House of Representatives Committee on Ways and Means
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Working Group on Debt, Equity, and Capital
And
Working Group on Small Business/Pass Throughs
House Committee on Ways and Means

Submission of:
National Venture Capital Association

Introduction

For the last four decades, the venture capital community has served as a founder and builder of companies, a creator of jobs, and a catalyst for innovation in the United States. This contribution has been achieved through high-risk, long-term investment of considerable time and dollars into small, emerging growth companies across the country and across industry sectors. According to a study conducted by econometrics firm Global Insight, U.S. companies that were started with venture capital since 1970 accounted for 12 million jobs and $3.1 trillion in revenues in 2010 and include historic innovators such as Genentech, Intel, FedEx, Microsoft, Apple, Google, Starbucks and eBay. Venture capital has differentiated the US economy from all others across the globe.

Yet despite the tremendous value generated by the venture capital industry, the ecosystem is a small and fragile one that requires consistency to thrive. To date, Congress has demonstrated a strong understanding of the necessary environmental factors required to foster a stable venture capital environment. The venture capital industry is asking you to continue to support this consistency and continue to recognize carried interest attributable to long term venture capital investment as it has been viewed historically– as a true capital gain. We believe an examination of the economics of carried interest will demonstrate not only that it is consistent with the spirit of long-standing tax policy but also that a tax change affecting the venture industry would be incongruous with the spirit of encouraging ongoing innovation that Congress has historically supported.

The Fundamentals of Venture Capital Investing, Compensation and Partnerships

The Venture Capital Investing Process

Venture capital funds typically are organized as partnerships. Although VCs invest significant portions of their personal savings in start-up companies, the capital needed by the emerging growth sector far outpaces any individual assets. For this reason, institutional investors such as pension funds, universities and endowments, and private foundations typically provide between 95 to 99 percent of the capital for the VC fund. Venture capitalists provide the remaining amount of capital. The VCs and institutions join together in a VC fund as the general partner (GP) and limited partners (LPs), respectively.

Once the venture fund is formed, the VC's job is to research markets that have the potential to grow exponentially with application of new ideas and risk capital. They then work to identify and nurture promising, innovative companies within these new markets. This nurturing takes the form of money and strategic management, including intangible guidance and goodwill – all equally important to the company's ultimate success.

This effort is not unlike raising a child from infancy to early adulthood. At some point in the future the VC hopes the company reaches maturity and can go public or become acquired. But you cannot just throw money at a company and expect it to succeed. As part of the investment, VCs take an active seat on the board of directors and provide strategic guidance for management based on their expertise. From time to time, they may also step in to help with certain management roles while the team is being built. Venture capitalists often have advanced science degrees and operational start-up expertise so our activities run the gamut from providing input on prototypes to implementing business development strategies to protecting intellectual property rights. They also instill and insist on formal corporate governance procedures including the development of formal committees and standard reporting procedures.

In addition, VCs make valuable intangible contributions to their companies through their knowledge of business processes. They also bring to bear their personal contacts and networks with customers, suppliers, and distributors, and knowledge of how to approach potential key hires. The strong reputation and goodwill established by venture firms is often the key to continuously open doors which would otherwise remain closed to a start-up company throughout its life cycle. For example, consider a company such as Intel that is looking to purchase new technologies to fabricate their semiconductor chips. Given the sophistication and risk involved in the fabrication process, Intel would be unlikely to purchase a technology from a stand-alone start-up company. But if that start-up had the financial backing and support of a venture firm, the start-up's product could be considered.

All of this broad industry experience adds significantly to the entrepreneur's calling card when they are building their business. This is the venture capital industry's good housekeeping seal of approval and it is how start-ups break into markets that have entrenched suppliers. In this regard, contacts and goodwill are the lifeblood of venture-backed companies. This is why entrepreneurs actively seek out venture investors who can add value to their companies.

