October 15, 2024

Honorable Jason Smith
Chairman
House Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Smith:

On behalf of our nation's venture capital investors and the entrepreneurs they support, I write to express our thoughts on how tax policy can encourage new company formation. Thank you for providing an opportunity through the Ways and Means Committee Tax Team process to present the views of the venture capital community and the entrepreneurial ecosystem concerning tax policy. We understand that the Committee is facing the challenging yet critical task of extending the expiring provisions of the Tax Cut and Jobs Act of 2017 (TCJA) by the end of next year.

As you may know, venture capital is a type of investment offered by investors to startups and small businesses with significant growth potential. Provided in return for equity or ownership stakes, venture capital plays a pivotal role in the business cycle, especially in the early, high-risk stages of emerging companies. As startups improve their products during these initial phases, venture capital offers essential funding to overcome common resource limitations that can hinder early growth. As these companies mature and advance through the business cycle, they may pursue further funding rounds, potentially leading to acquisitions, public offerings, or later-stage investments from institutional backers.

By helping startups, venture capital grows U.S. businesses and the workforce. It is important to note that startups are a unique business model that does not fit neatly into the definition of either large or small business. While startups begin as small enterprises, their objective is substantial growth and scalability. Research continues to show that emerging businesses fuel job creation by creating an average of about three million new jobs each year and accounting for most net new job creation, according to data from the U.S. Department of Labor and the U.S. Census Bureau[1]. However, venture capital undertakes significant risk when investing in small businesses. The Harvard Business Review reports that two-thirds of startups fail without returning a cent to their investors.[2] **This makes startup investment inherently high-risk, although successful startups can generate high returns for investors and create many good-paying jobs.**

As a startup goes through the entrepreneurial ecosystem's lifecycle, it normally generates losses while requiring multiple rounds of investment capital. For this reason, we think that Congress needs to ensure that changes in tax policy consider the unique needs of new company formation while understanding the potential benefits of robust job growth with a healthy startup framework. A healthy startup ecosystem is a major determinant in the ability of the country to realize economic progress in an increasingly competitive global economy. In fact, the share of global venture capital investment into U.S. companies has dropped from 90 percent in the 1990s to just 49 percent in 2023[3]. To maintain our leadership edge, the United States must prioritize greater scientific discovery and patient capital investment in an increasingly competitive world.

We believe next year's tax package offers a unique opportunity to solidify the U.S. leadership in innovation and investment in the entrepreneurial ecosystem. As such, we recommend continuing current tax policies such as the capital gains rate, the treatment of carried interest, and gain exclusion in the Qualified Small Business Stock (QSBS) program. Likewise, we are extremely grateful to the Chairman and

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[1] U.S. Department of Labor, & U.S. Census Bureau. 2023. *Emerging businesses and job creation data*.
[2] Why Startups Fail; May–June 2021 issue of *Harvard Business Review*.
[3] https://nvca.org/wp-content/uploads/2024/04/2024-YB-data-PDF.pdf

Committee Members for passing legislation earlier this year to restore R&D expensing temporarily. We believe a return to R&D expensing is extremely important to incentivize innovation and grow the U.S. economy.

Preserve Treatment of Carried Interest and Maintain Long-Term Capital Gains Rate:

Since the creation of the modern venture capital industry, capital gains treatment of carried interest has been an important feature of the tax code that properly aligns the long-term interests of investors and entrepreneurs to build great companies and jobs together. Because carried interest is the primary economic incentive for participation in venture capital, an increase in the tax rate on carried interest would negatively impact venture capital investment in startup companies.

<u>TCJA included new section 1061 to modify the holding period for long-term capital gain treatment with respect to a carried interest from one year to three years. As the Ways and Means Committee Report to TCJA stated at the time, the adoption of a three-year holding period "struck the right balance for economic growth and fairness without stifling investment." Consequently, we believe any further changes to the treatment of carried interest would upset this balance and be counterproductive.</u>

Further changes would deter venture capital investment in early-stage, high-risk startups, which often require long-term commitments before they become profitable. According to recent NVCA data, the average life span of a venture capital fund is 10-12 years, sometimes longer. **Reducing the carried interest incentive for investments of over three years would skew investors towards more stable, later-stage investments, depriving emerging startups of the critical early funding needed for innovation, job creation, and growth.** The consequences would be most severe for the technology, life sciences, and national security sectors. Keeping current tax policies intact will maintain a vibrant environment for startups that require patient capital and long-term support.

Protect Qualified Small Business Stock (QSBS):

Qualified Small Business Stock (QSBS) is pivotal in encouraging investment in high-risk startups and promoting innovation, job creation, and economic growth. By maintaining current policy, the U.S. can continue to attract significant private investment into sectors like technology and life sciences, where long-term capital is essential for driving breakthrough advancements. Without this benefit, the financial risk of investing in early-stage companies would increase, thus diminishing the long-term capital investment available to U.S. innovative small businesses. Preserving the Qualified Small Business Stock (QSBS) incentive is crucial for fostering venture capital investment in early-stage companies.

Return to Research and Development (R&D) Expensing:

Longstanding tax policy has supported investment in innovation by allowing businesses to fully deduct their R&D expenses in the same year as they are incurred. However, a provision included in TCJA requires R&D costs to be amortized over five years beginning after 2022. This change is creating tax liabilities for growth companies that are spending far more on research than they are realizing in revenue. While larger, established companies can often confidently project their revenue and expenses over a five-year period, many young companies do not make it to the five-year mark.

Earlier this year, led by the Committee, the House passed the American Workers and Families Act, which included a retroactive reinstatement of R&D expensing. As the Committee stated in its press release, the ability to expense R&D is essential to "encouraging American innovation and improving our competitive position versus China and the rest of the world."

Moreover, failing to restore R&D expensing would disproportionately impact young companies that allocate a substantial portion of their budgets to technology research, including innovations essential for national security and the energy transition. A recent survey of venture capital-backed companies by NVCA shows that four out of five respondents spend at least 70 percent of their budgets on two activities, wages and compensation and research and development (R&D).[4] The survey also found that nearly one in five venture capital-backed companies spend at least 85 percent of their budget on R&D activities. There is no doubt that U.S. startups need the ability to expense R&D to remain competitive with companies headquartered in other countries that offer stronger support for R&D, such as sizeable deductions and refundable R&D credits.

In closing, we appreciate the Committee's efforts to promote open dialogue on policies impacting all sectors of the economy—including venture capital and startups—to stimulate innovation, job creation, and nationwide investment. We look forward to working together on incentives that support investment in early-stage businesses for current and future entrepreneurs.

Sincerely,

Bobby Franklin

Bobby Franklin
President and CEO

[4] Venture Capital at Work, NVCA, available at Venture Capital Investment at Work - National Venture Capital Association - NVCA