

How a capital gains tax break could get cash to startups

By [Catherine Clifford](#), staff reporter

April 26, 2010: 11:38 AM ET

NEW YORK (CNNMoney.com) -- To motivate the well-off to funnel more of their cash into small businesses, should the federal government offer investors new tax breaks?

President Obama thinks so. He's thrown his support behind a proposal to eliminate capital gains taxes on investments made in 2010 and 2011 in qualifying small businesses. The House of Representatives has already passed the legislation; the Senate has yet to take it up.

"We should eliminate all capital gains taxes on small business investment so these folks can get the capital they need to grow and create jobs," Obama said at a February town hall meeting in Nashua, N.H. "That's particularly critical right now, because bank lending standards have tightened since the financial crisis and many small businesses are still [struggling to get loans](#)."

It's a message he's repeated often in recent months, and one that resonates with entrepreneurs: Nearly 60% of the 500 small business owners polled in February by PNC Financial Services Group think their business would benefit from the move.

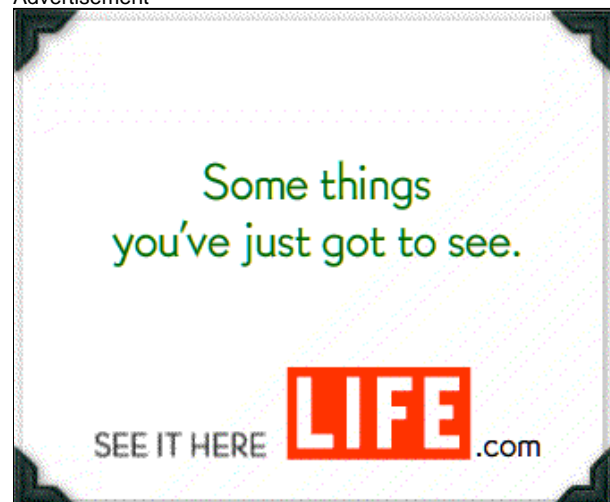
Here's a look at what the tax break would do -- and who would benefit.

What qualifies: The tax break would apply only to individuals, such as the "angel" investors who take early stakes in fledgling, privately held companies.

"This does not help the banks, it does not help the institutional investors," says Brett Palmer, the president of the National Association of Small Business Investment Companies (SBIC), which are government-subsidized small business venture funds. "This really is highly limited as to who can get the benefits. But to those that are really specialized in small business, it is attractive."

To qualify for the tax break, a small business needs to be a C corporation (sorry, [LLCs and S-corps](#)) with assets of less than \$50 million. Additional requirements rule out businesses in fields like accounting and law, farming, restaurant or hotel operations, and banking and financing. The tax break is really aimed at companies in fields with high jobs-growth potential, like manufacturing and technology.

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Additionally, the investor must buy the stock at "original issue," meaning it's purchased directly from the company, and has to hold it for at least five years.

Running the numbers: "Capital gains" are the profits investors make when they sell an asset that has risen in value. They're taxed differently than earned income, often at a lower rate.

But like any tax law, this one has a few loopholes and exclusions.

In 1993, Congress amended the tax code to let small business investors exclude from their income the first half their profit on qualifying investments. With the capital gains tax rate then at 28%, that took the effective maximum tax rate on small business investment profits down to 14%.

Over the next decade, Congress slashed the capital-gains tax rate, cutting it from a maximum of 28% down to today's 15%. But small business stock was specifically excluded from those reductions and continued to be taxed at the higher rate. That virtually wiped out the tax advantages of the income exclusion, putting the effective tax rate of 14% on small business profits almost on par with the overall capital gains tax rate of 15%.

Last year's Recovery Act stimulus bumped up the exclusion rate: For investments made between Feb. 17, 2009, and Jan. 1, 2011 (and held until at least February 2014), investors can exclude 75% of their profits from their income, bringing the effective tax rate on any gains they make down to 7%.

"That has a little bit of teeth," says Laura Warren, a tax attorney at Pepper Hamilton in Philadelphia. "But they didn't fix the AMT problem."