This sweat equity goes well beyond contacts and reputation. VC's are in constant contact with each of their company's management teams, typically 3 to 4 times per week. Because of the level of involvement with their portfolio companies, individual VCs typically sit on no more than 5-7 boards at any one time. On average, VC's frequently spend 70 percent of their time working with existing portfolio companies and only 10 percent making investment decisions. They spend another 20 percent of their time with professors, entrepreneurs and technology experts in order to identify and analyze the next emerging market like education and then look to find the best team within that market to invest in. The network and knowledge base that they build during their investigative phase is one of the assets they bring to a start-up when they join the board.

Venture capitalists invest in companies for anywhere from 5 to 10 years, often longer and rarely less, with the ultimate goal for the company being an initial public offering or acquisition, generating a long-term capital gain. Because they focus on high-risk technological advances, many VC-backed companies fail. In fact, it is estimated that on average, 40 percent of all venture investments lose some or all of the invested money. The next 40 percent generate a modest profit that returns the total capital invested and repays the fund for all of our operating expenses over the life of the fund. Only 20 percent of venture investments achieve realizable and meaningful gains. It is this last 20 percent that carries the returns for most venture funds. This is the nature of our business. The cost of taking this entrepreneurial risk is delicately balanced by gains earned from successful investments. This balance is critical in order to maintain support for an entire portfolio of hopeful start-ups.

Compensation Arrangements of VC Funds

For the work that they do, the venture capital firm typically receives two types of income – a 2 percent annual management fee and a 20 percent share of the VC fund's cumulative net profits. This 20 percent entrepreneurial profit share is typically referred to as the "carried interest." The management fee is guaranteed; the carried interest is entirely contingent upon a profitable fund.

While there are deviations from the norm, 2 percent and 20 percent have been consistent industry standards since the inception of the modern venture capital era, typically viewed as beginning in the 1970s when the Department of Labor's ERISA rules were revised so as to permit pension funds to invest in the asset class. Practically, this means that thirty years ago when Bob Swanson, the founder of Genentech, was looking for and found venture capital, the same carried interest structure was in place as exists today. It has worked and continues to work very well.

The 2 percent management fee is calculated annually as a percentage of the fund's total capital committed by its investors and typically declines over the life of the fund. It is used to pay for business operations, office space and systems, technical experts, research, travel expenses to meet with companies, as well as the entire firm's salaries including administrative and operations personnel. The management fee, including the salaries that VCs and their staff receive, is taxed as ordinary income.

The 20 percent carried interest is negotiated between GP and their LP's as *partners* and, in the venture capital world, is dependent on the fund's cumulative net profits, as calculated over the life of the fund. Gains and losses and usually expenses are netted for purposes of determining the 20 percent profit share. In non-tax parlance, this means that the partnership must have earned a profit over and above the contributed capital, including the management fee and expenses over the life of the fund, and across the entire basket of portfolio companies nurtured by the fund before a VC is entitled to the entrepreneurial profit share. In this regard, there is full *alignment of interests* between the GP and the LPs to maximize the value in all of the underlying portfolio companies.

This structure results in relatively straightforward partnership taxation. In its early years, the VC fund makes investments in portfolio companies and pays expenses, so the VC fund likely will only generate a net loss from expenses. These cumulative losses generally are allocated to all partners in proportion to their capital contributions. When portfolio companies are sold at a gain, the net profit typically first "reverses" the net losses previously allocated. Thereafter, the cumulative net profit typically is allocated 20 percent to the GP and 80 percent to all limited partners in proportion to their capital contributions.

Because the ultimate net profits of a VC fund are not determinable until the end of the fund's term which is typically well over 10 years, distributions of the carried interest to the GP are typically delayed until the LPs' capital contribution has been returned to them. These contributions include capital used to purchase companies that have not yet been sold *and* capital used to pay expenses, including the GP's management fee. The return of this capital typically will not begin to be achieved until 7 years into a fund. Only then is the carried interest shared with GPs.

