

July 17, 2017

The Honorable Orrin Hatch

Chairman, Committee on Finance

United States Senate

219 Dirksen Senate Office Building

Washington DC, 20510

Dear Chairman Hatch,

On behalf of our nation’s venture capital investors and the entrepreneurs they support, I write to express our thoughts on how tax reform can encourage new company formation. Thank you for providing us the opportunity to present the views of the venture capital community and the entrepreneurial ecosystem as it pertains to tax policy. We understand that tax reform is an incredibly difficult but critical national priority, and we appreciate the strong and steady leadership of the Senate Finance Committee in finding a way forward.

As venture capitalists, our members are investors in the nation’s startups. It is important to note that startups are a unique business model which does not fit neatly into the definition of either large or small business, where most business tax reform conversations have been focused. While startups begin as small enterprises, their objective is significant growth and scale opportunity. These are new companies taking incredible risks against long odds to become the next generation of successful American businesses.

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 recent research paper produced by Stanford University finds that of the 1,339 companies that have gone public between 1974 and 2015, 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. Venture capital has also been at the forefront of medical discovery, with venture capital fueling the growth of such success stories as Amgen, Genentech, and Gilead Sciences.

As a startup is going through the lifecycle of the entrepreneurial ecosystem, it normally generates losses while taking multiple rounds of investment capital to build the business. Therefore, proposals such as a corporate rate reduction or small business expensing—while critical to the U.S. economy—will have a limited impact on the survival rate of startups, most of which do not have profits (some will be completely pre-revenue) unless and until they achieve some level of success. Make no mistake: we support your efforts to make the tax code more competitive for all U.S. companies. At the same time, we strongly encourage you to make new company formation an additional priority in tax reform. This can be accomplished by focusing on how and where the tax code impacts entrepreneurship and modernizing the rules in the code to better reflect the realities of the entrepreneurial business model.

As you are already aware, tax policy is one of the most powerful economic levers that Congress has at its disposal. We strongly believe that encouraging new company formation in tax reform is additive to the broader goals of the policy campaign, namely economic growth, job creation and expanded economic opportunity. In fact, a healthy startup ecosystem is a major determinant in the ability of the country to realize economic progress in an increasingly competitive global economy.

Twenty years ago, over 90 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. But other countries have seen the economic success our country has realized through a robust entrepreneurial ecosystem and have rapidly transformed their policies to compete. In addition to such policy changes as regulatory and immigration reforms, as well as investments in basic research and education, tax policy has been a prominent policy mechanism employed to foster entrepreneurship. These efforts have been working at a time when policymakers in the U.S. have largely taken our leadership in entrepreneurship for granted. The result is that the percentage of global venture capital invested in U.S. startups has been falling precipitously, to 81 percent ten years ago, and all the way to 54 percent last year. In addition, over the last five years, at least half of the ten largest venture capital investments in the world occurred outside the United States.

**U.S. Venture Capital Investment Dollars as a Share of Global Total (2004-2016)**

Source: NVCA 2017 Yearbook, Data Provided by PitchBook

We believe that tax reform is a tremendous opportunity to reprioritize pro-entrepreneurship policy and solidify American leadership in this field. As such, we are enclosing a blueprint for how tax reform can encourage new company formation without creating a single new credit or deduction. We also caution against potentially damaging tax increases that could harm entrepreneurship, such as proposals to increase taxes on carried interest capital gains.

We are attaching discussion documents on six areas where the tax code significantly affects the entrepreneurial ecosystem. The first four are proposals for how to create a 21st century tax code that understands and supports the unique entrepreneurial business model. The following two cover fundamental tax policy that has encouraged long-term risk investment in U.S. startups. We hope to work with your committee to include a section in tax reform dedicated to entrepreneurship.

Sincerely,



Bobby Franklin

President and CEO



**PROPOSALS TO ENCOURAGE NEW COMPANY FORMATION**

**RESEARCH AND DEVELOPMENT TAX CREDIT**

***PROPOSAL:*** Expand ability of startups to offset payroll taxes with accumulated R&D credits. Specifically, NVCA proposes that startups with less than $100 million in assets (QSBS eligibility threshold with proposed NVCA modification) be able to offset up to $1 million worth of payroll taxes with R&D credits.

***CURRENT LAW:*** Current law allows very early stage startups, less than five years old and with less than $5 million in annual sales, to use R&D credits to offset up to $250,000 in payroll tax obligations.

