50 million, QSBS helps bring funding to startups "at a much more vulnerable point in their cycle," he says.

Getting early shares is the key, before a company hits $50 million in gross assets. That's not always an obvious moment, because gross assets is an accounting measure distinct from market valuation. Uber, founded in 2009 as UberCab, didn't hit that mark until the middle of 2013. By that point, IPO filings show, the company had issued more than 425 million shares, now valued at about $19 billion, which could be eligible for the QSBS benefit.

With the right moves, investors can supersize their benefit. One strategy is to carefully time stock sales over a couple of years. An investor can take advantage of both the $10 million and the 10-times-basis exclusions if they're claimed in separate calendar years. That way, someone who invested $2 million in a startup, for example, could pay no taxes while selling $30 million of stock.

Even if a startup gets bought before five years have elapsed, a taxpayer can protect his or her gain from taxes as long as the taxpayer was compensated in shares of the acquiring company and doesn't sell right away. Or taxes can be avoided by rolling gains from one QSBS-qualified company into another one.

Another technique involves trusts and estate planning. For example, a tech founder with three children could set up trusts for each child, transfer stock into them, and then all four family members could each shield $10 million—delivering $40 million tax-free. The transactions would need to be structured in ways that wouldn't spur a large gift tax bill, but otherwise should pass muster with the Internal Revenue Service, says Brad Dillon, director of fiduciary tax and trusts at Brown Brothers Harriman in New York. "We're not stretching the tax code in any way by setting up multiple trusts."

The bad news for many tech billionaires is they may still owe California taxes on their gains. The home of Silicon Valley, which taxes its richest residents at rates as high as 13.3%, is one of just a few states that doesn't recognize QSBS. In most of the rest of the country, QSBS will exclude both federal and state taxes.

QSBS has been on the books since 1993, one of dozens of tax changes, including higher rates on the wealthy, that Democratic President Bill Clinton championed after he took office that year. Initially, only half of a QSBS gain was protected from tax, while the rest could be subject to higher-than-normal tax rates. "It wasn't really that big of a deal," says Megan Lisa Jones, a tax attorney at Withersworldwide.

President Barack Obama floated the idea of expanding QSBS while still a candidate as the financial crisis deepened in October 2008. "To fuel the real engine of job creation in this country, I've also proposed eliminating all capital-gains taxes on investments in small businesses and startup companies," he said. The Democratic majority in Congress elected along with Obama agreed. By 2010, a temporary provision made 100% of the gains tax-free. "All of a sudden, it got more interesting," Jones says.

A Republican-led Congress made the benefit permanent in 2015. It took a while for even many accountants to

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realize that QSBS can be a powerful tax-avoidance tool. That's partly because of how the law was written: Only shares issued after Sept. 27, 2010, qualified for the full benefit, and they needed to be held for at least five years. "It wasn't until 2015 that people started to care about it," says Christopher Karachale, a partner at law firm Hanson Bridgett in San Francisco. "I've looked at 2016 tax returns where the accountant blew it."

But accountants and tax advisers quickly caught on. Startups began writing QSBS provisions into their investor agreements, promising to provide proof that their shares were issued before the $50 million threshold. Lyft's investor agreement, disclosed in its IPO filings, makes this promise to holders of series A and B stock, rounds when the ride-share company issued more than 15 million shares now valued at more than $900 million.

While venture investors and founders, who can afford top-notch tax advice, are using QSBS, tech workers might not be as lucky. The rules are complicated, and it can be easy to miss out. For example, early employees needed to have exercised options at a time when their startup was still under $50 million in assets. "If you planned well, you ended up with a phenomenal result," says Mary Russell, an attorney at Stock Option Counsel in Palo Alto, Calif., who advises tech employees on their compensation. "If you didn't, you were in a really tight, messy spot."

The tax law signed by President Donald Trump in 2017 is bringing QSBS to the attention of more investors. By slashing corporate tax rates, Trump's tax reform makes the C-corporation structure more attractive to entrepreneurs outside technology, Dillon says. Still, that doesn't mean lawmakers can't take the benefit away in the future—a 2014 proposal floated by then-House Ways and Means Chairman Dave Camp, a Republican, would have eliminated the QSBS provision to simplify the tax code. "There's legislative risk with this," says Brandon Smith, director of estate planning at Wetherby Asset Management. "If you're getting into something now, who's to say the benefits will be there five years from now?"

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