ANGEL CAPITAL ASSOCIATION

MEMORANDUM TO THE PRESIDENT-ELECT TRANSITION TEAM

1200 Pennsylvania Ave N.W. Suite 399
Washington, D.C. 20044

Subject: **INNOVATION, ECONOMIC OPPORTUNITY FOR ALL—Suggestions for immediate, mid-range and longer-term actions for maximum impact**
From: **ANGEL CAPITAL ASSOCIATION**

The purpose of this memorandum is to recommend steps the incoming Administration can take in support of President-elect Biden's Build Back Better agenda through investment in startup companies that fuel job creation and innovation. The Angel Capital Association looks forward to working with the new Administration in enhancing America's competitive standing globally and improving access and inclusion in economic prosperity for all segments of our society, including those who have traditionally been underserved. We have divided our recommendations into those steps President-elect Biden and his team can take immediately, within the first 100 days, and within the first year in office.

<u>What is Angel Investing and the Angel Capital Association (ACA)</u>

The Angel Capital Association is the world's largest professional organization of accredited angel investors, who invest individually or through angel groups, accredited on-line platforms and family offices. The Association represents over 14,000 members who invest <u>their own after-tax money</u> in high growth, early-stage, entrepreneurial companies. There are business angels and angel groups in every state. Last year angel investors wrote $24 billion in personal checks to an estimated 65,000 new companies, creating more than 270,000 new jobs, and supplying as much as 90% of the equity funding for these cutting-edge firms. Companies such as Home Depot, Google, Starbucks, Twitter, and PayPal were initially supported by Angels who believed in the entrepreneurs who founded these firms and helped them thrive.

Angel supported companies are usually too risky to qualify for bank loans and too small or too early for venture capitalists (VCs). In fact, angels invest in 15 times more start-up companies each year than do VC firms. And we provide not just capital, but time, expertise, mentorship, and governance—often to first time entrepreneurs who dearly need this help.

More importantly, Federal census data shows that high growth startups create *all* net new jobs in our country. A widely regarded study from the Census Bureau and Ewing Marion Kauffman Foundation found that since 2008 new businesses account for nearly all net new job growth and close to 20% of gross job creation. The report also found that over the past three decades, companies less than five-years-old have created on average 1.5 million jobs annually.

High-growth early-stage startups are fundamental to our economy. They are the firms that are addressing seminal concerns such as climate change, new vaccines, clean energy, and artificial intelligence, to name a few examples. To guarantee strong and sustained growth, your Administration has the opportunity to focus on key policies which benefit entrepreneurs and their investors.

Immediate Actions

1. Nominate a new Securities and Exchange (SEC) Chair who understands and supports access to capital by small businesses.

The JOBS Act was intended to ease the ability of small and young companies to access capital needed to succeed. Rulemaking by the SEC has expanded the number of people who can qualify to invest in startups by adjusting the definition of who qualifies as an "accredited investor." The SEC also has jurisdiction over how entrepreneurs can solicit investors and the reporting requirements of these nascent companies.

The SEC's core mission is ensuring stable and transparent markets, capital formation and investor protections. The SEC's commitment to investor protections, strengthened because of the Dodd-Frank Act has never been more aggressive. We firmly believe that the current Commission and professional staff at the SEC have strong investor protections credentials and that the next Chair should have a deep background in capital formation. Recovery from the economic destruction of the COVID-19 pandemic will require that the incoming Chair understand the importance of capital formation and early-stage/ startup companies to grow our economy.

We urge thoughtful consideration of a Chair nominee who understands capital markets and the innovation economy, and who is knowledgeable about the essential role angels play in helping young companies create jobs so that the current balance between capital formation and investor/market protection can be maintained.

2. Instruct the Securities and Exchange Commission (SEC) to retain the existing income and net worth definitions for Accredited Investors and retain the expanded definition that allows qualification via credentials and coursework.

The Dodd-Frank Act requires the SEC to review the definition of accredited investor every four years. The current definition sets a threshold that is based on wealth requirements and financial sophistication. Currently an accredited investor must have $1 million in net worth (not counting their primary residence) or $200K annual income. Retaining this net worth threshold allows under-represented individuals and communities to participate in this asset class, particularly those outside of major metropolitan areas.

The SEC has also expanded the definition of who is considered accredited by allowing investors to become accredited by demonstrating appropriate levels of financial sophistication. We believe this action will improve participation by minorities, women, and younger investors who otherwise are excluded from becoming accredited investors. The ACA plans to work with the SEC in determining a set of curricula that will meet the rigorous requirements of financial sophistication. Together we believe this effort will allow greater participation in the start-up economy as well as help entrepreneurs-of-color and female-led firms to gain wider access to capital.

Actions within the First 100 Days

1. Include the IGNITE American Innovation Act in priority Infrastructure/COVID-19 Relief legislation:

This bi-partisan bill has been introduced by Reps. Dean Phillips (D-MN) and Jackie Walorski (R-IN). It supports start-ups through the current economic crisis by allowing companies to monetize tax assets generated through research and development that creates long-term value. This passage could help accelerate R&D into such areas as bio-medical research, quantum computing, climate change, and advanced energy alternatives.