The VCs must pay tax on their carried interest as soon as the VC fund is cumulatively net profitable, which typically occurs in years 3-4. Because the GP carried interest distributions typically are delayed until all capital and accumulated expenses have been returned, which typically occurs in years 6-8, a type of "reverse deferral" (an acceleration of tax) is created. This requires the GP to negotiate to receive "tax distributions" from the VC fund. Like an advance or a "sales draw," these tax distributions will reduce the amount of carried interest later paid to the GP.

Carried interest is never guaranteed but it is taxed on a flow-through basis, determined by the character of income earned by the partnership. Given the early-stage nature of venture-backed companies, dividends are rare. Debt investments that might give rise to interest income, other than bridge loans, are also uncommon. Because the primary economic benefit in a VC fund arises from the value created in a pool of long-term investments, most of the VC fund's income that flows through to its partners (including the GP) is characterized as a long-term capital gain which Congress has determined to tax at a preferential tax rate. A VC's effective tax rate is often higher than the long-term capital gains rate, however, since the share of a VC fund's expenses (including the management fee) that flow through the VC fund to a VC generally are limited in deductibility or not deductible at all.

The Value of Sweat Equity and Intangibles

Consistent with current partnership tax laws, the VC fund structure encourages the pooling of labor and capital by allowing the partners to divide the profits from the enterprise – whether created by the VCs' labor or the combination of the VC and LPs' capital – in whatever manner they determine best rewards the long-term, entrepreneurial risk taken by each partner. This flexibility is essential to creating efficient and productive businesses and to attract new talent to the venture industry.

We believe that for the venture industry it is appropriate to reward investors of sweat equity with the same long-term capital gain tax benefits that investors of financial equity receive. Both will only succeed if the business builds in value – so both are subject to the same entrepreneurial risk and interests our aligned. In fact, if only financial investors were to receive this tax benefit, then only those with existing financial wealth would be "subsidized" by the government for their investment. But if the VCs' contributions of time, effort and counsel – as well as the intangible contributions made by VCs in the form of customer and supplier contacts, business process know how, and value-building and reputation – are as valuable to the success of the business as contributions of financial capital, and if the VCs do not receive their share of that value until after the financial investor receives its share, then both should be subject to the same tax treatment.

Venture capitalists often work with scientists and professors, who have made their discoveries in government-sponsored labs and universities, but need additional support to bring their innovations to market. By enabling the commercialization of these products, they often help the government realize further their investments in basic R&D. Often the most brilliant scientist, doctor, or professor lacks the business experience to build the company that will ultimately bring their products to the public. In these cases, venture capitalists serve as the business minds that, when combined with the science, create the successful commercial enterprise.

There are several further questions regarding venture capital carried interest which are frequently asked. The first is why is carried interest is different from an option. One reason is that the venture capitalist does not have the choice to walk away. As stated earlier, the VC Limited Partners require that VCs contribute a significant portion of their own personal savings to the VC fund, so if the companies perform poorly, they will *lose* money. Second, as an actual equity owner of the VC fund, the VC is subject to all of the partnership tax rules which apply. Because the economic arrangement is determined over the life of the VC fund, but each VC has to report and pay taxes annually, he or she can *lose* money that has been paid in taxes simply because of their status as a partner. For example, if there are early gains and later losses in the VC fund, the VC might have to pay tax on his or her carried interest share of the early gains, but if later losses offset those gains, might never be entitled to the economic benefit of that carried interest upon which tax was paid. Since later, offsetting losses generally can only be deducted against future capital gains, a VC that does not earn any capital gains in the future will lose the tax benefit associated with those losses. With an option there is only an upside. With carried interest there are two sides – up and down.

