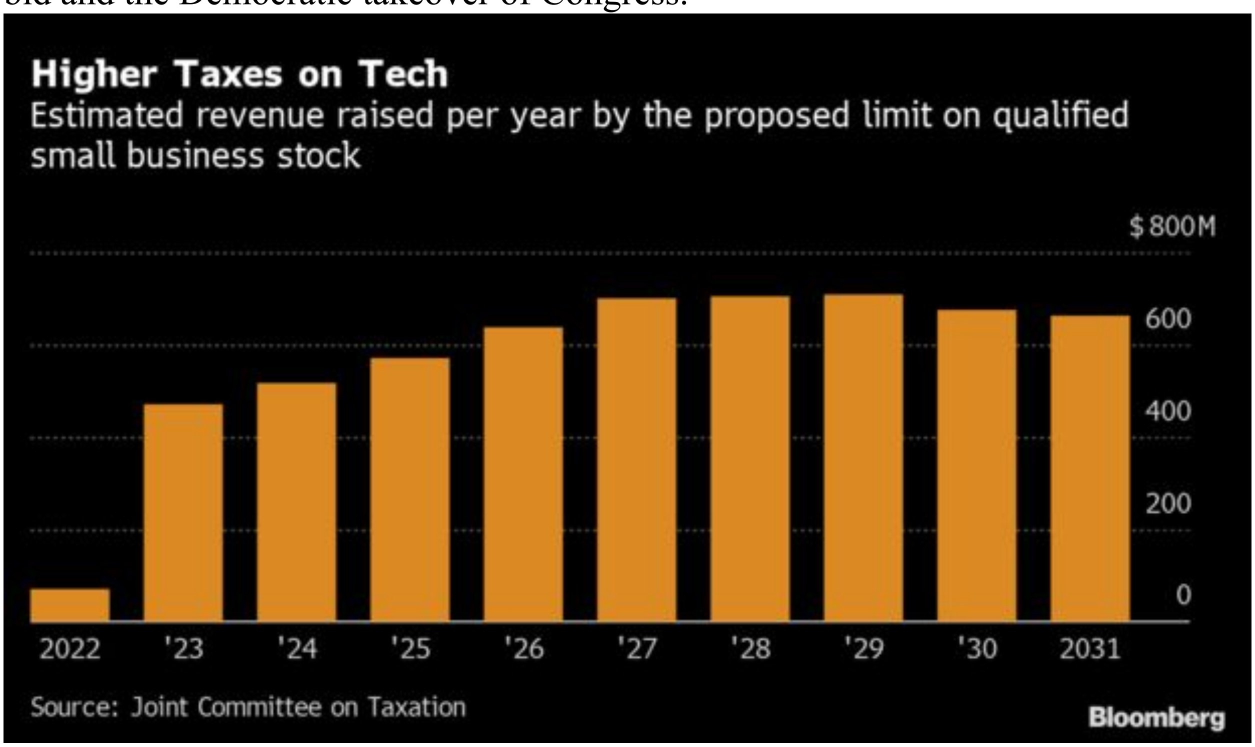
Tech Millionaires Fear Their Favorite Tax Break Will Be Chopped

By Ben Steverman and Kaustuv Basu / September 21, 2021 07:30AM ET /

Silicon Valley woke up last week to a surprise: A tax break that lets the tech industry's millionaires and billionaires shield their winnings from the Internal Revenue Service is being targeted by Democrats in Washington.

Once an obscure provision of the tax code, "qualified small business stock," or QSBS, benefits venture capital-backed startups in technology and other industries that are aiming to get very big, very quickly. If these young companies go public or get acquired, holders of their QSBS pay no capital gains taxes on windfalls of $10 million or — in some cases — even more. And despite its name, the vast majority of small businesses can never qualify for the tax break.

The tax proposal approved by the House Ways and Means committee last week wouldn't kill off QSBS entirely. Instead, it would cut in half the amount that QSBS can exclude from taxes. To critics, QSBS is expensive and unnecessary, a reward for investment that would have happened anyway — and one that benefits some of the richest people in the world, many of whom supported Joe Biden's presidential bid and the Democratic takeover of Congress.



