House of Representatives Committee on Ways and Means
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"Hearing on Fair and Equitable Tax Policy for America's Working Families"

Testimony of:
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Introduction

Chairman Rangel, Ranking Member McCrery, and members of the committee, my name is Jonathan Silver and I am the founder of, and a Managing Director at Core Capital Partners, a Washington, DC-based venture capital firm with approximately $350 million under management. At Core, we identify promising new technologies, often in the telecommunications, security and software sectors, and work to turn those inventions into viable commercial businesses. Core is also a member of the National Venture Capital Association, and I am here today representing the 480 member firms which together comprise 90 percent of all the venture capital under management in the United States.

My professional background spans both the private and public sectors. In addition to my investment work, which includes a stint as a partner in what was once one of the country's leading hedge funds, I was an Executive Branch appointee in the first Clinton Administration. I served as senior policy advisor to both the Secretaries of Commerce and Interior and as an advisor to the Secretary of the Treasury. In this capacity, I have had a chance to work with several of you and with members of your staffs in crafting thoughtful, forward-looking tax policy. I am here today in much the same spirit.

I would like to thank the Committee for the opportunity to share with you the venture industry's thoughts on three key issues, specifically:

1) the unique and valuable contribution venture capital investment makes to America's long-term economic growth;

2) why we in the venture community believe that the current capital gains tax treatment on a venture fund's carried interest is both correct and necessary; and,

3) how HR 2834, as drafted, could damage the entrepreneurial ecosystem in the United States – a system that has been at the heart of our country's economic leadership for decades.

How Venture Investment Contributes to Long-Term Growth

Literally thousands of companies would not exist today were it not for the venture capital support they received early on. Federal Express, Staples, Outback Steakhouse and Starbucks are well known examples of traditional companies that were launched with venture backing. Cisco, Google, EBay, Yahoo and countless other technology companies were all, at one time, just ideas that needed start-up capital and guidance.

In the same vein, venture capital has been an important catalyst for innovation in the life sciences and a multitude of medical innovations would not have been possible without it. Genentech started with venture backing. So did Amgen and Medtronic. Over the last several decades, venture capitalists have partnered with scientists to build successful businesses and bring to market such drugs as Herceptin, an important part of our war on cancer and Intergilin, which significantly reduces blood clotting. Studies suggest that more than one out of three Americans will use a medical product or service generated by a venture- backed life sciences company.

According to the econometrics firm Global Insight, last year US based, venture-backed companies accounted for more than 10.4 million jobs and generated over $2.3 trillion in revenue. Nearly one out of every ten private sector jobs is at a company that was originally venture-backed. Almost 18% of US GDP comes from venture-backed companies.

What is particularly important is that these are NEW jobs and, in fact, often NEW industries. For example, while the original breakthroughs were made in government labs, corporate R &D facilities and universities, it was venture capital that made the semiconductor industry possible. We also saw the commercial possibilities of the Internet before anyone else and jump-started the biotech industry. Venture investors are constantly looking for the next "big thing" and these days, many of us are active in building alternative energy companies in what is sometimes called the "clean technology" industry, a sector which I'm sure we all agree will play a vital role in America's global competitiveness for years to come.

Where will the next important businesses come from? The truth is, no one knows and that's why venture capitalists look everywhere, and in all fifty states, for those opportunities. It's why venture funds have backed Music Nation in New York City and Incept Biosystems in Ann Arbor, Michigan, Interface21 in West Melbourne, Florida, Boston Power in Westborough, Massachusetts and Click Forensics in San Antonio, Texas. I have attached a list of more than 3700 companies that have been funded in your states by the venture capital community. (Attachment A) Companies in the state of California have been omitted due to the length of that list. Each of these, and any of the many other companies venture capitalists start, could prove to be the beginning of new businesses, new industries and new jobs.

