ANGEL CAPITAL ASSOCIATION

October 9, 2024

The Honorable Jason Smith
Chairman, Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

Dear Chairman Smith and Members of the Committee:

On behalf of the 16,000 members of the Angel Capital Association that invest nearly $1 billion per year in early stage startups through private placement, we appreciate the opportunity to comment on the Committee's work looking ahead to the 119th Congress and the expiration of the Tax Cuts and Jobs Act (TCJA).

Angel investors invest their own money, typically post tax, in risky, early-stage startup companies, the majority of which never see a major liquidity event. Angel investors are the first group of investors after friends and families helping American entrepreneurs bring their ideas to fruition. Angel investments have been the critical initial funding source for great companies such as Apple, Google, Home Depot, Amazon and others that have fueled much of the job and GDP growth over the past five decades. Without the next generation of these startups, our economy would atrophy, and innovation/productivity would be stifled.

Section 1202:

As you look to the work of this Committee in the next Congress, our Association's number one priority is to retain Section 1202 of the Internal Revenue Code. Incentives such IRC Section 1202 (aka Qualified Small Business Stock or QSBS) are at the heart of maintaining a competitive advantage for the U.S. when it comes to driving thriving startup ecosystems throughout the country. Section 1202 is a proven job creator that has been supported by both sides of the aisle. It was created under President Clinton, supported by President Bush and in its current version was signed into law by President Obama as part of the bi-partisan PATH Act. During negotiations in 2017 on TCJA, the Angel Capital Association was pleased that President Trump considered Section 1202 settled tax policy and it was not revisited during negotiations.

At the ACA, we believe that Section 1202 should not only be maintained in the next bill, but that it should be expanded to include new provisions that will benefit investors and entrepreneurs alike. These enhancements have been proposed in Rep. Kustoff's bill (H.R. 2767, which passed this Committee by a unanimous vote of the Majority last year that called for the following:

- Provide time spent under a Convertible Note investment to be counted in the holding period.
- Establish a phased in tax incentive beginning at 50% at year 3, 75% at year 4 and maintaining a 100% exclusion for holding periods of 5 years or longer.
- Allowing corporate structures beyond just a C-Corp to be eligible for QSBS.

Let me comment a little deeper on the first two bullets.

In early stage investing, many entrepreneurs are not able to spend the time or money that is required to immediately jump into a priced equity round of financing and they may not need the typical level of investment that comes with such a round. So, they are often advised by other entrepreneurs, investors and lawyers to raise a smaller amount (to demonstrate proof of concept) utilizing a Convertible Promissory Note. However, it is critical to understand that investors view this as essentially an equity investment that will likely be converted to a priced equity round as the concept gains market traction even though it starts out as a debt instrument — so the intent behind QSBS is still met since the money is all at risk from the moment of the initial investment.

Side Note: To find a model Convertible Note document that can efficiently be utilized to raise early capital go to: https://angelcapitalassociation.org/angel-insights-publications/

At present, the clock does not start counting on Sec 1202 eligibility until that note converts to an equity round which may not happen for 12 to 36 months after the Convertible Note is issued. The risk to the U.S. innovation system is having investors consciously decide to NOT invest in that company until the equity round when Sec 1202 kicks in leaving the potential innovation starved for necessary capital that could keep it from growing and thriving at these critical very early stages of the company's life. This policy proposed in Rep. Kustoff's bill will contribute to U.S. competitiveness and our ability to keep our foot on the proverbial innovation pedal.

Regarding the second bullet, we know that angel investments by both investors and entrepreneurs often come from successful exits. They recycle the capital that was earned into new investments. At present the investor mindset is focused on the arbitrarily set 5-year holding period as that is how both investors and entrepreneurs maximize their return, but if they are incentivized to think about shorter holding periods, some companies will be able to successfully exit earlier and thus recycle more capital back into the market. We think a phased-in holding period alongside the Convertible Note provision would accelerate capital formation and job creation.

Finally, during negotiations in the last Congress with President Biden's Build Back Better agenda, House Democrats included a cap on 1202 and phased it out after $400,000 in adjusted gross income ("AGI"), with any proceeds being taxed as capital gains and/or ordinary income. ACA is opposed to linking AGI to 1202. To be an accredited investor (thus Angel Investor) you must have either $1,000,000 in investible assets (excluding primary residence) or $200,000 in annual income. Many of our members who professionally manage funds or invest in angel groups have annual incomes below $400,000 in most years. If they are fortunate to have a successful exit after several years of investing, the $400,000 cap proposed by the President and House Democrats presumes this is an annual income level rather than a rare windfall and disincentives them, making our asset class less desirable. While slogans on keeping rates the same for certain people under an AGI threshold are popular, the Angel Capital Association does not believe 1202 should be part of the debate.

Valuation of Non Public Stock in Individual Retirement Accounts:

One of the benefits of being an entrepreneur and/or an investor in an early-stage company is the ability to receive company stock in lieu of compensation. While most angel investments are high risk and ultimately fail, those that are successful and can be sold or brought public help provide critical capital to reinvest in new companies, helping perpetuate the angel ecosystem. Nothing makes an angel investor or entrepreneur want to come back into the marketplace and put their assets into a new start-up like a successful exit.

Under Build Back Better, Congressional Democrats considered limiting non-public stock held in individual retirement accounts to $1 million. All stock given to investors and employers at the time of vesting has a valuation and stock placed in a ROTH IRA is subject to tax being paid in the year it was granted at the then-current valuation. Our tax policy needs to encourage early-stage investment, consistent tax policy, and clear rules of the road. Limiting non-public shares in IRA's will undermine the goal of capital formation and retirement security that Congress should be encouraging.

Mark to Market:

ACA is opposed to the Administration's plan to require assets above a certain level be marked to market to determine capital gains. ACA investors invest in companies that traditionally have non-public stock, and determining valuations of those holdings on an annual basis will create confusion and a huge disincentive to invest in this asset class. Current ideas around mark to market of exempt real-estate, registered mutual funds and other investments <u>will have a strong negative ripple effect by making early-stage investments more complicated</u>, <u>more costly on a tax-basis and significantly less attractive to angel investors.</u>

Tax Treatment of Carried Interest:

The Administration, under Build Back Better, attempted to tax carried interest as ordinary income. About 35% of Angel Capital Members are set up as funds, with a professional asset manager taking a salary. This is a growing part of the ACA community with Gen X and other investors giving part of their investment resources to a local fund focused on a certain sector, geography or group and relieving themselves from having to do research and make investment decisions on their own. The fund managers typically take limited salary knowing that their primary incentive is a successful exit taxed as capital gains and not ordinary income. **The ACA is opposed to any changes in the current law pertaining to carried interest.**

The Angel Capital Association thanks you and the Members of this Committee for this opportunity to present our position and we offer our resources and the subject matter expertise of our members to you and your fellow legislators as needed in the future.

There is incredible work going on by innovative founders everywhere and it is all our jobs to make sure that great ideas and great companies can succeed. We can't do that without your help, and we look forward to working collaboratively with you to keep the U.S. the greatest entrepreneurial country on earth.

Sincerely,

Patrick Gouhin, CEO