

September 24, 2021

The Honorable Nancy Pelosi
Speaker
U.S. House of Representatives
H-232, The Capitol
Washington, D.C. 20515

The Honorable Kevin McCarthy
Minority Leader
U.S. House of Representatives
H-204, The Capitol
Washington, D.C. 20515

Dear Speaker Pelosi and Leader McCarthy:

The undersigned organizations write to encourage policymakers to remove provisions in the Build Back Better Act that would curtail the effectiveness of Qualified Small Business Stock (QSBS) in incentivizing investment in innovative small businesses and startups.

Small businesses and startups are at the heart of the American economy, driving a substantial portion of all new job creation, innovation, and opportunity for their employees.¹ As the United States seeks to build a broad-based economic recovery that expands opportunity to more people, our country's tax regime should advance that ambition.

The Qualified Small Business Stock rule has proven effective in promoting investment in startups and early-stage growth companies in regions and communities across the country. QSBS limits capital gains taxes for founders, employees, and investors in qualified small businesses. The QSBS exclusion encourages investment at the earliest stage in a company's life cycle. It enables employee-owners who take higher risks to join an early-stage company to receive commensurate return on that investment of time, expertise, and hard work. This is why bipartisan policymakers have supported this provision over the years.

Policymakers put constraints in place to drive the intended outcomes. To qualify, the enterprise must, among other things, have less than \$50 million in assets, 80% of which are used in active conduct of a qualified business. And the stock owners must hold the stock for five years. This bipartisan incentive to drive investment to this sector was first passed in 1993 under President Clinton and later expanded under President Obama.

Developing and investing in startups and early-stage growth companies carry substantially more risk than investing in more mature companies. These companies fail at higher rates and even those that succeed do not provide employee-owners and inventors regular access to liquidity, meaning any investment of time, resources, or capital, must be for the long-term. The QSBS framework incentivizes that long-term investment and employee retention in startups and early-stage companies. Recent data indicates that QSBS shares are present in over 50 percent of seed-stage and Series A deals.²

¹ Small business startups, especially those with at least 20 employees, play a large role in net job creation.
<https://sgp.fas.org/crs/misc/R41523.pdf>

² <https://www.aumni.fund/blog/top-3-mistakes-vcs-make-with-qsbs>

The QSBS exclusion helps small businesses and nascent corporate competitors to attract and retain talented employees. Early-stage companies generally cannot pay the same salaries or provide the same benefits as large corporations, and they certainly cannot provide the same job security, but they can compete for talent by supplementing salary with a piece of ownership of the enterprise. And QSBS enables early-stage employees to unlock the full value of the equity that they earned in the small businesses they helped build. This further incentivizes talented people to work at the innovative startups building the future. Importantly, sharing the economics of the enterprise with workers creates a powerful alignment of interests that helps small businesses take on incumbents with exponentially more resources, and win.

Long-term investors in qualified small businesses will also be able to maximize the return on investment, which serves as an inducement to invest in these potentially riskier investments. For these investors, these decisions are five or more year time horizons in a market segment where not every company succeeds. QSBS, however, helps draw that long-term investment towards these enterprises, lowering the cost of capital for small businesses and helping them raise the money necessary to invest in their people and products, and ultimately grow. It also provides those investors more capital to recycle into additional investments that begin the next phase of innovations and products and markets.

QSBS is particularly critical in driving more investments to startups into emerging technology regions. Institutional investors such as pension funds, endowments and foundations, are often too large to devote capital to small companies in rural and underserved communities. And early-stage technology companies are too risky for debt financing. This means taxable investors are central to any effort to increase economic opportunity through the growth of nascent corporate competitors.

The Ways and Means Committee recently approved a provision curtailing the QSBS exclusion as part of the Build Back Better Act, and applied the tax change to sales of stock, as opposed to new investments. This change would not only diminish the incentives that successfully bolster small businesses and their employees, but would also punish taxpayers who invested in or earned QSBS shares years ago by changing the treatment for existing shares and imposing a tax on them. Employee-owners, founders, and investors made economic decisions in the past based on the QQSBS construct supported on a bipartisan basis. This policy would change the rules on them after they followed the rules applicable at the time and held up their end of the bargain.

The proposed change would include an arbitrary income threshold to determine a taxpayer's eligibility, further complicating the purpose of the incentives. As described above, startups often compensate for lower salaries by offering equity, often in the form of QSBS. Given the long holding periods, this change would mean that employees receiving QSBS in year 1 cannot know if their future personal circumstances will preclude them from realizing the benefit of section 1202 at the time of stock sale. This uncertainty means that the section 1202 capital gains exclusion will no longer be an inducement for joining a startup over an established company. Thus, if this provision is enacted, section 1202 will lose much of its intended value to help attract employees to small startups.

Similarly, investors abhor uncertainty and the same uncertainty about whether section 1202 capital gains exclusion will be available to them at the time of exit from an investment will substantially diminish the effectiveness of section 1202 to attract capital as well. As a result, this proposal will have the effect of

substantially reducing, if not eliminating, the effectiveness of a longstanding provision of the tax code to drive capital to small businesses and startups.

Finally, it is important to measure the ramifications of such a change against the revenue Congress is seeking to raise with the provision. The Joint Committee on Taxation's own estimate is that the tax revenue gained by this change to QSBS will only generate approximately \$570 million in additional tax revenue per year. In addition to the negative impact on the small business ecosystem, this fails to consider the risk of losing investment in many early stage companies and the potential tax revenue those businesses can generate.

We appreciate the objectives of the Build Back Better Act and policymakers' desire to expand economic opportunity and accelerate domestic innovation. Supporting small businesses and startups is a key economic engine to realize that vision. We encourage House Members to preserve the current treatment and the related positive impacts on the startup ecosystem, the employee base, and the broader economy.

We appreciate your time and consideration.