February 19, 2021

The Honorable Bill Pascrell
U.S. House of Representatives
2409 Rayburn House Office Building
Washington, DC 20515

Dear Representative Pascrell,

On behalf of our nation's venture capital (VC) investors and the entrepreneurs they support, I write to express our strong opposition to the *Carried Interest Fairness Act*. This legislation would impose a tax increase on venture capital funds in a manner that would devastate the economics of startup investment. Instead, we urge you to work with our members to identify ways to strengthen and expand entrepreneurship and new company formation in this country.

**Background on 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 high-risk, long-term equity investments into innovative young companies. A recent survey of companies backed by venture capital showed that four out of five respondents spent at least 70 percent of their total expenses on two activities: wages and compensation and research and development. This statistic highlights the extent to which venture capital finances job creation and innovation despite the risks inherent in funding companies expected to operate in revenue loss positions for years.

Venture funds are generally partnerships that last ten to fifteen years, building investments far longer than any other asset class. It is also important to understand that VCs do not simply pick winners, they actively work to develop startups into successful companies. VCs work alongside the entrepreneurs, often taking board seats, providing strategic advice and counsel, opening their contact networks, and generally doing whatever they can to help their portfolio companies succeed.

**Economic Impact of Venture Capital Investment**

Research continues to show that 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 research paper produced by Stanford University finds that of the 1,339 companies that went public between 1974 and 2015, 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.

Technology-focused entrepreneurial activity is particularly important to creating economic opportunity for American workers. A recent report from the University of North Carolina's Kenan Institute of Private Enterprise found that total high-technology employment in the U.S. grew by around 20 percent from 2007-2016, and that these jobs both paid higher median wages and were created faster coming out of the financial crisis than non-high-technology jobs in states across the U.S. This illustrates a fundamental trend in the modern economy: the path to greater economic opportunity for American workers runs through technological progress and long-term investment.

**Overview of Carried Interest Capital Gains**

Put simply, carried interest is the profit share that venture capitalists receive *only* if the overall fund is successful. Of course, if a venture fund is successful, it is because new businesses have been built and as a result, hundreds to thousands of new jobs created. So long as the asset giving rise to the profits was held for at least three years, it is eligible for long-term capital gains treatment. There are few examples in public policy where the interests of the American economy and the tax code are so well aligned.

Moreover, this tax treatment is not unique to investment partnerships; in fact, all partnerships receive capital gains treatment on this sort of activity. If two people started a restaurant together and one provided capital (limited partner) and the other the expertise in the kitchen (general partner), both would receive capital gains treatment on the sale of the restaurant if it increased in value. The only aspect of capital gains tax policy that is unique to investment partnerships is the fact that an asset must be held three years in order to get long-term capital gains treatment for general partners; all other partnerships still only need to hold an asset for one year or longer.

**Carried Interest Fairness Act is a Tax on Long-Term Investment**

Increasing taxes on carried interest earned by venture capitalists runs counter to urgings by many economists and policymakers on both sides of the aisle who maintain that patient, equity investment be rewarded over short-term bets and financial engineering. A change in the *Tax Cuts and Jobs Act* (TCJA) requiring any asset giving rise to carried interest be held for at least three years for long-term capital gains treatment means that the *Carried Interest Fairness Act* is now a tax increase focused only on (and thus discouraging) longer-term investment.

In fact, after passage of TCJA, it is likely that the vast majority of hedge fund income no longer receives long-term capital gains treatment. But the *Carried Interest Fairness Act* would devastate venture capital investment where it can take a decade or even longer before a fund is successful enough to realize carried interest. Venture capital is the smallest of all alternative investment classes (thereby receiving the least in fees), holds investments far longer than other asset classes, and is the riskiest. Further, because VC funds are so long-term in nature, there are simply fewer opportunities to realize carried interest even in a successful career. Finally, a majority of venture funds will never be successful enough to earn carried interest due to the high-risk nature of startup investing. Yet, the United States is better for having had an entrepreneur dare to dream big and learn lessons that will increase the likelihood of her success with the next idea.

**Consequences on Startup Investment and Economic Development**

A tax increase on carried interest will disrupt the startup investment model in a number of dangerous ways. Because the bill increases taxes on carried interest only for assets held longer than three years, it will particularly discourage early-stage and other longer-term investing. It will make it more difficult to attract and retain talent across the industry. And it will create barriers to entry for new venture capital funds in emerging regions and underrepresented communities. For reference, the median size venture capital fund outside of the top three states is $43 million under management. The fees generated by small funds are often not enough for VCs to be able to take salary, meaning for many noncoastal VC funds, <u>carried interest is the sole economic incentive for participation in venture capital</u>.

***Carried Interest Fairness Act* Hurts the Build Back Better Agenda**

From climate change to job creation and economic development, President Biden's Build Back Better agenda will require significant amounts of patient equity investment, as well as knowledge and experience in building new technology companies. This is essentially the core of venture capital activity where 2020 was a record year for investments into such critical fields as climate technology, digital health, biotechnology, and quantum computing. Simply put, the President's vision will need the active participation of venture capital funds in order to be realized. Yet, because the *Carried Interest Fairness Act* is now primarily a tax on longer-held investments by partnerships, the burden of the tax increase will fall squarely on the investors and types of investment needed in the private sector to make the Build Back Better agenda a reality.

Twenty years ago, 94 percent of global venture capital was invested into U.S. startups. The U.S. created the venture capital industry and for a long time held a dominant advantage. However, the world is catching up, and last year just over half of global venture capital investment went into U.S. startups. At a time when global competition is raging over leadership of the next generation of technologies such as quantum computing, machine learning and next-generation biotechnology, this bill would deliver a self-inflicted wound to our country's competitiveness. We urge you to reconsider this legislation and instead work with us on ways to encourage innovation and new company formation in the U.S.

Sincerely,

Bobby Franklin

Bobby Franklin
President and CEO