TAX POLICY AND THE ENTREPRENEURIAL ECOSYSTEM

Tax reform should encourage the growth of more startups into the next generation of successful American companies.

Venture Capital and Tax Reform:

America needs a tax policy that encourages new company creation. Startups generally have to operate for years using investment capital to develop a novel product, and so the investment environment is absolutely critical to entrepreneurship. The U.S. has done a good job over the last 35 years sustaining tax policy that encourages patient, long-term investment, and the country has benefited significantly as a result.

But where we've done quite poorly has been with rules in the code that seem to forget startups exist. Whether it's trying to curb a perceived tax abuse that inadvertently sweeps startups into the definition, or writing rules that focus only on the circumstances of large companies, all too often tax policy just overlooks the ecosystem. It's a telling sign when the major business tax reform plans of both Republicans and Democrats ignore new company creation as a priority.

Unfortunately, there have been proposals to change what we have done well in the tax code and increase taxes on the entrepreneurial ecosystem in order to pay for unrelated priorities. Carried interest, for instance, has been an important feature of the tax code that properly aligns the interests of investors and entrepreneurs since the creation of the modern venture capital industry.

Effective tax reform must consider how current tax policy affects the American entrepreneurial ecosystem, protect what is working, and make modifications and improvements where opportunities to encourage patient capital investment and entrepreneurial activity exist.

Protect What is Working:

NVCA will continue to support sensible partnership tax rules that have facilitated the creation and growth of the venture capital industry and the entrepreneurial ecosystem. These include:

- **Capital Gains Rate and Carried Interest:** A globally competitive capital gains rate applicable to carried interest earned by venture capitalists.
- **Capital Gains Rate Differential**: A meaningful differential between the capital gains rate and ordinary income rates to encourage risk investment and entrepreneurship.
- **Entity Level Taxation:** The continued ability to use partnerships as an important flexible structure to bring together the various components of the entrepreneurial ecosystem without being burdened by new regulations or tax increases.

Reforms to Encourage New Company Creation:
Tax reform should also be an opportunity to encourage new company creation by changing rules in the tax code which penalize or discriminate against startups. These include:

- **382 Safe Harbor:** Protect innovative startups from punitive tax rules which discourage investment in innovation by creating a safe harbor for startups from the Net Operating Loss limitation rules under Section 382.
- **QSBS Reform:** Simplify and expand the Qualified Small Business Stock rules so they can function more effectively as an important incentive for investment in early stage startups.
- **R&D Credit Reform:** Make the R&D credit work for startups, where a disproportionate amount of innovation is taking place in the American economy.
- **Startup Acquisition Parity:** Change Section 338(h)(10) rules to allow corporations to use the same accounting rules when acquiring a startup that they can use when buying a division of another company or an S corporation.
- **Stock Options Tax Deferral:** Pass S.3152/H.R. 5719 to allow startup employees a reasonable period of time to defer paying taxes on exercised stock options.

Overview of Venture Capital:

Venture capitalists create partnerships with institutional investors to combine the capital held by pension funds, endowments, foundations and others with their talent and expertise to make risky, long-term equity investments into innovative startups. Typically, they invest early in the promise of an idea, then actively support a startup with strategic advice and mentorship, contact lists and multiple investment rounds spanning between five and ten years. Hopefully startups succeed against huge risks and grow into successful companies, but in over 50 percent of deals, they fail. The nature of startups is that for every company that is wildly successful, there are numerous companies that don't succeed. It is through this process of experimentation and the competition of emerging technologies that the next generation of leading global companies are created.

Impact of Venture Capital:

New businesses are the engine of job creation in the United States, creating an average of about 3 million new jobs each year and accounting for virtually all net new job creation, according to data from the U.S. Department of Labor and the U.S. Census Bureau. A recent research paper produced by Stanford University finds that of the 1,339 companies that have gone public since 1974, a full 42 percent can trace their roots to venture capital. Those venture-backed companies account for an astounding 85 percent of all research and development spending by companies that have gone public since 1974. And on July 29, 2016, an important milestone was reached when five companies that had been backed by venture capital—Apple, Alphabet, Microsoft, Amazon, and Facebook—held the top five spots on the ranking of largest U.S. companies by market capitalization.