Innovation Coalition
U.S. House of Representatives, Committee on Ways and Means
Republican Tax Teams
October 15, 2024

The undersigned organizations representing the U.S. innovation ecosystem appreciate the Committee's leadership and the opportunity to submit comments to modernize the tax code to bolster innovation and broaden economic opportunity, while increasing U.S. growth and competitiveness.

The U.S. economy is the largest, most dynamic in the world because of the American entrepreneurial spirit and its power to drive economic growth, innovation, and opportunity.

Innovation, Job Creation and Economic Opportunity
Startups and growth businesses have long been the backbone of the American workforce. Research in recent years has demonstrated that new businesses are disproportionately responsible for the innovations that drive productivity growth and economic growth, and account for virtually all net new job creation. Thriving entrepreneurship, therefore, is the engine of economic prosperity and opportunity expansion.

Today's entrepreneurs are not just creating jobs, they are building the future—turning a concept into a company and solving global problems. Expanding access to capital for these entrepreneurs and businesses is critical. Too often startups and young businesses are unable to access bank lending, so must turn to alternative means such as raising equity capital — providing an investor an equity stake in the company in exchange for capital. This equity financing typically comes from friends and families, angel investors, and venture capital firms. The foundation of this financing model is what makes it unique and effective. Private capital and private markets provide long-term, risk-forward capital to startups and growing businesses. Building is hard and takes time. The result of this work, however, is undeniable: seven out of the ten most valuable companies were venture backed; 87% of the top ten companies by market capitalization have been created by VC-backed companies; 75% of the total market value comes from VC-backed companies.

Startups, growth businesses, and their investors drive job creation, economic growth, innovation, and U.S. competitiveness. The policy framework should support this engine. This is especially true of tax policy, which affects nearly every aspect of the economy. Driving a tax regime that maintains competitive tax rates for corporations, individuals, and pass-through entities while attracting capital to the U.S. and incentivizing investment will be critical. Beyond this, there are key pillars that would, if adopted, bolster the innovation ecosystem and expand the value of ownership.

Preserve and expand innovation ecosystem

Startups and growth businesses are a vital part of the American economy but depend heavily on investment capital to innovate, build a new workforce, and achieve meaningful growth. Founding, investing in, and working for a startup can be riskier by nature. In the earlier stages of a business, tax policy can be particularly impactful to affect critical decisions that would create more opportunities for companies to grow, attract resources, and boost productivity. The tax code should make it easier for growth businesses to access the financing they need to succeed in today's economy.

- *Expand QSBS treatment.*
  Congress enacted the qualified small business stock (QSBS) exclusion[1] (section 1202 of the Internal Revenue Code (IRC)) to spur job creation and incentivize long-term investment in startups and small businesses, which are inherently risky. This important bipartisan provision exempts most startup investors, employees, and founders from capital gains taxes when selling their equity if they have met certain conditions, including a five-year holding commitment. The QSBS incentive attracts essential capital formation from early-stage investors across the country that helps entrepreneurs pursue innovative ideas and companies that fuel continued economic growth.

  The QSBS exclusion is vital to the innovation economy and American competitiveness. We urge Congress to expand eligibility to more businesses, making it easier and cheaper for entrepreneurs to raise capital and provide more flexibility in financing options.

- *Preserve capital gains rate and carried interest tax treatment*.
  Long-term capital gains offer favorable tax treatment to investors that provide longer term capital (greater than one year). This capital spurs job creation, new businesses, economic growth—all of which are favorable policy outcomes. We encourage Congress to maintain this lever to incentivize asset investments with longer holding periods.

  Carried interest helps align the interests of investment fund managers with its investors—the pension funds, university endowments, and other investors—by tethering the majority of the fund manager's compensation to the fund's performance. When the investors in the fund benefit, the fund manager benefits. Fund managers are generally compensated in two ways: management fees and carried interest. While management fees are charged as a percentage of assets under management (AUM) (generally 2%), carried interest is the percentage of a private fund's investment profits a fund manager receives as compensation (generally 20%). Because these profits are a return on investment, they are taxed at a capital gains rate like other investments. Much like equity in a startup or other companies, carried interest is used to incentivize fund managers. This incentive is particularly critical for emerging fund managers, who have fewer assets under management and rely on carry and its tax treatment to continue to grow and invest in emerging founders. Efforts to eliminate or limit carried interest tax treatment would disproportionately impact those emerging fund managers who back early-stage businesses and provide them with long-term investment horizons.