***REASON FOR CHANGE:*** Congress made a great start in encouraging the growth of more innovative American companies when this provision was created recently as part of the PATH Act. But the size restrictions associated with the provision leave many startups unable to access the benefits of their R&D credits. A typical startup will still be quite early in the process of development when the size/age limits eliminate their ability to benefit from the R&D credit. This creates a strange dichotomy where startup companies cannot access the benefits of the R&D credit when they need it the most.

As global competition for innovative entrepreneurship continues to increase, a number of other countries including Canada, Spain, France and Britain, have created variations of refundable R&D credits. We believe that these improvements to the R&D credit will provide a fair and material benefit for American startups and will be a strong step forward in shoring up our leadership in entrepreneurship.

**QUALIFIED SMALL BUSINESS STOCK RULES (Section 1202)**

***PROPOSAL:***  NVCA proposes a list of ten reforms to Section 1202 with the goal of accomplishing two objectives:

1. Make the eligibility rules easier to understand and enforce, and modify the process in order to provide greater certainty for prospective investors.
2. Increase the gross asset limit and index for inflation going forward.

The proposed changes below would provide greater predictability to investors at the outset that successful investments in early stage companies, which are in the spirit of QSBS rules, either provide a tax benefit or lose eligibility for a clearly understood reason. This greater predictability will allow investors to more fully consider the benefits of 1202 when deciding whether to invest, driving critical investment that fuels the innovative companies our economy needs for job creation and long-term growth.

Specifically, we support the following changes:

Reforms to Simplify QSBS Eligibility

1. Change the requirement that the Qualified Small Business (QSB) adhere to the 80 percent value test for “substantially all” of the shareholder holding period to an annual test of quarterly averages for each year of an investor’s holding period.
   1. Currently, during “substantially all” of the shareholder’s holding period, 80 percent or more of the company’s assets by value must be used in a qualifying business.
   2. The undefined “substantially all” of the shareholder’s holding period means that even an immaterial or minor infraction of short duration by a genuine startup could cost the shareholders 1202 eligibility. Opportunities for this include small periods where a startup may supplement income with consulting services or use some working capital to invest in marketable securities. Even if only brief, the rules are strict enough to eliminate 1202 eligibility permanently for the investors.
   3. The risks created by these tests undermine the effectiveness of 1202 because they create uncertainty. These rules were written without a real world appreciation of the lack of resources available to early stage companies for highly technical record keeping.
   4. This proposed reform is similar to how the Real Estate Investment Trust (REIT) rules work in the code and would provide greater certainty by limiting the chance that a negligible action by an early stage company would render the entire investment ineligible for 1202.
2. Allow investors whose shares have become ineligible after the five year holding requirement was met to use a previous ownership change event (fundraising round, initial public offering (IPO), merger) as a basis for claiming QSBS benefit.
3. Direct the IRS to create a self-certification form for startups to use in order to hold themselves out as 1202-eligible in that tax year.
   1. Could be similar to CA form 3565.
   2. Allowing 1202-eligible companies a method to market themselves as eligible would be a helpful tool both for companies trying to attract investment and for investors looking to decide whether to put their money in a startup.
4. Tie eligibility of all company stock to same reporting metrics by the company so that a QSB is only a company that satisfies the annual reporting requirements on a newly established QSB form (see number 3), similar to REIT declarations.
5. Reduce the prohibited period for redemptions from 4 years to 2 years
   1. This would help with documentation complications that startups often have.
6. Clarify that the active business requirement not disqualify certain active businesses such as healthcare services.

Reforms to Expand 1202

1. Increase $50 million dollar threshold to $100 million.
2. Index asset threshold to inflation.

Related Provisions

Section 1045 Rollovers

1. Expand rollover period to 180 days.
2. Allow rollovers at firm level to be eligible.

***CURRENT LAW:*** Section 1202 was originally passed with strong bipartisan support to further the goal of driving American job creation, innovation and long-term economic competitiveness by providing a benefit to investors who provide long-term capital investment to innovative small businesses. Current law allows investors in certain startups with less than $50 million in assets who hold the stock for at least five years to exempt up to $10 million or 10 times the basis of the stock, whichever is greater, from capital gains taxes.

***REASON FOR CHANGE:*** The Qualified Small Business Stock (QSBS) rules contained in Section 1202 can be an effective motivation for investments in early stage startups.

Unfortunately, the significant complexity of the eligibility rules and a size limit that hasn’t increased with inflation or economic realities have limited the ability of Section 1202 to bolster the entrepreneurial ecosystem as well as the policy goals envisioned by those who passed the law. We propose a number of ideas to make it easier to determine the eligibility of investments while keeping in place the anti-abuse rules currently in the law. We also propose several ideas to expand the impact of 1202, to update its size limits and to increase its potential for driving investment into startup communities across the country.

