ANGEL CAPITAL ASSOCIATION

July 17, 2017

The Honorable Orrin Hatch
Chairman, Committee on Finance
United States Senate
Washington, DC 20510

Dear Chairman Hatch,

Thank you for asking stakeholders in the American economy to provide ideas and feedback on improving our tax system. The Angel Capital Association is supportive of tax reform policies that encourage economic growth and the formation of new companies. Today we offer recommendations on two areas you specifically asked about in your request for tax reform feedback – strengthening businesses and removing impediments to investments.

By way of background, the Angel Capital Association (ACA) is the professional association of 13,000 angel investors across the country who invest financial and mentorship capital in high growth startups. Angel investors are most often individual accredited investors who invest their own money directly into new businesses before these companies receive other types of capital, as they are too embryonic for Venture Capital or bank loans. Angels invest an estimated $25 billion in about 70,000 startups every year, and angels have provided about 90 percent of the outside equity early-stage companies have received for two decades. These startups are in every state and most communities, many on Main Street.

The companies that receive angel capital are major creators of jobs, innovation and economic activity in our nation. The Census Bureau, Ewing Marion Kauffman Foundation and leading academics credit high growth companies that are less than five years old as the creators of all net new jobs in the US over a 25-year period.

Given the importance of innovation and the accompanying job growth to our economic prosperity, ACA strongly encourages tax policies that support the creation of new businesses and that address the fiscal challenges these startups face in successfully growing. These policies need to be deeply rooted in an understanding of the impact of startups and the entrepreneurial ecosystem.

ACA strongly supports tax reform that makes American businesses large and small more competitive in the world. We want to make sure that the newer businesses that have a chance to turn into the next Amazon or Genentech also can benefit from tax reform. These startups have a very different tax profile than most corporations for two important reasons:

- **Not profitable (yet)**. They are not making a profit to tax while they are building up their products, services and innovations. Some, particularly in the life sciences sector, are "pre-revenue," even while employing many people at above average salaries because of the knowledge and skills required.

- **Investor risk and illiquidity.** They need significant equity capital that require their investors to take significant risks and be incredibly patient with illiquid assets. Angel and other equity investors committing capital to truly new businesses must plan for half of their investments to fail and most often wait many years for returns by the 7 percent of companies the generate 75 percent of their returns. Because other investment opportunities present less risk, but have much less impact on economic growth, it makes good economic sense and is good tax policy to provide incentives for investing personal money into these promising, impactful, but very risky startups. Otherwise, startups will have less and less access to the capital and growth expertise they really need to succeed, generating prosperity, and creating jobs.

Understanding these important realities of the entrepreneurial ecosystem, ACA recommends the following tax policies to strengthen entrepreneurial businesses and ensure access to the best capital for their formation and growth:

1. Continuation of the 100% exemption on gains in Qualified Small Business Stock

The PATH Act included a 100% exclusion for gains on Qualified Small Business Stock (also known as Section 1202). Section 1202 has consistently received broad bi-partisan support in recognition that investments in small businesses are a leading driver of job creation and economic expansion in the US economy. A permanent 100% exemption on Section 1202 gains has been an effective motivation for investments in qualifying small businesses (QSBs).

ACA believes this exclusion makes a real difference in investing in startups – and because angels tend to re-invest their gains back in additional new companies, it leads to more capital for more startups. Our most important policy priority is to ensure that Section 1202 remains in the tax code and the 100% exclusion continues as passed in the PATH Act. If there are opportunities to improve it so that it better meets the intended goals, ACA suggests simplifying QSB reporting requirements and making other enhancements so that this provision of the tax code provides a more reliable incentive to angel investors to support small businesses that fuel job creation in the US economy:

- First, because QSBs must meet certain financial and operational requirements, we believe Congress should direct the IRS to adopt reporting obligations for companies that make it clear to the investor whether the company is a QSB. These can take the form of check the box certification on annual or quarterly corporate tax filings similar to REIT certifications. This would also allow Congress and the IRS to track data about the use and benefits of Section 1202 and assure investors of their ability to appropriately utilize the exemption.

- Related to the first recommendation, we believe the requirement that a QSB adhere to the 80 percent value test for "substantially all" of the shareholder holding period should be updated to an annual test of quarterly averages for each year of an investor's required holding period.

Currently, there is no guidance on what "substantially all" means. This proposal would simplify and clarify the requirement. In addition, the 80 percent test should be revised to apply only during the required holding period. Once the holding period is met, the policy objective of encouraging investment into early stage companies is achieved and the testing for that investment should no longer apply, regardless of how long the investor holds the stock after the requisite holding period is achieved.