2. Include the American Innovation and Jobs Act in must-pass Infrastructure/COVID-19 Relief legislation:

This bi-partisan legislation introduced by Senators Hassan (D-NH) and Young (R-IN) would restore immediate expensing for research and development investments. It would also double the cap on the refundable R&D tax credit from $250,000 to $500,000 and gradually increase the cap to $750,000 over the next 10 years. Further, it would allow more startups to participate in this credit by increasing the eligibility threshold from $5 million to $15 million in gross receipts. Additionally, it would increase the time period during which startups can claim the R&D credit from 5 year to 8 years and would increase the Alternative Simplified Credit rate from 14% to 20% for startups, creating parity with the traditional R&D tax credit. This measure, coupled with the IGNITE Act, could significantly accelerate basic research in the United States, helping regain our foothold as the world's leader in global innovation.

3. Endorse and Support legislation to lift the cap on Angel Funds

Prior to 2019, funds that pooled angel investor monies and allowed angels to invest as a group in startups had no financial limits but could only have 99 angels co-invest. The cap on the 99-investor limit was raised in 2019 to 249 investors, an action ACA supported and applauds. However, at the same time a cap was placed on the size of the fund to no more than $10 million. This limit has made it difficult for angel groups and platforms to provide funding to startups that require significant initial infusions of money, such as those involved in bio-medical research, and follow-on support as the companies gain traction. The ACA intends to draft legislation recommending removal of the cap. We would like to work with the new Administration and Congress in finding sponsors for the bill and seeking your support for this small, but important, change that will further increase the availability of capital to startup firms.

Actions within the First Year

1. Retain and improve the tax exemption that increases access to capital for qualified small businesses

ACA appreciates that President-elect Biden has emphasized the need for revisions to the US Tax Code to improve fairness and equity of the Code. We support tax reform that enhances access to capital for fledgling entrepreneurs, including women and minorities. In 2015 the PATH Act allowed for Qualified Small Business Stock (QSBS) to be 100% exempted from federal income taxation. This provision has catalyzed investment in innovative startups, recognizing the inherent risks in these types of companies and the jobs and economic diversity benefits that come from these investments.

Currently the Section 1202 exemption applies only to investments held for five years or longer in companies that are created as "C" corporations. This limits the impact of Section 1202 and undermines the intent of its passage. ACA is recommending several small changes to this provision including decreasing the required holding period from five (5) years to three (3), allowing small businesses operating as limited liability corporations to qualify, and allowing investments in convertible notes to also qualify. ACA would be pleased at the appropriate time to provide draft legislative language to implement these improvements.

2. <u>Retain tax code provisions that recognize the risks associated with investments in qualified small business startups.</u>

Section 1244 of the tax code allows for a deduction as an ordinary loss in a startup investment, rather than a capital loss, against a taxpayer's federal tax obligation. Section 1045 allows deferral of taxes on qualified small business stock sales. Pre-seed and seed-stage companies are a highly risky asset class and many of them fail. Angels are investing their <u>personal after-tax dollars</u> in these risky ventures, and Section 1244 and 1045 help to partially mitigate the risks and promote continued investment in other ventures.

The ACA believes it is in the best interests of the economy to retain these two provisions and also supports improvements as follows:

a) Currently the qualified small business must have equity of $1 million or less at the time of investment, a dollar limit set in 1978. We believe this limit should be raised to at least $5 million, particularly for firms involved in biotech research.
b) We believe these tax provisions should also apply to investments made via a convertible note since many startups use this as their initial investment vehicle before they issue stock.

3. <u>Promote a differential between capital gains and ordinary income</u>.

Many long-time angel investors point out that angel and VC investments in innovative higher-risk new companies grew when the capital gains tax rate for long-term investments decreased to 15 percent. Retaining a lower tax rate to encourage job-creating investment than the rate for ordinary income, even when ordinary income rates are reduced and simplified, would be an important incentive to support access to financial resources for these risky, but job creating startups.

4. <u>Continue current tax treatment of carried interest for angel and VC funds under $25 million</u>

Angel groups that pool their individual members' own monies into a fund often do not receive any compensation for the work they do in managing and investing these monies until after one of their successful small firms has an exit that returns more to the angels than the original investment. The carried interest is used to help cover some of the costs angels incur in managing the fund. ACA recommends that for smaller investment-type funds that support the innovation economy, the provisions applying to the tax treatment of carried interest remain as is.

Conclusion—Access and Inclusion

Angel investors are proud to be an important resource for the startup companies that have created the large majority of net new jobs in the United States over a 25-year period. Angel-backed firms have been some of the most prolific job creators and innovators in recent times.

As a professional association, we are also proud of the improvements we have achieved in ensuring the women and people of color are included in our membership and are represented in the entrepreneurs we support. Earlier this year, we launched a major new diversity, equity, and inclusion initiative to further this effort by focusing on minority groups and regions not previously aware of angel investing. Additionally, we have recently created a new non-profit entity which will enhance educational and events opportunities for people of all backgrounds who would like to participate in the startup ecosystem.

We look forward to working with the new Administration in furthering policies that increase participation in and access to more opportunities for potential entrepreneurs from disadvantaged and underserved communities. Together, with the new Administration, we can revitalize the economic engine to ensure that all segments of our society participate in a better America.