Of particular importance, if Congress makes the recommended reforms, Section 1202 could become one of the most powerful incentives for venture capital fund and entrepreneurial capital formation in non-coastal regions, places where large institutional (and tax-exempt) investors do not often invest in venture capital. A more predictable investment incentive can increase the number of angel capital investors and encourage more investors into regional venture capital funds, both critical elements to growing more startup communities around the country.

As stated above, if one excludes California, Massachusetts, and New York, the median size venture capital fund in the U.S. is about $15 million dollars. This is simply not big enough for most large institutional investors, so attracting taxable investors is critical to expanding entrepreneurship to more regions in the country. Making 1202 easier to understand is a powerful way to encourage that expansion.

**SECTION 382/SECTION 383 SAFE HARBOR**

***PROPOSAL:*** Create a safe harbor from Section 382/Section 383 limitation rules for startups going through viable fundraising rounds and ownership changes.

NVCA has worked on the following safe harbor proposal that would apply to companies less than 12 years old:

* Exempt capital contributions to the company from ownership change calculations.  In other words, capital contributed to the company from a fundraising round would be disregarded for purposes of determining an ownership change under Section 382/383.
* Exempt R&D expenses ([defined as Section 174 expenses](http://www.nolo.com/legal-encyclopedia/deducting-research-experimentation-expenses.html)) from limitation, protecting these expenses, which generally receive favorable tax treatment, from loss limitation penalties.
* Provide a more robust long-term tax exempt rate for all other accumulated Net Operating Losses (NOLs) by allowing an additional 5 percentage points to be added to the rate (currently around 2%).
  + In broad strokes, the current limitation is determined by multiplying the fair market value of the company by the long-term tax exempt rate.  This equation creates the ceiling for the amount of NOLs that can offset income per year going forward.  The lower the long-term rate, the more severe the limitation will be.
  + For instance, a company that sells at a $50M valuation could see their allowance triple from an annual limitation of $1.25M to $.375M.
* Exempt R&D credits from limitations under Section 383.

The special rules for qualified new loss corporations would not apply to loss corporations who do not comply with the continuity of business enterprise test under subsection (c)(1), disregarding (c)(2).

***CURRENT LAW:*** Section 382/383 drastically limits, and very often eliminates the ability of startups to utilize accumulated NOLs and R&D credits as they raise investment capital and grow their businesses. The basic model of entrepreneurship necessarily generates NOLs that should be available to offset income if the company becomes profitable. But the Section 382/383 rules often impose an overly restrictive limitation on most startups, thereby creating an arbitrary penalty for investment in hiring and innovation.

***REASON FOR CHANGE:*** In an attempt to combat loss trafficking, Congress created a complex tax regulatory regime that specifically targets loss corporations going through ownership changes. Unfortunately, the law does not take into account the fact that most startups are loss corporations as they spend their formative years either in a loss position or completely pre-revenue while they take investment capital to build out their businesses. It’s important to remember that, despite the fact that the rules were intended to combat abusive transactions where companies were being acquired solely for their losses, the current reality is that Section 382/383 impact a broad swath of viable startup transactions for no legitimate public policy purpose.

Under the statute, an IPO, merger or acquisition, or even a fundraising round can constitute an ownership change and trigger penalties under Section 382/383. Even worse, many startups simply surrender the value of their NOLs and R&D credits in the face of the incredible complexity of the rules. This has the economic effect of increasing the cost of R&D investment at the startup level, a dangerous and counterproductive policy consequence of these overreaching tax regulations.

Congress can foster economic growth simply by modernizing the rules in the code to stop penalizing startups for investing in job creation and innovation Startups are seeking solutions to some of the most challenging issues we face, including cures for cancer and other diseases, technological innovation, cybersecurity and energy. Importantly, because startups generally spend most of their capital on R&D and salaries, the types of expenses these rules limit for startups are some of the most societally beneficial expenditures with the greatest economic and human impact. In other words, the Section 382/383 rules actually punish startups for incurring the same expenses that, for incumbent companies, federal policy seeks to encourage.

**EMPOWERING EMPLOYEES THROUGH STOCK OWNERSHIP ACT**

***PROPOSAL:*** Pass the Empowering Employees through Stock Ownership Act, which would allow startup employees to defer tax liability on income arising from exercised but illiquid stock options.

***CURRENT LAW:*** Generally, employees must pay tax when they exercise their options or when their Restricted Stock Units (RSUs) vest.