The economic importance of these new companies cannot be understated. They are a critical part of our national economic engine. From 2003-2006, a period chosen to exclude the potential effects of the tech "bubble", the employment growth rate of all US-based, venture-backed companies was more than 2 ½ times more than that of non-venture backed companies. That is also part of the reason that many of your state economic development agencies are actively looking for ways to attract venture capital investment. They know that venture backed businesses generate jobs and taxes and have a significant positive spillover effect on the life of a community.

There are two essential points to make here. These are NEW jobs and these are GOOD jobs. That these are new jobs is clear. Simply put, these jobs did not exist before venture capitalists started these companies. But further, these jobs are often in industries that require new economy skills which will be viable and transferable for years to come. This is organic job growth; we do not use leverage; there is no financial engineering taking place in these start-ups. This is sweat equity on the part of the entrepreneur and his or her backers. We are all working to create something real and tangible and valuable out of nothing and that's the very best kind of economic growth. No other asset class shares this distinction.

Venture Capitalists Act as Company Founders

Perhaps it would be useful to spend just a moment explaining what venture capitalists actually do and how the venture business works. I believe it will become clear that we work in many important ways exactly like the founders and entrepreneurs we back and quite differently from financial managers in other asset classes.

Venture funds raise capital from institutional investors like pension funds, endowments, and foundations and to a lesser extent from individual investors. Our charge is to invest these funds in the most promising start-ups, with the understanding that we will work with these companies until they can go public, be acquired by a larger entity or, as is sometimes necessary, shut down.

These start-ups almost all begin the same way, with an entrepreneur and a VC agreeing on an idea. There is no strategic plan, or, at least, not much of one. There is no senior management team; there are no customers. There is just our collective belief that the initial idea can potentially be turned into a viable and profitable business.

When we launch a company, we are investing both time and money, just like the entrepreneur. We generally invest a small amount at first and we expect to continue to finance the company as it grows. We often require the company to meet business-related milestones in order to receive additional rounds of financing. For an early-stage company, five or six rounds of financing is not unusual. Our investment in each company typically lasts 7-10 years, often more and rarely less. We see no cash returns until the company goes public or is acquired. Even at that point in the life cycle, venture capitalists are not paid from company dollars but by outside parties establishing a fair market value.

We also invest our time and lots of it. We take a seat on the board and work with the management team, often on a daily basis, developing strategy, introducing the company to customers and suppliers, identifying and hiring key managers, and leveraging our past experience to address competitive and operating issues.

Let me give you a sense of scale. At Core, over the life of a fund, we expect to make somewhere between 20-25 investments. We have five partners. A fund's initial investment period usually lasts about five years. So, our partners make 1-2 investments a year per partner. We do not have hundreds of positions in the portfolio and we couldn't, because we don't invest in stocks, we start companies.

We are often as actively involved as the founder. Very frequently, the initial idea for a company is developed by a professor or a research scientist who does not want to leave his or her current position. They may be involved a day or two a week, lending technical guidance to the new company. We get involved in building out the company. The combination of their technical knowledge and our business knowledge is equally responsible for the company's success. If we co-founded the company, work equally hard, make intellectual contributions of equal value, why should the founder's share on the sale of the company be treated as a capital gain and ours viewed as performance for service and ordinary income?

I believe it is important to understand that venture capitalists and entrepreneurs are really co-founders, we are not just financiers. Without our active, ongoing involvement, many of these companies fail, or fail to launch, and potentially important innovations remain in the garage, incubator or lab. For their contribution, entrepreneurs receive founders stock, which, if sold, is taxed at the capital gains rate. Venture capitalists, for our contribution, receive carried interest, which is also taxed at the capital gains rate, but only to the extent attributable to the value created by the sales of our companies. This arrangement creates an equilibrium of incentives for all the key players.

