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Quantifying the 100% Exclusion of Capital Gains on Small Business Stock

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Abstract

In 2010, Congress increased the exclusion for capital gains from the sale of Qualified Small Business Stock (QSBS) from 50 percent of the gains to 100 percent. The prospect of tax-free capital gains encourages taxpayers both to invest in corporations that qualify for this provision and to engage in creative tax planning to increase the amounts of eligible capital gains. This paper uses data from e-filed tax returns between 2012 and 2022 to provide the first empirical estimates of gains excluded under this provision and the increase in such gains after the exclusion was raised to 100 percent. Exclusions under this provision have increased substantially over the past decade, peaking at over $40 billion for tax year 2021 before decreasing in 2022. An average of just under 33,000 individual taxpayers excluded QSBS gains each year. The distribution of QSBS exclusions is highly skewed. The median annual exclusion among individual taxpayers excluding any gains is $2,810; the 90th percentile is $590,940. Individuals who exclude more than $1 million total between 2012 and 2022 account for 90 percent of gains excluded. Taxpayers with average total positive income under $100,000 account for 20 percent of returns claiming an exclusion but less than 2 percent of gains excluded over this period. Taxpayers with average total positive income over $1 million account for 26 percent of returns claiming an exclusion and nearly 75 percent of gains excluded. Total exclusions claimed by trusts are about 1/6 of that claimed by individuals.

[1] This research is being conducted while the authors are employees at the U.S. Department of the Treasury. Findings, interpretations, and conclusions expressed in this paper are entirely those of the authors and do not necessarily reflect the views or official positions of the U.S. Department of the Treasury. Any taxpayer data used in this research was kept in a secured Treasury data repository, and all results have been reviewed to ensure no confidential information is disclosed.

I. Introduction

In 1993, Congress enacted a 50 percent exclusion for capital gains from the sale of qualified small businesses stock. This provision was intended to address concerns that the Tax Reform Act of 1986 had reduced the incentive to invest in new small businesses by increasing the tax rate on capital gains. In 2010 and 2011, the exclusion was increased first to 75 percent and then 100 percent on new investments. In addition, excluded gains on QSBS purchased after the enactment of the latter change were no longer treated as a preference item for the Alternative Minimum Tax.

The generosity of the new 100 percent exclusion for Qualified Small Business Stock (QSBS) and potential for untaxed capital gains did not go unnoticed by investors, businesses, and the media. As a larger share of QSBS became eligible for 100 percent exclusion, claims grew substantially, peaking at over $40 billion in exclusions claimed in 2021 before decreasing the following year.

There is only limited empirical work examining the effects of the 100 percent exclusion and none that directly measures the amounts of excluded gains. Studying the exclusion is challenging because there are no information returns for QSBS issuance and no requirements for eligible corporations to register with the IRS. As a result, the IRS does not observe anything about QSBS until taxpayers sell the stock and claim the exclusion on Form 8949.

In this paper, we provide the first empirical estimates of the use of the exclusion for gains from QSBS and the characteristics of those claims. We provide estimates of the number of individual and trust returns claiming an exclusion and the amount of gains excluded for individuals, complex trusts, and other taxpayers. We characterize repeat claiming behavior and the holding period for QSBS stock that is eligible for the exclusion when sold. Finally, we document the distribution of QSBS claims and dollars excluded by income and the amount of the exclusion.

Taxpayers have made over $140 billion in all exclusion claims since 2012, and the amount of gains increased dramatically in recent years. Between 2012 and 2022, roughly 217,000 individual taxpayers and 25,000 trusts and estates claimed a 1202 exclusion. We find that the distribution of QSBS exclusions is highly skewed. The median annual exclusion among individual taxpayers excluding gains is $2,810; the 90th percentile is $590,940. Taxpayers with average total positive income under $100,000 account for 20 percent of returns claiming an exclusion but less than 2 percent of gains excluded between 2012 and 2022. Taxpayers with total positive income over $1 million account for 26 percent of returns claiming an exclusion and nearly 75 percent of gains excluded.

Our paper contributes to several areas of study. First, we contribute to the literature studying the effect of tax incentives on entrepreneurs and small businesses. Gentry and Hubbard (2000, 2004) examined the impact of income tax rates and tax progressivity on entrepreneurial activity. Bruce and Mohsin (2006) employed a broad approach using time-series analysis to examine the role of income, payroll, capital gains, and estate taxes on self-employment. Cullen and Gordon (2007) examined how entrepreneurs' behavior and appetite for risk taking is affected by tax policy such as tax rates on business and wage income, differential treatment of losses and profits, and, most notably for QSBS, the option to incorporate. Dimitrova and Eswar (2022) examine the effects of state-level capital gains taxes, with a particular focus on the role and responsiveness of venture capital general partners to after-tax returns. This literature emphasizes that smaller firms, especially in high growth industries, may be particularly responsive to favorable tax treatment of capital gains as the benefits inherently accrue to investments with substantial gains.

Second, our estimates add to the literature measuring the aggregate tax rate on capital gains and the extent to which certain capital gains go untaxed. Prior research has documented a variety of reasons that lead to capital gains avoiding taxation. These include the declining share of stock held in taxable accounts (Burman, Clausing, and Austin 2017; Rosenthal and Austin 2016), investor heterogeneity and portfolio strategies (Poterba 1987), and the step-up in basis that occurs when assets are held until death (Gravelle 2022). Our work extends this literature by identifying an additional way in which capital gains avoid taxation and demonstrating its significant and growing size.