***REASON FOR CHANGE:*** Stock options are a critical tool for attracting talented individuals to work at our nation’s startups. Employees are often compensated with stock options as a promise that if the startup succeeds, everybody shares in the gain. Stock options are particularly important for startups that are often cash strapped and using all resources available to develop and build a novel product. But as the U.S. capital markets have become more hostile to small capitalization companies, many startups are opting to stay private longer rather than pursue an initial public offering (IPO). This has given rise to challenges for employees at our nation’s startups when their stock options vest without a liquid market to sell their shares in order to pay the taxes that are due.

**Total U.S. IPOs by Year, 1980-2015**

Source: Initial Public Offerings: Updated Statistics. Jay Ritter, University of Florida, March 2016

Allowing an additional period of time for employees to defer taxes on exercised stock options is a common sense solution to this challenge that will encourage more talented Americans to help build today’s startups into tomorrow’s Fortune 500 success stories.



**TAX POLICY FUNDAMENTAL TO THE ECONOMICS OF THE ENTREPRENEURIAL ECOSYSTEM**

**CARRIED INTEREST CAPITAL GAINS**

***CURRENT LAW:*** Carried interest has historically been eligible for capital gains treatment because it is the venture capitalist’s share of the profits from a partnership that builds startups over the long-term. These profits are a result of years of value creation from an initial risky investment and a great deal of hard work from everyone involved. It is important to remember that successful venture capitalists do not simply pick winning investments; they build winners by providing value to a startup throughout the company-building lifecycle over a long period of time. They often support portfolio companies with multiple investment rounds generally spanning five to ten years, or longer, serve on the boards of portfolio companies, provide strategic advice, open contact lists, and generally do whatever needs to be done for a company to succeed.

Carried interest capital gains are similar to stock awards received by startup founders in that both venture capitalists and founders invest time, energy and creativity against huge risks in the hopes of creating long-term value. As a result, both types of ownership interests are currently eligible for capital gains tax treatment if they succeed.

***RATIONALE FOR CURRENT POLICY:*** While many different factors have converged over time to create America’s leadership in innovation, significant credit is due to our long-standing tax policy that supports the spirit of entrepreneurship. One such policy is the capital gains treatment of carried interest received by venture capitalists.

*Role of Carried Interest Capital Gains in Venture Capital*

Carried interest is the *primary* economic incentive for participation in 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 (and their own capital) to make risky, long-term equity investments into innovative startups. These are generally partnerships that last ten to fifteen years. Carried interest is the general partner’s share of gains (if there are any) from the partnership in accordance with the partnership agreement. Capital gains treatment of carried interest is an important feature of the tax code that properly aligns the long-term interests of investors and entrepreneurs to build great companies together since the creation of the modern venture capital industry. Venture capital activity is entirely consistent with the core concepts of a log-term capital gains tax rate. As such, partnership gains attributable to the general partners of a venture capital partnership should continue to be afforded capital gains treatment.

*Benefits of Current Policy:*

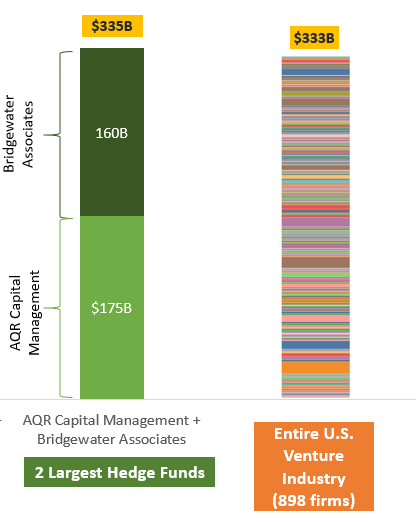
If one were ’white boarding’ the best public policy solutions to encourage new company creation, they would be hard pressed to find a more perfect alignment of interests than the carried interest capital gains a venture capitalist receives from a successful startup investment. When a startup fails, the carried interest on a deal is zero. In fact, carried interest is only realized if one or more startups in a venture capital fund are so successful as to offset the inevitable failures in the fund. Carried interest tax policy is defined by a simple equation, which holds that no benefit is extended unless and until our country receives the benefit of greater economic activity through company and job creation. This policy has been critical to our country’s economic success.

*Venture Capital would be Most Severely Impacted Industry*

Despite the significant amount of public discussion about carried interest capital gains being a tax benefit for hedge funds, a tax increase on carried interest capital gains would have the least impact on the hedge fund business model and the most severe impact on the venture capital business model. Reasons for this include:

* Venture capital is the smallest asset class of investment partnerships. To put this in perspective, the asset size of the two largest hedge funds adds up to the size of the entire venture capital industry. Management fees are a far less significant source of compensation for VCs, meaning the potential for carried interest is far more critical, and in fact is the primary economic incentive for participation in venture capital.