Venture Capital is a Long Term and High Risk Investment in Value Building

Venture capitalists embrace patient, long-term, high-risk investment to create a valuable asset – a company. As I noted, the life of a venture capital investment in a company is 7-10 years and life sciences companies typically remain in a portfolio for 10 – 15 years. We do not "flip" companies by buying or selling them quickly. There is nothing to "flip." We remain invested in a company over multiple rounds for multiple years. Every single dollar of venture capital investment goes toward company growth. We typically do not use leverage, charge the company any fees, or pull dividends from the company during our involvement.

A venture capital fund is not liquid. Investors, including the venture capitalists themselves, must be prepared to have their investments committed for the life of the fund. The long-term commitment is especially significant given the high risk nature of our business. It is estimated that approximately 40 percent of all venture backed companies fail; 40 percent make only modest returns; only 20 percent of companies achieve realizable gains. It is this last 20 percent which venture capitalists rely on to cover all the other losses and generate returns to the fund.

Venture Capital Remains a Relatively Small, Cottage Industry

Despite the value that has been created by venture capital investment, our asset class remains a very small component of the alternative investment sphere. To give you some perspective, venture capital investment in 2006 represented only 0.2% of US GDP. In 2006, the venture capital industry raised only one quarter of what the buyout industry raised. Thus far in 2007 buyouts are outraising venture capital by a ratio of 8:1. We manage 15 percent of what the hedge fund industry manages. There are less than 800 active venture capital firms in the United States, and that number has been declining for the last 5 years. The notion that venture capital has grown exponentially as an asset class is factually incorrect.

Venture Capital and Carried Interest

Now that I have explained what we do, I would like to share with you how we are compensated. For our contribution, 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 and taxed at an ordinary income rate; the carried interest is entirely contingent upon a profitable fund and is taxed based on the type of income earned by that fund. So, to the extent the fund sells companies, the carried interest is taxed at the capital gains rate.

In order to be treated as a long-term capital gain, carried interest must satisfy many requirements. It is contingent upon the profits of the venture capital fund and cannot be guaranteed in any form. Unlike most compensation income, if the venture capital fund loses money or just breaks even, we do not receive any carried interest. Carried interest also must be attributable to companies that have been held for over one year making the payment different from end-of-year bonuses that look at performance during a single year, rather than over a long-term period. Carried interest also must be attributable to the sale (either IPO or acquisition) of a capital asset to a third party. This is what makes carried interest different from other performance-based compensation that takes money and value out of the company's coffers, rather than leaving the value in the company and being "paid" by a third party. This is also what makes carried interest different from a lawyer being paid on a contingency fee basis or from an author being paid royalty income for his or her book sales. In those cases, the lawyer and author did not give up a capital asset to someone else.

Venture capitalists have openly used this same structure for the last 30 years. We pay ordinary income tax on the guaranteed portion of our compensation that is not contingent upon building value. We do not employ creative tax structures. We do not use offshore accounts or deferred income structures to avoid paying taxes.

Like our investments, the carried interest which we receive is also long term and high risk. It is not paid out every year. It is certainly not a guaranteed “pay for performance” bonus. In fact, many venture capitalists can apply tremendous effort and skill in helping their companies grow and still never receive carried interest compensation. Here is why: unlike a bonus that is earned each year by an employee at an investment bank or other financial services corporations, carried interest in the venture capital context will only begin to be paid out if institutional investors are made whole on their *entire* investment in the venture capital fund, including in most cases their re-payment of all their management fees. This is a very large, multi-million dollar hurdle for a fund to achieve. Therefore, we typically do not receive distributions of carried interest on the IPO or sale of a single company. The returns of a single company are not typically enough to make the limited partners whole. Instead, it takes almost the entire fund life to see “how the story will end” so it is often not until year 7 or 8 that the possibility of carried interest is even available. But it is this possibility of earning carried interest that is the primary incentive for venture capitalists to stay in the game – and work to grow our companies to the best of our abilities for the full ten years or longer. In this regard our interests are perfectly aligned with both the limited partners (who want us working the portfolio until the last company exits) and the entrepreneurs (who also want us as a founding partner until a successful outcome). Carried interest, and the favorable capital gains tax treatment that is currently applied to it, is our incentive to invest our time into these high risk companies for the long term.