Finally, we contribute directly to the literature studying Section 1202. To our knowledge, there are only two papers in economics that directly study Section 1202: Edwards and Todenhaupt (2020) and Chen and Farre-Mensa (2023). Both papers use the passage of the Small Business Jobs Act (SBJA) of 2010 as a quasi-experiment and focus on its effect on business activity. Edwards and Todenhaupt use within-firm variation to compare funding rounds which occurred before and after the SBJA. They find investment in start-up firms increased by approximately 12%, consistent with higher expected after-tax returns. Chen and Farre-Mensa compare firms in industries eligible for Section 1202 to ineligible industries and find that, after the 2010 increase of the QSBS exclusion to 100%, eligible industries experienced more firm births, more startup employment, and increased ability to raise first-round venture capital funds.

In contrast to these two papers' focus on business responses to changes in Section 1202, our paper studies shareholder behavior and provides the first direct evidence on realized capital gains excluded under Section 1202. There is also an extensive literature in legal scholarship which analyzes Section 1202 (e.g., Polsky and Yale 2023, Gottschalk and Wiener 2021, Viard 2021, Lee et al. 2020, Viswanathan 2020). As these papers note, however, to date there has been no empirical quantification of the exclusion's actual utilization, a gap our research directly addresses.

Section II of this paper provides the historical background on how this provision has evolved over time since its enactment in 1993 and describes the rules for determining eligibility for this provision. Section III describes the data used for this project. Section IV provides new empirical evidence on the extent and patterns of use of this provision from 2012 to 2022. Section V summarizes our results.

II. Background

Prior to the Tax Reform Act of 1986 (TRA-86), taxpayers could exclude 60 percent of the excess of net long-term gains over any short-term net losses. Since the top rate on ordinary income was 50 percent, the effective top capital gains rate was 20 percent. TRA-86 repealed this exclusion and reduced the top rate on ordinary income to 28 percent. As a result, the top rate on long-term capital gains increased to 28 percent. This increase in the top capital gains rate to the same rate as on ordinary income led to concerns that investments in small and startup businesses would be adversely affected. These concerns generated proposals for a new provision targeted at encouraging such investments.[2]

In 1993, Congress enacted Section 1202 providing a 50 percent exclusion of gains from the sale of QSBS. This provision was also intended as a targeted substitute for proposals for a general reduction in capital gains tax rates being proposed at the time. Section 1202's eligibility

[2] The provision owes its existence to the efforts of Senator Dale Bumpers, who chaired the Senate's Small Business Committee. The House Ways and Means Committee justified the original enactment of the exclusion in 1993 on the following grounds: "The committee believes that targeted relief for investors who risk their funds in new ventures, small businesses, and specialized small business investment companies, will encourage investment in these enterprises. This should encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing. H.R. Rep. 103-111, at 600 (1993).

requirements were designed to target the tax benefit specifically to investments in small, capital-intensive businesses while limiting revenue costs. For stock to be qualified small business stock, the taxpayer must have acquired the stock at its original issue; the corporation's gross assets prior to and immediately after issuance must not exceed $50 million; and at least 80 percent of the assets of the corporation must be used in a qualified trade or business, among other requirements. Otherwise eligible stock will not be treated as qualified small business stock in certain cases such as where the corporation purchases its own stock around the time of issuance. Taxpayers may only claim an exclusion for QSBS they hold for at least five years. Unlike many tax provisions, corporations are not required to certify their QSBS eligibility with the IRS or shareholders. See Appendix A for more detailed eligibility requirements and restrictions.

When the top capital gains rate was reduced from 28 percent to 20 percent in 1997, 42 percent of the excluded QSBS gain was made a preference under the alternative minimum tax (AMT). This change took effect before any taxpayers could claim an exclusion for gain from QSBS because it was less than five years after the original enactment and thus no taxpayer had met the holding period requirement. The inclusion of 42 percent of the excluded gain as an AMT preference item resulted in a top effective tax rate of 19.88 percent for taxpayers subject to the AMT, only slightly below the new 20 percent top rate on long-term gains.[3] While taxpayers with substantial wages or business income could still benefit substantially from the exclusion for gains from QSBS, treating the exclusion as an AMT preference item meant that taxpayers for whom gains on QSBS were large relative to other sources of income realized a very small benefit. In addition, a 28 percent rate continued to apply to the portion of section 1202 gains that was not excluded from income. Thus, the effective rate on 1202 gains for non-AMT taxpayers remained unchanged at 14 percent following this legislation.

Congress also enacted a "rollover" provision in 1997 that allows taxpayers to defer tax on gains from the sale of QSBS provided they use the gains to purchase additional QSBS. Section 1045 allows a tax-free rollover of QSBS that has been held for at least six months and sold to someone

[3] Alternative Minimum Taxable Income includes the 50 percent of gain included in regular taxable income and 42 percent of the excluded gain, or 71 percent of the gain. Multiplying the 28 percent top AMT rate by the 71 percent inclusion rate yields 19.88 percent. For additional discussion of the role of the AMT preference in determining the tax benefits of the exclusion for QSBS, see Drucker and Farrell (2021) and Gottshalk (2021). For another view, Edwards (2021) argues for the importance of angel investors.

other than a corporation. Replacement small business stock must be purchased within 60 days, and basis in the newly acquired stock is reduced by the amount of the excluded gain. The first six months of the holding period carries over to the replacement small business stock.

Tax legislation in 2003 reduced the top capital gains rate to 15 percent and the portion of excluded 1202 gains added back under the AMT to 7 percent for stock sold after May 6, 2003. This resulted in an effective rate of 14.98 percent for taxpayers subject to the AMT. Under current law, the 7 percent AMT preference continues to apply to stock purchased prior to 2010. For non-AMT taxpayers, the effective rate again remained at 14 percent.