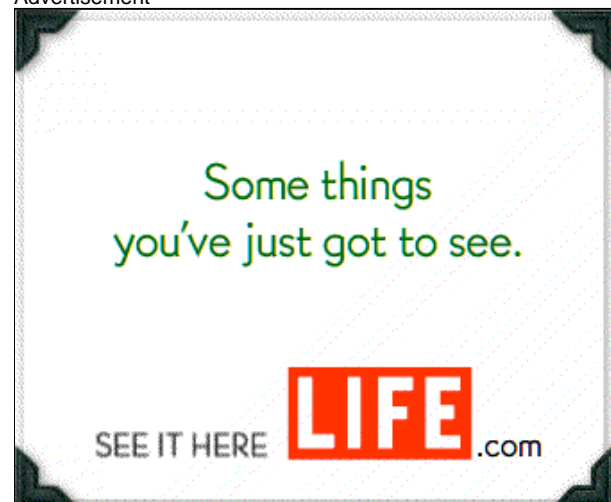
The alternative minimum tax (AMT) is a separate tax structure that aims to close loopholes by eliminating deductions for high-income filers. Most investors, especially angel investors, are subject to the AMT.

The proposal that President Obama backs -- the one that has made it halfway through Congress -- would temporarily raise the exclusion to 100% and protect the gains from AMT exposure.

Will it work? It's hard to find a small business that can directly trace an investment back to the favorable capital-gains treatment investors get. Those in the field say that's largely because the tax advantages in place now are so slight.

"On the [current tax breaks], I don't think I can track someone down and say 'this is what happened,'" says Palmer, president of

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the NASBIC.

He thinks that would change if the proposed full tax break on all small-business investment profits goes through: "With the 100% and the AMT fix, we would have a boatload."

But will individual investors actually change their behavior and amp up their startup funding?

Mac Lewis, a partner with Minneapolis-based venture capital firm Sherpa Partners, hadn't heard of the proposed change. "I guess it didn't get much visibility," he says. "Getting the word out to entrepreneurs would be a good thing."

"There you have really stumbled on the issue -- it is very attractive, but confusing," says Marianne Hudson, the executive director of the Angel Capital Association. "It does sound very motivating to angels, but they are scratching their heads trying to figure out what it means. There is kind of a long list of rules that go with it."

Still, if you dangle a tax credit, those with money will probably chase it.

"We are entering a very high tax environment for a very long time," Palmer notes. "The new tax regime is going to be affecting people's investment decisions going forward, because there are high taxes coming down the pike."

And Warren likes the relative simplicity of the proposed new rules. "From the psychological perspective, there are no complications -- it is an easier sell, it is clean," she says. "You can explain to

somebody in non-technical terms that they are not going to pay tax on the sale of small business stock."

Those in the market say they're ready to open their wallets. Venture capitalist Lewis thinks the tax break could "motivate people to become angel investors who wouldn't otherwise have made that investment."

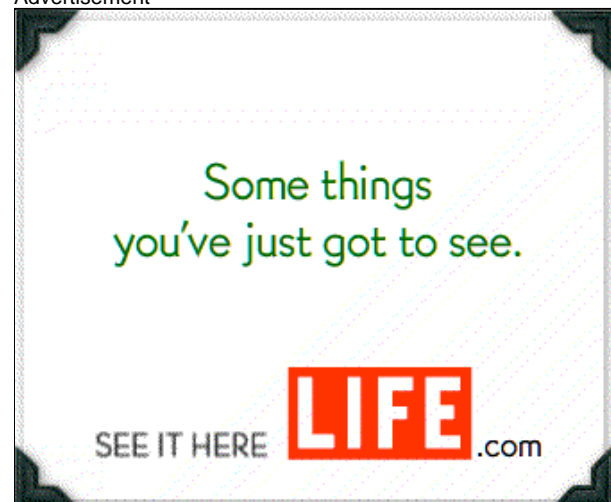
"I look at it as nice, a great thing that might improve the amount of capital somewhat going into early-stage capital investing," says Liddy Karter, managing director of Karter Capital, a venture capital advisory firm in Connecticut.

But Karter was quick to cite the rub on capital-gains tax breaks: They only matter if you hit the jackpot. A typical angel investor turns a profit on just one deal in 10.

"I would prefer to see something that is a bit more frontloaded, because frankly, so many of our investments don't come out making money," she says.

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