August 30, 2021

The Honorable Ron Wyden
Chairman, United States Senate Committee on Finance
219 Hart Senate Office Building
Washington, DC 20510-6200

Dear Chairman Wyden,

On behalf of our nation's venture capital (VC) investors and the entrepreneurs they support, I write to express our strong opposition to the *Ending the Carried Interest Loophole Act.* This legislation would impose annual tax burdens on the general partners of venture capital funds regardless of whether the funds **ever** generate any profit. Moreover, the extreme nature of the bill would stymie current bipartisan efforts to harness innovation and encourage long-term investment to address critical societal challenges such as access to economic opportunity, climate change, and restoring American economic dynamism. This would cost the country far more in lost tax revenues from foregone economic activity than it could ever hope to raise.

Background on Venture Capital

Venture capitalists create partnerships to combine their talent and expertise with capital held by pension funds, endowments, foundations and others 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 expenses on two activities: wages and compensation, and research and development.[1] This highlights the extent to which venture capital finances job creation and innovation even though the bulk of the companies they fund expect to operate in revenue loss positions for years.

VC funds generally last 10 to 15 years, building investments far longer than virtually any other asset class. It is also important to understand that VCs do not simply pick winners; they actively work to help 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. Unfortunately, a majority of these companies don't ultimately return even the capital invested, a stark illustration of the high-risk nature of the business.

[1] https://nvca.org/venture-capital-investment-at-work/

Economic Impact of Venture Capital Investment

A research paper produced by Will Gornall of the University of British Columbia and Ilya Strebulaev of Stanford University found that companies backed by venture capital play a pivotal role in innovation and competition in the U.S. economy.[2] The paper found that VC-backed companies account for roughly 50 percent of companies that have gone public in the last 50 years and that these companies are responsible for 77 percent of total market capitalization and more than 92 percent of research and development (R&D) investment of all companies that went public during this time. Perhaps more important, the paper found that the American VC industry is causally responsible for the rise of one-fifth of the current largest 300 U.S. public companies, and that three quarters of the largest U.S. VC-backed companies would not have existed or achieved their current scale without an active VC industry.

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.[3] This illustrates a fundamental trend in the modern economy: the path to greater economic opportunity for American workers runs through innovation, technological progress and long-term investment.

***Ending the Carried Interest Loophole Act* Is a Tax on Long-Term Investment – Not Income**

The novel concept of taxation contemplated by the *Ending the Carried Interest Loophole Act* ignores basic principles of sound tax policy. While the title may indicate otherwise, the *Ending the Carried Interest Loophole Act* is not actually a tax on carried interest or any other sort of profit, but instead creates a new annual tax on the very existence of venture capital funds. Because the bill is actually a tax on a fund's existence, it creates effective tax rates that are inverse to the profits generated by the fund. For the VC funds that ultimately do not succeed, their effective tax rate under this legislation would be, quite literally, infinity. Even moderately successful funds will face tax burdens in excess of their entire profits share. Ironically, only the most successful funds would ultimately be taxed at rates comparable to ordinary income.

This novel approach would clearly inhibit the formation of new funds by adding the imposition of a new annual tax on phantom ordinary income to the already significant risk inherent in creating these funds. In addition to forgoing steady salaries from safer jobs to start new enterprises, paying the hundreds of thousands of dollars it costs to organize a VC fund, and contributing the capital to the fund required by the Limited Partners Agreement[4] (generally 2 percent of a fund), the *Ending the Carried Interest Loophole Act* would require VCs to also find money to pay taxes on an annual basis at the outset of the fund. Startup investment is long-term

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[2] "The Economic Impact of Venture Capital: Evidence from Public Companies," Will Gornall and Ilya Strebulaev (June 2021), available at [The Economic Impact of Venture Capital: Evidence from Public Companies by Will Gornall, Ilya A. Strebulaev :: SSRN]

[3] "*Frontiers of Entrepreneurship* 2020 Trends Report," University of North Carolina – Chapel Hill, available at https://frontiers.unc.edu/wp-content/uploads/2020/01/2020-TrendsInEntrepreneurshipReport.pdf

[4] The Limited Partners Agreement (LPA) is the contractual agreement governing the relationship between limited partners (LPs) and general partners (GPs) in a venture capital fund.

and illiquid by nature, so even successful VC funds often don't begin realizing profits until at least five years into the lifespan of the fund. For many VCs, the only option to comply with this tax regime would be to seek a loan, putting these individuals in the unenviable position of taking on debt to pay taxes in order to participate in a high-risk enterprise that often times never generates any profit.

In fact, the legislation even acknowledges the high-risk nature of long-term investment: "The specified rate keys off of the 5-year HQM Corporate Bond Yield Curve, which reflects low-risk borrowings, and adds 9 percentage points, *to better approximate yields of higher-risk borrowings*." We certainly agree that investment in frontier technologies and challengers to incumbent companies is high-risk with many failures, but that should be taken as a reason not to create arbitrary taxable events and force potential VCs to risk even more in order to participate in startup investment.

The legislation does provide a putative recoupment mechanism, but it will be ineffective in many cases and should be soundly rejected for the precedent it would set in tax policy. It relies on the faulty assumption that every single VC can utilize the bill's manufactured capital losses in the future by offsetting capital gains from other income. This will often not be the case. For those who do not realize enough capital gains to utilize the capital losses provided, meaning those with less wealth, capital losses are worthless. Under the *Ending the Carried Interest Loophole Act,* VCs with less wealth whose fund is not successful enough could even be driven into bankruptcy for lack of ability to cover the loan necessary to pay the taxes due.

***Ending the Carried Interest Loophole Act* Would Undermine 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 long-term equity investment, as well as knowledge and experience in building new technology companies. This is essentially the core of venture capital activity as most venture capital investment is used by startups to finance payroll and R&D expenses. We're pleased to report that 2020 was a record year for investments into such critical fields as climate technology, digital health, biotechnology, and quantum computing. But since the *Ending the Carried Interest Loophole Act* is a tax on the mere existence of venture capital funds, capital available for these activities would dry up. The bill would work against the prospects of programs such as the *Endless Frontier Act*, the State Small Business Credit Initiative, new Advanced Research Project Agencies for health, climate, and infrastructure, the President's entire climate agenda, and many other programs with the goal of harnessing innovation to move our country forward. And as we can see from the economies of other countries, if venture capital is not around to support an entrepreneurial ecosystem, no other investment class, nor government spending, can fill this gap.

Nearly twenty years ago, 83 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 irreparably damage our country's competitiveness. We stand ready to be a partner in the development and implementation of the President's infrastructure plan. We urge you to reconsider this legislation and instead work with us on ways to harness innovation and new company formation to expand economic opportunity and address the climate crisis.

Sincerely,

Bobby Franklin

Bobby Franklin
President and CEO