Legislation enacted in 2009 increased the excludable portion of QSBS gains to 75 percent for stock acquired from February 18, 2009, to December 31, 2010, lowering the top effective tax rate from 14 to 7 percent for taxpayers not subject to the AMT. This legislation made no changes to the treatment of excluded gains under the AMT, so the effective rate remained 14.98 percent for taxpayers subject to the AMT. Because of the required 5-year holding period, no sales qualifying for this treatment could occur until February 19, 2014. Legislation enacted in 2010 further increased the excludable portion to 100 percent for stock issued from September 28, 2010, through December 31, 2010 and entirely removed excluded gains from AMTI for QSBS issued after September 28, 2010. These changes in combination allowed for a zero percent tax rate on QSBS gains under both the regular tax and AMT. The earliest sales could qualify for the 100 percent exclusion was September 29, 2015. Later legislation made the 100 percent exclusion permanent.[4]

Finally, the top rate on capital gains increased to 20 percent on January 1, 2013, and the 3.8 percent Net Investment Income Tax became effective on January 1, 2013. Together these changes increased the top rate on capital gains to 23.8 percent. While these changes had no effect on the taxation of QSBS gains, they increased the advantage of QSBS gains relative to capital gains from all other stock.

As discussed in Section IV, this 100 percent exclusion has led to a substantial increase in these tax-free capital gains and coincided with an increasing share of 1202 exclusions being claimed by trusts and estates.

[4] Between September 2010 to December 2015, the 100 percent exclusion expired multiple times and reverted to a 50 percent exclusion. In each case, the exclusion percentage was retroactively restored to 100 percent. In the end, the 50 percent exclusion applied to QSBS issued from 8/10/1993 to 2/17/2009, the 75 percent exclusion applied from 2/18/2009 to 9/27/2010, and the 100 percent exclusion applied to QSBS issued after 9/28/2010.

III. Data

Our analysis uses the population of e-filed Form 8949 filings for individuals and certain trusts from 2012 through 2022. We observe QSBS claims when a taxpayer reports the sale or rollover of QSBS on Form 8949 and claims the exclusion as a negative adjustment in computing the capital gain. Thus, we observe the culmination of QSBS investments but are unable to observe the outstanding stock of QSBS gains. We identify QSBS transactions using Form 8949's adjustment code "Q", which is prescribed for QSBS exclusions.[5] We supplement the Code Q records by searching for additional indications of 1202 claims among transactions with either no adjustment code listed or code "O" (for other). We examine the description field of these transactions for terms likely to be QSBS claims such as "QSB", "1202", or similar text. To avoid overidentifying Section 1202 claims, we exclude entries with terms frequently associated with other tax provisions such as "excess", "main home", or "spouse". We drop duplicate entries and any entry without a tax year, reporting a loss, or with an incomplete adjustment. The full sample of Section 1202 exclusions includes a substantial number of very small exclusion amounts – some as small as one penny. To focus on economically meaningful transactions, we restrict the sample to exclusion claims of at least $1. Throughout the paper, all dollar amounts are reported in current dollars.

We observe Form 8949 filings made by individuals and by other filers, including trusts and estates. We link the individual Form 8949 filings to Form 1040 filings to obtain individual taxpayers' total positive income (TPI) and other characteristics. TPI is the sum of positive values of different sources of income reported on an individual tax return. QSBS gains that are excluded from income are also excluded from TPI. We link the non-individual Form 8949 filings to Form 1041 filings to obtain certain trust and estate information. About 16% of these non-individual records, representing 27% of the total amount excluded by non-individuals, either link to a Form 1041 without an entity type specified or do not link to a Form 1041. Throughout the rest of this paper, we refer to the full set of non-individual claimants as "trusts and estates."

Our estimates represent a lower bound on the total amount of exclusions claimed under Section 1202, for two reasons. First, while we observe the universe of e-filed returns, we only observe

[5] Adjustments reported on Form 8949, "Sales and Other Dispositions of Capital Assets", are not exclusive to Section 1202 claims. Other codes indicate various adjustments to income, such as those for main residential sales, wash sales, and Qualified Opportunity Funds, among others. Codes may refer to positive or negative adjustments to income.

paper-filed returns for certain years: 2007, 2012, and 2018. For these years we have access to the IRS SOI special studies on Sales of Capital Assets (SOCA). Because these include samples of both paper and e-filed returns, we use these files to benchmark the relative size of the paper-filing 1202 claims. Consistent with broader increases in e-filing, the share of paper filings declines across the SOCA years, even among high income taxpayers. Among the filings with 1202 claims we identify in the 2018 SOCA data, fewer than 5 percent of filers and 1202 exclusion claim amounts are from paper filers. This is consistent with broader trends in paper and electronic filing. The share of all individual tax returns filed electronically increased from 57 percent in 2007 to 83 percent in 2012, 93 percent in 2018, and 97 percent in 2022. Second, as described above, we rely on taxpayers indicating their 1202 exclusion claim on Form 8949 by reporting code Q consistent with the instructions or indicating a 1202 claim in the property description. It is likely we miss some taxpayers who claim a 1202 exclusion but without correctly reporting code Q or indicating a QSBS transaction in the description. We note, however, that taxpayers have incentives to indicate a QSBS exclusion rather than a large negative adjustment without any justification.