The U.S. Treasury "Green Book," a collection of revenue-raising proposals released earlier this year, seemed to indicate that President Biden's administration wouldn't touch QSBS. Then the Ways and Means plan released on Sept. 13 included the QSBS restrictions on page 628 of 881. They would apply only to taxpayers whose income is $400,000 or more, but that should cover almost everyone cashing in QSBS shares.

"People felt like they got sideswiped. It's really a surprise. We didn't see this coming at all," said Christopher Karachale, a partner at the law firm Hanson Bridgett LLP in San Francisco who is an expert on the break.

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Because the legislative text said the change applied to transactions "after Sept. 13," some holders of QSBS told Karachale they were rushing to sell their shares that day, hoping they could still claim the full tax break on next year's 1040 form. There were "a lot of people freaking out," he said.

Investors in tech and other startups still hope to stop the change.

"We're mobilizing all the resources we've got," said Angel Capital Association CEO Patrick Gouhin, who argued QSBS is especially valuable for incentivizing "high risk" early-stage investments. "This can be devastating to the startup ecosystem. This is going to make it more challenging for entrepreneurs to find the capital they need to grow their companies."

If the House proposal survives the lobbying onslaught, the beneficiaries of QSBS would still pay a significantly lower rate than other investors on non-QSBS gains or than workers on their wages. Karachale calculates the provision would raise the federal tax rate on a $10 million QSBS gain to almost 17%, up from 0% currently.

House Ways and Means Chairman Richard Neal "wholeheartedly rejects the notion that stock sales taxed at this rate would have any effect on innovation and investment," a Ways and Means Committee Democratic aide said. "He believes that Silicon Valley millionaires making these disingenuous arguments are among the extremely wealthy people who should be contributing more, not less, to support investments in critical infrastructure and services that make success in this country possible."

Speaker Nancy Pelosi and California Democratic congressman Ro Khanna, who represent large swathes of the San Francisco Bay Area, declined to comment.

To qualify as QSBS, the shares must be acquired before a startup hits $50 million in gross assets, a cut-off that often includes investors in seed, series A and series B funding rounds, as well as founders and earliest employees. Only businesses that file their taxes as C-corporations qualify — a rule that includes Silicon Valley startups but excludes most other smaller businesses, which tend to be S-corporations or other passthrough entities.

Small businesses, and many large ones, aren't C-corporations because that requires companies pay a second layer of tax to the IRS at the corporate level, before shareholders are levied taxes on their dividends and gains. Passthrough businesses, by contrast, pay taxes once, on their owners' individual returns. There are advantages to the C-corp status, however, when a company is destined to either go public or get acquired, which is why they're the favorite structure for startups in software, bio tech and other hot areas.

Technically, there are limits on how much QSBS gains can be shielded from taxes — capped at either $10 million or ten times an initial investment, whichever is more. But Silicon Valley accountants and lawyers have found a way around this: By putting QSBS in several trusts, startup founders and funders can multiply their tax-free gains, from just $10 million to $40 million or $50 million. "Every single person walking down University Avenue [in Palo Alto, California] has two or three irrevocable n on-grantor trusts funded with QSBS," Karachale said.

The Joint Committee on Taxation estimates the proposed limits on QSBS would raise an extra $5.7 billion over the next decade. But Manoj Viswanathan, a professor at the University of California, Hastings law school in San Francisco, has researched the issue and said those estimates "could be off by an order of magnitude," underestimating how much startup founders, investors and early employees end up saving via the QSBS break.

Karachale agreed, saying the scorekeeper may not realize how popular and ubiquitous QSBS has become in Silicon Valley — and how many lucrative startups have come into the money. See, for example, the wave of special purpose acquisition companies, or SPACs, going onto the stock market, and the boom in fintech offerings including Coinbase Global Inc. and Robinhood Markets Inc.

"Everybody is going through that assuming they're getting QSBS," Karachale said.

An excess of capital that's waiting to be deployed means QSBS is "just a giveaway," said Viswanathan of UC-Hastings. "It's a windfall for Silicon Valley as opposed to an incentive."

But advocates say the point of QSBS is to encourage entrepreneurs and boost innovation.

"This provision does not appreciate the delicate balance that has made us the epitome, and Silicon Valley the literal home, of high risk/high reward entrepreneurship," said Ashmeet Sidana, founder of Engineering Capital, which invests in technology companies, in Mountain View, California. He said limits on QSBS would reduce rewards for "investors who enable innovation and long-term building, versus speculators who don't really enable innovation."

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