Another question is why is carried interest is different from compensation received by other service providers. As mentioned, carried interest is *contingent* upon value being built in the entire portfolio of companies. Other service providers such as consultants receive *guaranteed* payments – similar to management fees. Even if a portion of their compensation is performance-based, that compensation typically is based on *annual* performance whereas carried interest (in order to get the tax benefits of long-term capital gain) is attributable to value built up in portfolio companies over many years. Furthermore, when performance-based compensation is paid to other service providers, it depletes the assets of the business, thereby depleting its value. When a VC receives carried interest, that means that the business was sold and a third party has paid that VC, leaving the assets and value inside the business. Other performance-based compensation, whether paid by a company to its executives or paid to a lawyer as a contingency fee upon winning a case, does not involve the sale of a capital asset – a condition currently and historically required to receive capital gain treatment. Venture capital carried interest, on the other hand, is only afforded long-term capital gain treatment if a VC fund sells a business, a capital asset, in which value has been created.

Venture carried interest is very similar to founder's stock or a sole proprietor's interest in his business. When founders start a company, they typically receive common stock in the company in exchange for their ideas and labor. At some time, the company may issue preferred stock to a financial investor in exchange for what is presumably far more financial capital than the founder invested. If the company is successful and is sold or goes public, the founder will be permitted to sell the founder's stock and receive long-term capital gains tax treatment. Even company executives or employees who receive "restricted stock" after the start-up has received venture financing can receive long-term capital gains treatment when they later sell their stock. The only distinction is that if the executives pay less than fair market value for the stock upon receipt, they will recognize ordinary income for the difference upon receipt. But all of the later "upside" is eligible for long-term capital gains treatment.

Carried interest is like the stock received by the founder of a start-up company because both the VC and the founder receive equity interests in the businesses that are disproportionate to the financial capital invested in those businesses. The same might exist for a sole proprietor who borrows financial capital from a lender. Each, however, invests time, energy and money in the hopes of building value in our businesses. As a result, all should (and currently do) receive capital gain tax treatment when the business is sold and that value is realized.

Consider the scenario in which two friends come together to form a business. One friend has the time and passion to run the enterprise on a daily basis; the other has the financial capital to allow the business to set up shop and open its doors. Historically, if that business is successful at the end of the day, the partners determine how to share the profits, even if they determine to do so in a manner that is not pro-rata to the financial capital each committed at the outset. The ecosystem of the entrepreneur, venture capitalist and limited partners is analogous: all contribute different components in hopes of making the start-up profitable but the limited partners have decided to split their part of that potential profit in a non-pro-rata manner in order to reward both the entrepreneur and the VCs. At the VC fund level, the limited partners have essentially made the decision that if the fund is cumulatively profitable, balancing all the portfolio company investments, then they are willing to give an extra profit incentive to the venture capital partner in exchange for the value they have created from actively working with portfolio companies.

If sweat equity or intangibles are not recognized as having long term value associated with them, then venture capitalists may as well be passive investors. This scenario would be potentially devastating to the entrepreneurial community that actively seeks venture capital for the intangible value of expertise and networks they receive alongside the financial investment. They are not in the market for high risk credit – which is what venture capital would become without the sweat equity. For the entrepreneur's sake, we don't believe that Congress wishes to change the venture capital value proposition –investment and sweat equity combined create value long term together. This is the spirit in which capital gains tax policy was enacted – and it has fostered the environment needed for a thriving entrepreneurial community here in the United States.

Taxing Carried Interest Earned by Venture Capitalists Will Hurt Venture Capital and the US economy

Taxing carried interest earned by venture capitalists will fundamentally change the venture capital business. In 1979 the Department of Labor's Prudent Man rule allowed pension funds to invest in our asset class, and that change had a profound and positive effect on investment and innovation. Our fear is that taxing carried interest earned by venture capitalists would have the opposite effect, chilling venture investment, and thereby unintentionally causing harm to the US economy. It will not happen immediately and there will be no giant implosion. By the time the damage is felt, however, it will be too late. Specifically, there are several ways in which the bill is likely to result in fewer US companies receiving venture capital.