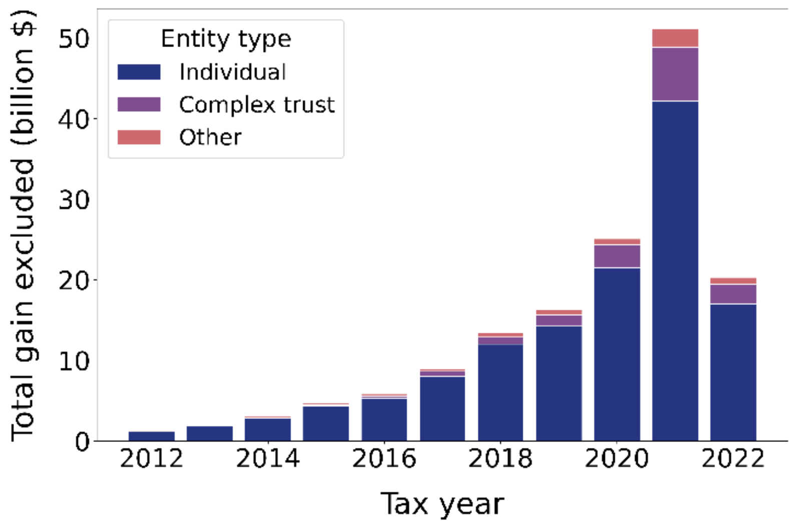
IV. Results

In this section we provide new evidence on aggregate Section 1202 exclusions over time; whether taxpayers claim Section 1202 exclusions only once or in multiple years; typical holding periods for realized gains under Section 1202; and the distribution of Section 1202 exclusion amounts overall and in relation to taxpayers' total income.

A. Total Excluded Gains

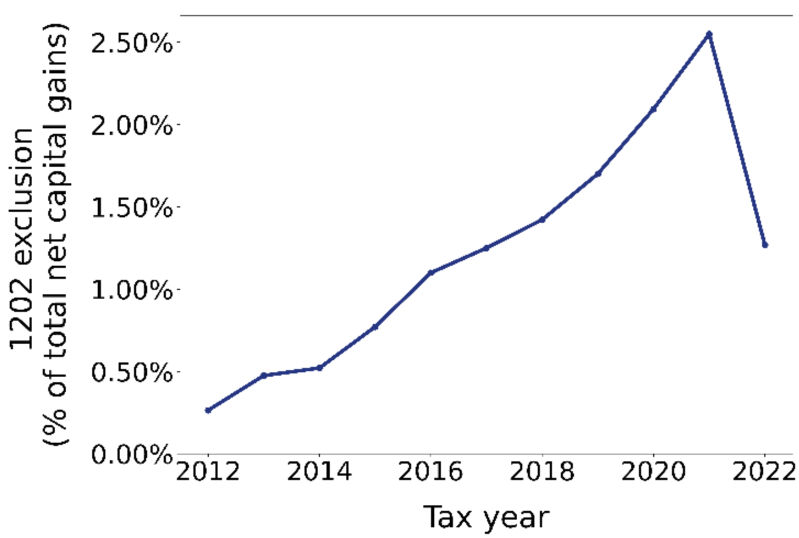
Figure 1: Aggregate 1202 exclusions: total claims and share of net capital gains, 2012-2022

Panel A: Total gain excluded



Notes: This figure presents the total 1202 exclusion amounts claimed annually from 2012 to 2022 on e-filed tax returns, categorized by individual taxpayers, complex trusts, and other. 'Other' includes estates, simple trusts, and other non-individual entities filing form 8949. Dollars excluded are reported in current dollars. The stacked bar chart illustrates the distribution and trends across different entity types over the specified tax years.

Panel B: Exclusion as share of total net capital gains



Notes: This figure shows Section 1202 exclusions as a percentage of total net capital gains reported on tax returns from 2012 to 2022. The percentage is calculated as total 1202 exclusions claimed on e-filed returns divided by total net capital gains reported in the IRS' SOI tax stats, Table 1- Individual Income Tax Returns: Selected Income and Tax Items. Because this total net capital gains amount includes both e-filed and paper-filed returns, this percentage represents a lower bound for all 1202 exclusions as a share of total net capital gains.

The increase in gains excluded under Section 1202 over the past decade by type of taxpayer is shown in Figure 1. Panel A shows the aggregate amount of 1202 exclusions claimed in each tax year from 2012 through 2022, with separate series for individual taxpayers, complex trusts, and other entities.

Individual claims consistently represent the largest share of excluded gains, but the composition has evolved over time. While individuals accounted for nearly all claims in 2012 ($1.18 billion versus $0.14 billion for other entities), complex trusts have become increasingly significant, growing from negligible amounts in 2012-2014 to $6.65 billion in 2021, when 1202 exclusions peaked during the sample period. The growth in trust claims contributes to the overall increase in exclusions, with total claims reaching $51.1 billion in 2021, of which individuals claimed $42.2 billion (82.5 percent), complex trusts claimed $6.65 billion (13 percent), and other entities such as simple trusts and estates claimed $2.27 billion (4.5 percent).