The Venture Capital Partnership is Aligned

For the last thirty years, the limited partner community has understood our contribution to founding companies very well. Their understanding is reflected in our partnership agreements which grant us 20 percent of the funds' profits in exchange for our sweat equity. We are only successful if the fund is successful. It is not unlike a partnership in which two individuals come together to open a store. Person A has the capital; Person B has the time and knowledge to run the store and grow the business. If the store is successful and is ultimately sold, that partnership has determined on its own that Person A is entitled to 80 percent of the profits; Person B is entitled to 20 percent. Both pay tax at capital gains rates because that is the fair treatment of each individual's contribution under current partnership and tax law. The venture capital scenario is no different.

HR 2834 suggests that capital gains tax treatment should only be offered for the *financial* capital the individual invests. While venture capitalists do indeed invest their own money alongside of the limited partners and entrepreneurs, most venture capitalists do not have the personal wealth to fund the number of companies necessary to operate a fund on their own. Under the proposed law, venture capitalists would lose the majority of their tax incentive to operate as we do today, offering our sweat equity and intangibles in exchange for what is, in essence, founder's stock. If Congress passes HR 2834 without amendment, you will be sending a strong message to the US venture capital community which says you do not believe that what we do creates value.

HR 2834 Will Hurt Venture Capital and the US economy

HR 2834, if passed as currently written, will fundamentally change the venture capital business. I cannot tell you what the exact nature and form that change will take, but we do know that HR 2834 would dramatically change the venture capital-entrepreneur-limited partner paradigm, and such transformations do not happen without repercussions. 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 HR 2834 will 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 three 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, our ability to take financial risk would shrink. Because we rely on the profits from our 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 we can remain in business if only 20 percent of our companies provide meaningful returns, we will 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 our investment decision-making, and 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 our 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 of us 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. 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…and I should point out that it is only reasonable to assume that states like Michigan, Pennsylvania, Florida and Ohio, with great young companies but few venture capitalists will be hit first and hardest.

Finally, and with an eye to our global competitiveness, the taxation of carried interest has an impact on the capital that is deployed by venture capital firms in the US, as young venture capitalists entering (or moving within) the industry might favor non-US firms if US tax laws become less accommodating. It is true that US tax rules might prevent US citizens from such a behavioral response. There are, however, many non-US venture capitalists who currently operate in the US, but who could easily move their activities back to their home countries. Many of those countries, like Israel, India and China, are actively pursuing venture capital activity through tax- and regulatory-friendly environments in order to compete with the US in the innovation- and knowledge-based economy. Similarly, firms with multi-national teams and multi-national strategies could shift more capital to their non-US activities. This global shift in venture investing is already happening. A significant number of successful, experienced American venture capitalists are shifting their focus to new funds in China and India where they are apprenticing new, local venture capitalists and forming companies and jobs. In 2006, US venture capitalists invested over $3.4 billion dollars in Asian companies, doubling the funds invested in 2004. The year 2007 is on track to surpass this number with ease. This movement overseas has happened over a very short period of time demonstrating that money and human capital does respond quickly to market incentives.

Conclusion

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 the current examination of the intersection of capital gains policy and partnership tax law, we urge you to recognize the immensely important and positive impact that our current tax treatment has had in promoting investment and economic growth. We also urge you to consider the potential harm HR 2834 could inflict on the fragile entrepreneurial ecosystem if applied to venture capital. By acknowledging that venture capital plays a special role in the US economy, you will be standing up for company creation, for new jobs, and for innovation. You will be standing up for your individual states where a successful venture backed company can create a thriving regional economy just as Dell did for Austin or Medtronic for Minneapolis. And you will be affirming that Congress understands that capital gains tax treatment for venture capital investment should continue because, as an asset class, we create long-term, measurable, risk-based, and undisputed value for the US economy.

I thank you for your time.