First, if the carried interest tax on the industry were doubled, VCs ability to take financial risk would shrink. Because they rely on the profits from successful investments to outweigh the losses on the companies that fail, an increase in the tax rate requires funds to generate more successful company exits to make themselves whole. Where today a firm can remain in business if only 20 percent of their companies provide meaningful returns, such a tax change would mean a firm would now need 25 or 30 percent of our companies to perform well to make up for the additional taxes. This requirement will necessarily factor into investment decision-making, particularly with respect to any investment that could result in a total loss. Companies that are now within the range of acceptable risk may no longer meet this threshold and may cease to receive venture financing. The net result is that venture firms will tend to favor later-stage companies in order to reduce the effort, the risk, and the time required to exit. Early-stage companies would be harder to form and fund, reducing the overall number of venture backed companies and hurting the life blood of the entrepreneurial ecosystem. If venture capitalists do not fund these risky companies, no one will.

Second, a doubling of the carried interest tax rate will, almost certainly, affect the ability to attract talented professionals to the industry. Venture capitalists possess a unique skill set – technological expertise and business acumen. These skills are in high demand and there is competition for these individuals, who are well positioned to follow other career paths. It is the promise of carried interest that allows venture capital to compete with other careers from a financial perspective. However, the long delay before any potential carried interest is ever paid requires significant confidence and foresight in any professional. Taxation as an owner of the businesses those professionals build (i.e., as capital gain) has enabled those who are partners in venture funds to continue to attract junior talent. If this factor is eliminated, it will be one more reason for these professionals to seek more consistently lucrative positions in less high-risk and less innovative industries. The number of venture capital professionals and firms has declined in each of the last 5 years. Today it is estimated that there are only 522 active venture firms in the United States and just over 5800 industry principals, down considerably from 627 firms and 8600 professionals in 2007. We are reaching a dangerous tipping point in which we do not have enough professionals coming in to the industry to enable the industry to make capital available to companies which need it most. States with great young companies but few venture capitalists will be hit first and hardest.

Since the 1970s, the U.S. venture capital and entrepreneurial ecosystem has been the envy of the world. Uniquely, our startup economy not only leveraged the attributes listed above, but also consistently fostered an environment that allowed entrepreneurs to take a risk, start a company, access capital and to succeed *or* fail. Just as we have seen the emergence of a global economy in almost every sector of society, in the last several years we have begun to see the US venture capital model exported to other developing countries such as India, Israel and China.

Perhaps more significant, those countries, which now have expanding internal markets and participate in the global economy in a more comprehensive manner, are also fostering indigenous venture capital markets. Foreign born nationals who have been educated in the US, and perhaps have started companies here, now have a viable option to return home and become part of the local venture base, whether in Israel, India or China. This was not the case just five years ago. Also many foreign countries have witnessed how venture capital has benefited the US economy and are becoming very aggressive in attracting these talents to their shores. We have seen this with the burgeoning semiconductor business in China, with the biotech industry in Singapore, and in the large and growing software market in India, all of which are being led by foreign nationals who began their careers in the US. Even in Europe where considerable pressure is being placed on the private equity industry, government officials are simultaneously affirming support for venture investment in small start-ups. Given the opportunity, these foreign economies would be all too happy to grab the brass ring from the United States. The game is ours to lose.

To continue to foster an environment of venture investment and entrepreneurial success in the US, we need public policy makers to continue to embrace a consistent, long-term perspective as it relates to capital formation policies, including taxes. As an industry, venture capitalists are eager to continue to invest in entrepreneurs with the same enthusiasm and commitment put forth in the past, but we do require your support.

Conclusion

America has always rewarded risk takers from its earliest days until now. Through our capital markets, our tax laws and our regulatory structures, the government has made it possible for those with a promising idea to take the leap of faith and set out on a risky but potentially rewarding path. We believe that Congress has understood well the venture capital value contribution to this process and has enacted and maintained tax policies that promote this activity. Congress always faces difficult choices as it reviews tax policy at large, and the discussion around capital gains tax policy clearly generates strong views from Members on both sides of the aisle. As you continue to examine the intersection of capital gains policy and partnership tax law, we urge you to affirm that Congress understands that capital gains tax treatment for venture capital investment should continue because the industry invests over the long term to create measurable, risk-based, and undisputed value for the U.S. economy.

A Q&A is attached.