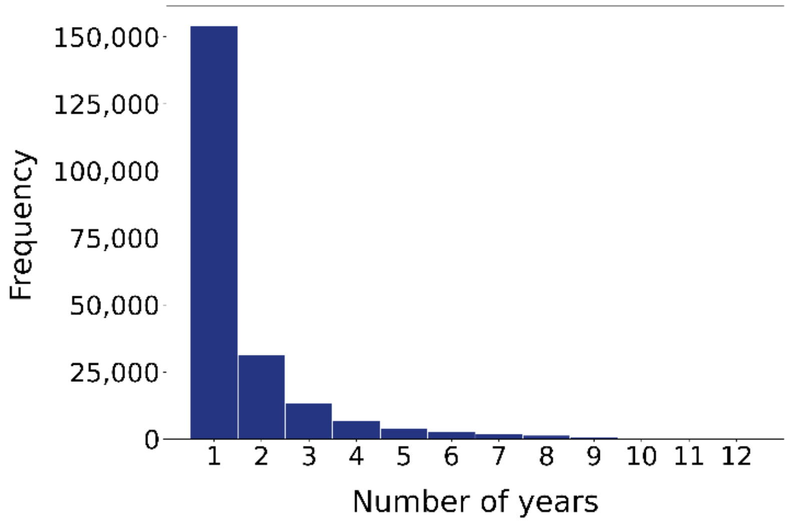
Aggregate 1202 exclusions have not only grown in absolute amounts, but also relative to all net capital gains, as shown in Figure 1, Panel B. Exclusions in 2012 represented less than 0.5 percent of total net realized capital gains. By 2021 this had grown to more than 2.5 percent, falling back to about 1.5 percent in 2022. Over the entire period from 2012 to 2022, total net capital gains reported on tax returns amounted to approximately $10 trillion, with Section 1202 exclusions accounting for $152 billion, or 1.5 percent of all capital gains during this period.

B. Frequency of exclusion claims

Figure 2 shows the distribution of the number of tax years in which individuals (Panel A) and trusts and estates (Panel B) claim the exclusion among those who claim it at least once. While the majority claim the exclusion in only a single year, a substantial minority claim it in multiple years. Three-quarters of individuals claim the exclusion in only a single year while less than 6% claim in five or more years. Repeat claims are slightly more common for trusts and estates, with approximately two-thirds claiming the exclusion in only a single year and slightly more than 6% claiming in five or more years. Repeated claims may reflect multiple sales of QSBS in one company or sales of QSBS in different companies.

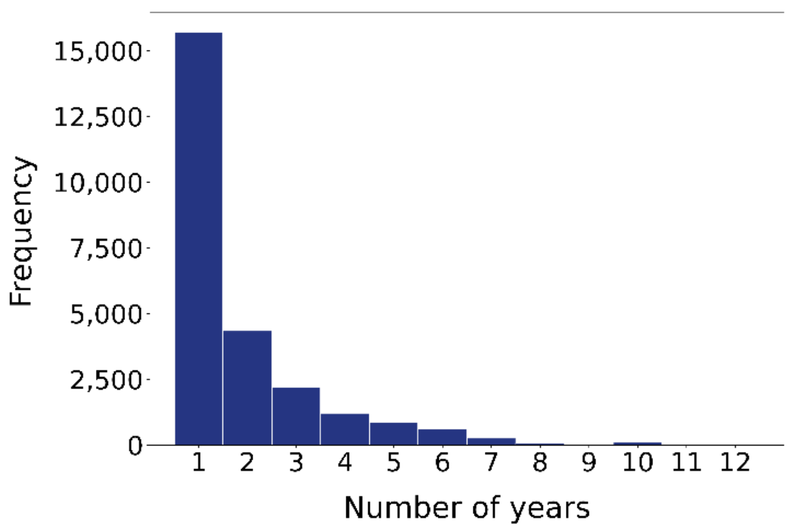
Figure 2: Frequency of 1202 claiming across years, 2012-2022

Panel A: Individuals



Notes: This histogram presents the distribution of the number of years individual taxpayers have claimed QSBS exclusions on e-filed tax returns from 2012 to 2022. The horizontal axis represents the number of years taxpayers have filed for the exclusion, ranging from 1 to 11 years, while the vertical axis indicates the frequency (number of taxpayers). The distribution demonstrates the extent to which taxpayers claim the exclusion in single versus multiple years during the sample period.

Panel B: Trusts and estates



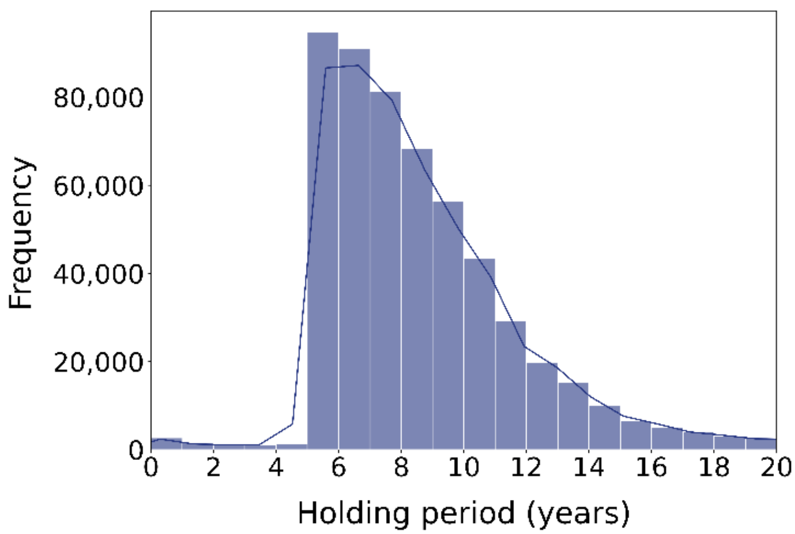
Notes: This histogram presents the distribution of the number of years trusts and estates have claimed QSBS exclusions on e-filed tax returns from 2012 to 2022. The horizontal axis represents the number of years entities have filed for the exclusion, ranging from 1 to 11 years, while the vertical axis indicates the frequency (number of entities). The distribution demonstrates the extent to which entities claim the exclusion in single versus multiple years during the sample period.