**Assets Under Management (AUM) As of Dec. 31, 2016 ($ billions)**



Source: NVCA 2017 Yearbook, Data Provided by PitchBook; hedge fund websites

* Venture capitalists hold assets for the longest, and therefore wait the longest to realize carried interest if their fund is successful. As stated above, the *typical* VC partnership agreement runs a decade, with options for extensions for further years that are commonly exercised. In the time it takes a VC to realize carry from one fund, participants in shorter-term asset classes can see carry from multiple funds. Conversely, a significant amount of hedge fund assets are not even held long enough to qualify for the long-term capital gains rate.
* Venture capital is also among the highest risk asset classes, and many venture capital funds never realize carried interest.

*Consequences of a Carried Interest Capital Gains Tax Increase:*

A tax increase on carried interest capital gains actually 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. The net result of a tax increase on carried interest capital gains would be a shift away from riskier investments with greater promise for breakthrough innovation and towards safer investment strategies that favor incremental progress.

In addition, a tax increase on carried interest earned by venture capitalists would have its most severe impact on new fund formation, particularly in underserved regions of the country. Setting aside California, Massachusetts, and New York, the median size venture capital fund in the remaining 47 states is about $15 million. The 2 percent management fee on a fund of that size means that, after fund expenses, there might be little or nothing remaining for general partner salaries. In these cases, carried interest capital gains can be the *sole* economic incentive for participation in venture capital.

**VC Funds Raised by State Headquarter 2012-Q2 2017, Sum and Median**

Source: PitchBook

Sadly, in this increasingly global competition to build the next generation of companies, the current debate over carried interest capital gains has it all wrong. In fact, if there are changes to the taxation of the entrepreneurial business model, they should be to instead *support* participation in the entrepreneurial ecosystem to shore up our leadership position.

**CAPITAL GAINS RATE DIFFERENTIAL**

***CURRENT LAW:*** America has benefited from significant risk investment and entrepreneurship encouraged by maintaining a globally competitive capital gains rate with a meaningful differential between the capital gains tax rate and ordinary income rates.

***RATIONALE FOR CURRENT POLICY:*** U.S. capital gains tax policy has been critical to the success of the U.S. entrepreneurial ecosystem. Primarily, the policy has facilitated patient capital formation for high-risk enterprises and encouraged entrepreneurship.

*The Role of Capital Gains Policy in Facilitating Patient Capital Formation for Startups*

A competitive capital gains tax rate with a meaningful differential from the top ordinary income tax rate is fundamental to fostering a climate where entrepreneurship and risk investment can continue to flourish. The business model of venture capital is to invest for longer periods (5-10 years on average) in risky companies with little track record but strong growth potential. The long-term and high-risk nature of venture capital make it particularly sensitive to investment policy. A basic rule of finance is that the longer capital is invested without a return to the investor, the higher the return must be to compensate for that illiquidity. Venture capital activity is exactly in line with the philosophy behind a capital gains rate differential. In fact, an additional lower rate for longer-held investments in startups, such as that offered by the Qualified Small Business Stock Rules (QSBS), is an improvement to our investment climate because of the significant holding periods that are the norm for entrepreneurial investment.

**Median Time (Years) from 1st VC Financing to IPO (2004-2016)**

Source: NVCA 2017 Yearbook, Data Provided by PitchBook

Angel and venture capital are the only significant sources of patient capital available to startups and entrepreneurs. America is the global leader in innovation—a critical component in a globally competitive economy—in large part because of our entrepreneurial capital formation climate. And as we can see from the economies of other countries, if venture capital isn’t around to support an entrepreneurial ecosystem, no other investment class, nor government spending, can fill this gap.

*The Role of Capital Gains Policy in Encouraging Entrepreneurship*

The capital gains rate is also critical to encouraging Americans to become founders of companies. Whether to undertake the challenge of entrepreneurship is an incredibly difficult decision. As a society, we hope these men and women will leave their jobs and dedicate their lives to an endeavor. But they must make this choice knowing that it is more likely than not to fail, potentially leaving them without an income or benefits, and an uncertain future.

Much of the success of a country’s entrepreneurial ecosystem is determined by an appetite for risk, which is largely a combination of the policy environment and cultural norms. It must be acceptable both financially and culturally to try and fail. And the rewards for success must be significant enough to make taking such huge risks worthwhile, particularly in light of the high failure rates of startup-up companies. A competitive capital gains rate with a meaningful differential is a core policy choice that facilitates this environment.