- Allow investors to count the time they held LLC interests which are then converted into QSBS into the five-year holding period. Many early stage companies are started as LLCs and then later converted to C Corporations when they want to attract VC or institutional capital. Allowing angel investors to count the time during which they held LLC interest (provided they otherwise satisfy the QSB requirements) to meet the five-year hold period is consistent with the policy objective to encourage investments in early stage businesses.

- Increase the time to rollover gains in QSBS. Currently Section 1045 allows taxpayers to rollover their gain from the sale of QSBS if the holding period has not been achieved, but Section 1045 only allows 60 days for the rollover to occur. We believe this is an artificially and unrealistically short time; it not only limits investors' ability to avail themselves of the benefit, but it also deprives other QSBs of a prime source of potential growth capital. To fulfill the policy objective of Section 1045, we recommend revising the rollover period to the later of 180 days or the end of the investor's tax year in which the sale occurred. This allows for more reasonable amount of time to seek a suitable rollover investment and provides for flexibility within a tax year thus reducing the need to amend or modify a prior return.

2. Qualified Small Businesses use R&D credits to offset payroll taxes

The PATH Act included another helpful policy for startups – allowing them to take the R&D credit against their payroll taxes rather than corporate income taxes. Research and development is an important part of the innovation leadership for the US and it leads to growth of companies of all sizes and therefore economic health of our country.

Congress got it right to make the R&D tax credit permanent for companies of all sizes and particularly to provide an alternate way for startups to use a credit that previously didn't apply to them. Please continue this important credit and the ability for startups to credit up to $250,000 annually for five years to their payroll taxes. This is "real money" for growing startups, allowing them to hire more employees and create more innovations that improve peoples' quality of life. ACA supports growing the impact of this tax credit provision on the US GDP by allowing startups meeting the criteria for Qualified Small Businesses to offset up to $1 million per year in payroll taxes with R&D credits.

3. Competitive differential for capital gains rate

The angel community experienced explosive growth when long-term capital gains rates fell below ordinary income rates in 1997 and again with the Jobs and Growth Tax Relief Reconciliation Act of 2003. Venture capital also grew with these policies, which is important for angel-backed companies to continue their growth and expansion.

Angel investors appreciate a goal of tax reform is to reduce and simplify individual income tax rates and we support that policy goal. We do, however, encourage consideration of a meaningful differential between ordinary income and long-term capital gains rates to continue incentives for early-stage equity investment in high growth startups. The combination of the economic impact of investments in innovative startups and the risk and illiquidity angels take should be recognized with a dependable lower tax rate for capital gains an appropriate tax policy tool. A lower rate would also lead to investment in more startups, since many angels re-invest those gains in even more startups.

As our colleagues at the National Venture Capital Association note, "an additional lower rate for longer-held investments, such as that offered by the Qualified Small Business Stock Rules, is an improvement to our investment climate because of the significant holding periods that are the norm for entrepreneurial investment."

America needs to continue developing tax and other policies that support the entrepreneurial and innovation economy. With other countries across the globe developing tax policies aimed at growing their own startup and innovation economies, the US needs tax policies that keep our country in its preeminent leadership role.

4. Reform Net Operating Loss credit rules for startups

Section 382 of the tax code allows for companies to use credits for Net Operating Losses (NOLs) in future years when they are profitable, but it also restricts use of the NOL credits by companies that go through ownership changes. There is an understandable purpose for the restrictions – limiting "trafficking" of NOL credits. However, the limitation actually keeps most equity-backed startups from using NOL credits because the very nature of raising angel and VC funding means significant ownership changes happen with each round of funding.

ACA encourages your committee to consider reforms to the limitations that allow startups to raise equity capital without fear of losing NOL credits. Being able to keep these credits make startups more attractive to investors, increasing potential capital to them for growth or acquisition. There may be multiple ways to address this policy issue for startups, from exempting NOLs generated by qualifying R&D by Qualified Small Businesses to creating safe harbors for startups going through viable fundraising rounds and ownership changes.

5. Empower Employees through Stock Ownership

ACA supports the bipartisan Empowering Employees through Stock Ownership (EESO) Act, sponsored by Senators Heller and Warner. This legislation will address one of the impediments to ensuring that employees in young, startup companies can genuinely benefit from obtaining an ownership stake in their firm. We know firsthand the challenges and obstacles new companies face, including the hurdles of attracting and retaining top-level talent especially with their limited funding. The EESO Act helps encourage meaningful employee ownership participation in young firms by delaying the tax payment requirements on the value of their stock holdings before these shares have economic value because there usually are no public markets for these shares.

ACA is proud of the essential role we play in fostering innovation, job creation, and economic diversity through our financial and technical support for the startup ecosystem. Thank you for the opportunity to provide ideas that support economic growth and particularly help the companies that we nurture and support.

Sincerely,

Marianne Hudson
Executive Director