C. Holding periods

Figure 3 shows the distribution of holding periods for claimed exclusions, again plotting individuals and trusts and estates separately for comparison. The modal holding period for individuals is 5 years, corresponding to the minimum required holding period, though many claims occur after longer holding periods. For trusts and estates, the modal period is slightly longer at 6 years. The long right tail and substantial mass beyond 5 years of holding suggests that the 5-year holding requirement, while binding for some taxpayers, is not the only factor taxpayers consider when deciding whether and when to sell their QSBS. Some 1202 claims have holding periods less than 5 years, which could reflect taxpayers selling QSBS that had been rolled over from earlier QSBS on which the holding period could be combined to meet the 5-year requirement.

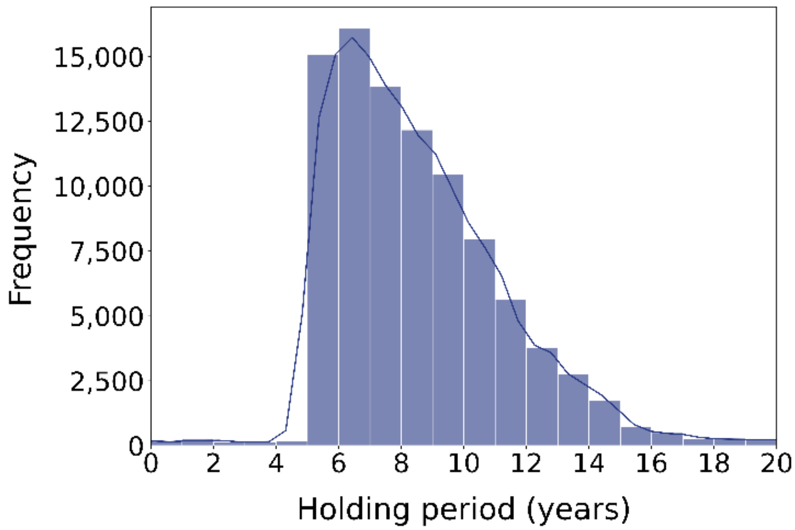
Figure 3: Holding periods for 1202 exclusion claims, 2012-2022

Panel A: Individuals



Notes: This histogram shows the distribution of holding periods for assets eligible for QSBS exclusions among individual taxpayers claiming the exclusion on e-filed tax returns from 2012 to 2022. The holding period is measured in years and is presented on the horizontal axis, with bins ranging from 0 to 20 years. The vertical axis shows the frequency of QSBS exclusion claims corresponding to each holding period. The distribution indicates the typical holding duration of QSBS-qualified assets.

Panel B: Trusts and estates



Notes: This histogram shows the distribution of holding periods for assets eligible for QSBS exclusions among trusts and estates from 2012 to 2022. The holding period is measured in years and is presented on the horizontal axis, with bins ranging from 0 to 20 years. The vertical axis shows the frequency of QSBS exclusion claims corresponding to each holding period. The distribution indicates the typical holding duration of QSBS-qualified assets.

D. Distribution of excluded amounts

Finally, we analyze the distribution of exclusion amounts. We begin by describing claims and exclusions at the claimant-year level. Multi-year claimants appear more than once but multiple QSBS claims within a year appear as a single observation. From 2012 through 2022, roughly 217,310 individual taxpayers made claims for an exclusion under 1202. Because some taxpayers claim in multiple years, this results in an average of about 32,700 per year. Roughly 25,410 trusts and estates made claims over the same period, averaging about 4,300 per year.

Moving from left to right in Table 1, we first calculate percentiles within the trusts and estates observations. Annual claims by trusts and estates show a median annual exclusion claim of $3,680 and a 90th percentile claim of $569,310. We also calculate percentiles within the individual observations, and find a slightly lower median exclusion claim of $2,810, though a higher 90th percentile claim of $590,940. The annual average trust and estate claim of $453,950 is higher than the annual average individual claim of $362,750. In the bottom two rows, we report the number of observations, years in which each taxpayer makes a claim, and the number of unique taxpayers.

In the four rightmost columns of Table 1, we split annual claims by individual taxpayers according to their three-year average (TPI), using the current year and prior two tax years, and then calculate 1202 exclusion claim percentiles within each of those groups. Annual exclusion amounts are positively correlated with income (the percentile amounts increase moving from left to right in the columns), from a median of $17 for those with TPI under $100,000 to a median of $20,850 for those with TPI over $1 million.

Table 1: Percentiles of Annual QSBS Exclusions, 2012-2022

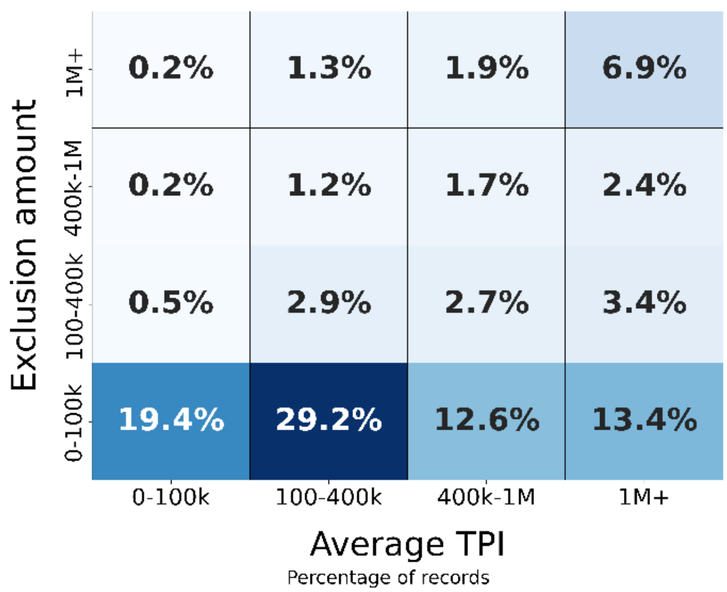
			Individual claims split by claimant average TPI			
Percentile of exclusion amount	Trusts and estates	Individuals	0 to 100K TPI	100 to 400K TPI	400K to 1M TPI	1M+ TPI
25	190	30	3	8	140	1,260
50	3,680	2,810	17	250	6,530	20,850
75	51,450	67,820	500	22,440	101,980	281,300
90	569,310	590,940	16,730	162,790	499,290	1,842,590
Average	453,950	362,750	40,190	133,480	253,210	743,580
Number of Claimant-Years	47,790	359,970	52,360	104,600	73,600	128,730
Number of Unique Claimants	25,410	217,310	43,210	75,220	41,450	56,830

Notes: Table 1 shows percentiles and averages of annual QSBS exclusion claims, as well as the number of observations and number of unique claimants for the full sample of e-filed exclusion claims made between 2012 and 2022 by trusts and estates, by individuals, and split by Total Positive Income (TPI) for individual taxpayers. TPI and dollars excluded are reported in current dollars. Exclusion amounts represent annual amounts. The number of claimant-years counts taxpayers separately in each year with a 1202 claim; the number of unique claimants counts each claiming taxpayer once. To provide a representative measure of income levels, we calculate a three-year average of TPI using the current year and prior two tax years and use this for splitting the claimant-year observations by TPI. For the number of unique claimants split by TPI, we calculate each unique claimant's average TPI over the full sample period. We exclude the 0.2% of claimants that are missing values for TPI when calculating statistics within TPI groups.

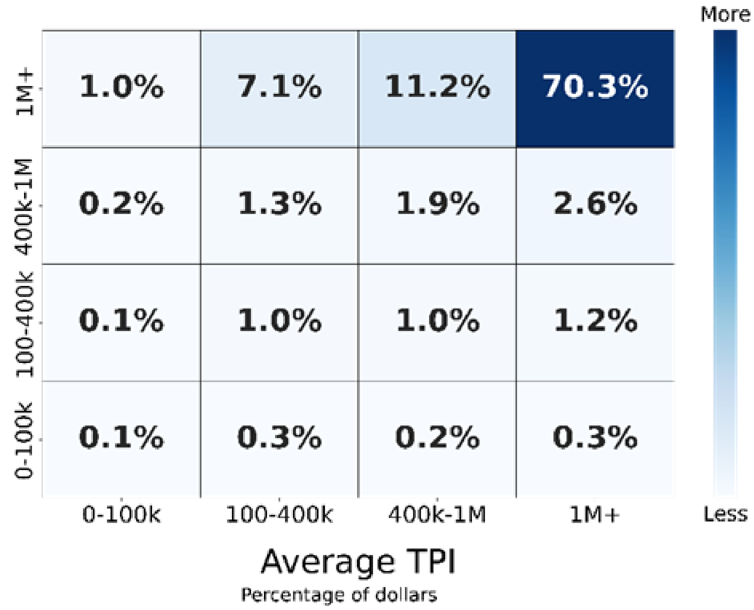
To further examine the relationship between TPI and total QSBS claims by individuals, we further aggregate from the individual-year to the individual level, summing each individual's 1202 exclusions and averaging their TPI across the sample period. Figure 4, Panel A shows the distribution of the number of claims across income and exclusion amounts. Taxpayers with TPI under $100,000 account for 20 percent of claims, taxpayers with TPI between $100,000 and $400,000 account for 35 percent of claims, and taxpayers with TPI above $1 million account for 26 percent of claims. Panel B, however, shows the distribution of the amounts of those claims, revealing that although taxpayers with TPI under $400,000 account for more than half of individual returns with a claim, 70.3 percent of all excluded dollars come from taxpayers with TPI over $1 million claiming exclusions over $1 million. Thus, while most claims for exclusion are for modest amounts, the bulk of the excluded gains, and thus tax savings, accrues to high-income individuals making large exclusion claims.

Figure 4: Distribution of QSBS claims and dollars excluded by TPI

Panel A: Distribution of claims by average TPI and exclusion amount



Panel B: Distribution of total dollars excluded by income and exclusion amount



Notes: This figure presents two heatmaps showing the distribution of QSBS exclusion claims of at least $1 on e-filed individual tax returns from 2012 to 2022. Taxpayers are categorized by their average TPI and their total exclusion amount over the sample period. TPI and dollars excluded are reported in current dollars. Panel A displays the percentage distribution of QSBS exclusion claims across TPI categories (ranging from "0-100k" to "1M+") and exclusion amounts (from "0-100k" to "1M+"), with cell color intensity indicating the proportion of total claims in each category combination. Panel B shows the percentage distribution of total dollars excluded across the same categories, with color intensity representing the share of total excluded dollars in each cell.

V. Conclusion

This paper provides the first empirical analysis of Section 1202 exclusions. Using data from e-filed tax returns from 2012 to 2022, we document substantial growth in QSBS claims, with individual taxpayers excluding over $40 billion in gains at the peak in 2021. Our analysis reveals several patterns in how the provision is used. While the median annual QSBS claim by individuals is relatively modest - an exclusion of $2,810 - the distribution is heavily skewed. The majority of excluded dollars come from high-income taxpayers making large exclusion claims, with 70.3 percent of total excluded gains generated by taxpayers with average total positive income over $1 million claiming cumulative exclusions over $1 million. Most individuals who claim the exclusion do so only once in our 11-year sample period, though about one quarter make claims in multiple years. The modal holding period is 5 years, corresponding to the minimum required holding period, suggesting that this requirement influences realization timing but is not the only relevant factor.

QSBS remains understudied given its growth, its generosity, and its salience with entrepreneurs. Additional research examining the characteristics of businesses issuing QSBS, including industry concentration, geographic distribution, and firm size would be beneficial to policymakers and the public.

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Appendix A: Detailed Section 1202 Eligibility Requirements

To qualify for Section 1202 treatment, corporations must meet specific size and issuance requirements. The corporation may not have gross assets of more than $50 million at any time after the date of enactment in 1993 through the time the stock is issued, including the proceeds received from the sale of the stock. The stock must be acquired at original issue from the corporation (or through an intermediary).

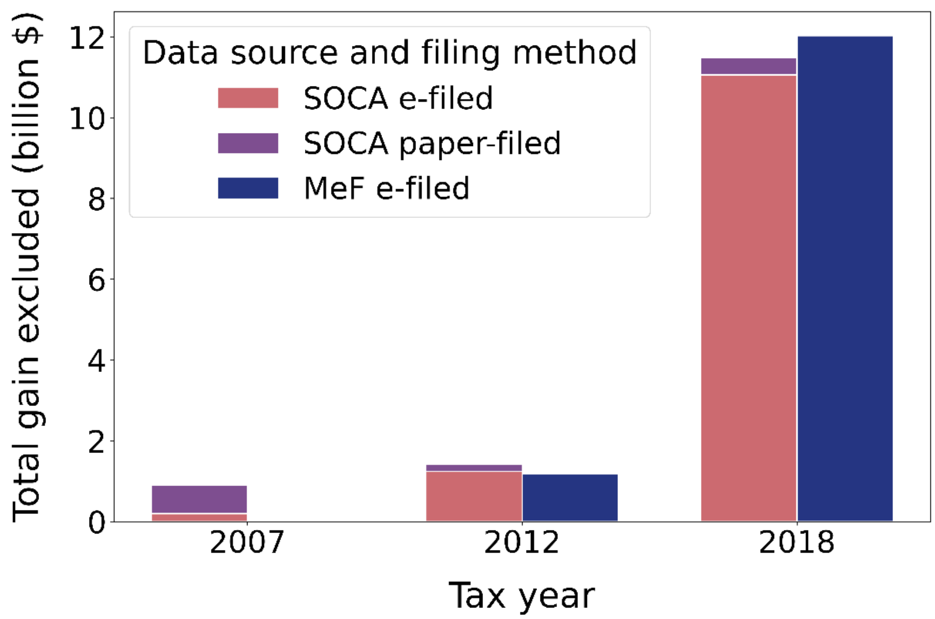
QSBS treatment is disallowed if the corporation redeems more than 5 percent of its shares one-year before or one-year after the issuance, or if it redeems stock from the purchasing shareholder (or a related party) in the 4-year period surrounding the issuance.

The corporation must engage in a qualified trade or business, generally excluding service-oriented businesses. Specifically excluded are services in the fields of health, law, engineering, accounting, performing arts, consulting, financial services, and brokerage, as well as any banking, insurance, financing, leasing, investment, farming, hotel, restaurant, or similar businesses, and any business involving production or extraction of products eligible for depletion deductions (such as oil and gas). Additionally, real estate holdings not used in active business conduct cannot exceed 10 percent of total corporate asset value during the shareholder's holding period.

The corporation must meet specific asset deployment tests. First, 80 percent of assets must be used in trade or business activities. Working capital and specified assets (those held for investment that are reasonably expected to be used within 2 years to finance research and experimentation or to increase working capital) are treated as used in the active conduct of a trade or business. After 2 years of existence, at least 30 percent of assets must be trade or business assets other than working capital or these specified assets. The active business and working capital requirements apply throughout the shareholder's holding period. Unlike many tax provisions, C-Corporations seeking QSBS treatment for their shares are not required to certify eligibility with either the IRS or their stockholders.

Appendix B: Comparison of Paper and E-filed Returns

Figure A1: Comparison of 1202 exclusion claims across data sources



Notes: This figure presents total gain excluded under Section 1202 by data source and filing method. Data are from IRS Modernized e-File (MeF) system returns and the Sales of Capital Assets (SOCA) studies. SOCA data are estimates from a sample; MeF data are totals from the population. SOCA data are shown separately for electronic and paper-filed returns. MeF data are not available prior to 2009. All values are in billions of current dollars.

This figure compares total gain excluded under Section 1202 across different IRS data sources and filing methods. The data come from two sources: the IRS Modernized e-File (MeF) system, which contains the universe of electronically filed returns since 2009, and the Sales of Capital Assets (SOCA) studies, which provide weighted samples of both paper and electronically filed returns for selected years. The SOCA studies are designed to be representative of all tax returns when weights are applied, making them useful for understanding the prevalence of paper filing.

For 2012 and 2018, we observe similar total exclusion amounts between the MeF data and the SOCA sample, suggesting that the MeF data captures most Section 1202 claims. The SOCA data also shows that paper-filed returns (shown in purple) represent a declining share of total claims, from a substantial portion in 2007 to a small fraction by 2018. In 2012, the MeF data shows approximately $200 million less in total exclusions than the SOCA data, or 14% of the SOCA total of $1.4 billion. In 2018, this pattern flips, with the MeF data showing $500 million more, or 5%

more than the SOCA total of $11.5 billion. No MeF data are available for 2007, as electronic filing was then handled through a different system (the IRS Electronic Filing System, or ELF) that did not capture the information needed to identify Section 1202 claims. This comparison across data sources helps validate our use of MeF data for analyzing Section 1202 claims in more recent years, as it suggests we capture the vast majority of claims through electronic filing records.