- *Promote corporate investment in innovation*.
  Restoring 100% immediate expensing for research and development (R&D) costs and making bonus depreciation permanent will boost investments in innovation and give an edge to U.S. competitiveness. The ability to deduct R&D expenses has incentivized critical investments in the advancement of research and technology, which has led to

[1] QSBS coalition letter from the innovation ecosystem, submitted April 20, 2023.

countless scientific breakthroughs and accelerated decades of economic growth. The Tax Cuts and Jobs Act (TCJA) repealed the option to expense R&D under section 174 of the IRC in 2022 and required businesses to capitalize those costs—including software development costs—and amortize them over a period of five years for domestic research or 15 years for foreign research.

As a result, businesses that may have broken even or lost money are now facing significant tax bills because of the substantial and unexpected increase to their taxable income—including tax liability on federal grants awarded through Small Business Innovation Research and Small Business Technology Transfer programs. The consequence of this fiscal bias against R&D is not merely theoretical; it is having tangible, negative effects compared to the pre-TCJA policy. Since the amortization requirement took effect in 2022, R&D spending has experienced a sharp decline. While R&D spending grew at an average annual rate of 6.6% in the five years prior to the amortization requirement, it expanded less than 1% in the 12 months ending in March 2024. The nation's startups are hit disproportionately by this change, as they tend to invest heavily in developing, testing, and improving their new product or service. A significant and unexpected tax burden can be devastating for innovative but fragile new companies with small reserves to sustain a tax hike in the crucial early years.

We encourage[2] Congress to restore full R&D expensing under section 174 and make section 168(k) 100% bonus depreciation permanent, incentivizing businesses to invest in new technology, computer software, and machinery that help them to grow, hire, and expand.

- *Modernize net operating loss treatment to support startups*
  Calibrating treatment of net operating losses (NOLs) to reflect the unique nature of startups will spur investment and help startups grow. Building a business, bringing a product to market, and developing beneficial medical treatments all require investment. And that investment can incur losses that the tax code enables businesses to write down, as reflected in section 382 of the IRC, often referred to as NOLs. Policymakers appropriately sought to prevent loss trafficking where companies acquire failing firms with enormous losses for the sole purpose of using those losses to offset other income. Implementation of this policy has had unintended consequences that penalize startups. Startups and certain private companies that invest to build their businesses accrue NOLs, often still raising capital to continue to develop products and services and achieve growth. These ongoing investments can limit a startup's ability to use the NOLs as intended.

  We encourage Congress to modernize the NOL-related rules (sections 382 and 383) to better reflect the unique nature of startups by establishing a safe harbor for startups that are fundraising that would enable this category of businesses to maintain their NOL treatment during ongoing investment.

[2] R&D coalition letter from the innovation ecosystem, submitted January 11, 2024.

Expand value of ownership
Equity ownership drives performance, innovation, and economic opportunity. Our tax code should incentivize and enable more employee-owners to realize and optimize the full value of ownership. Employee equity helps companies attract and retain the best talent, creating a more engaged workforce that improves company performance. It also aligns interests around the long-term, innovative efforts that the most ambitious startups and small businesses undertake. Employee ownership enables the people building the company to participate in its profit. This can lead to uncapped upside that creates a sustainable asset for wealth creation. And when wages have not kept pace for all but the highest earners, this can help erode income inequality. Equity ownership is critical to employees, U.S. companies, and our communities. The tax code can help bolster it and make equity ownership meaningful.

- *Align taxation to time of sale*.
  Taxation on equity ownership should be aligned to the year that shares are sold. Tax on equity compensation is often applied to paper gains, not actual gains. Stock options such as non-qualified stock options are taxed the year the employee purchases the options, and illiquid equity ownership may be included in the alternative minimum tax calculation. This means the employee-owner often pays taxes before they sell any shares. Further, despite paying taxes on that share value, there is no guarantee the value will not fall in the future or that the employee will ever realize such gain. A critical roadblock to employee ownership has increasingly become a concern around the affordability of exercising these options. Whether making it more affordable for employees to purchase stock options, pay taxes upon equity grant, or exercise incentive stock options (ISOs) within the limited 90-day (or three-month) post-termination exercise period when an employee departs a company, improvements can be made to the tax code to better support equity holders by aligning the tax liability to the year equity shares are sold.

  We encourage Congress to shift the equity ownership tax burden to the year of sale to help employees realize the full value of their hard-earned equity. We also urge Congress to extend the duration in which former employees can exercise their options following their departure from an equity ownership company.

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The tax code can hinder growth or unlock it by driving investment to the innovation ecosystem and empowering those builders to further invest in their people, products, and the future. These principles and examples will be critical to driving American competitiveness and innovation. The list we have provided is not comprehensive, but it offers fundamental principles to inform your early deliberations on the future of U.S. tax policy.

We applaud your leadership and look forward to working together towards our common goal of creating innovation and economic growth for more Americans.

Sincerely,

Advanced Medical Technology Association (AdvaMed)
Angel Capital Association (ACA)
Carta
Center for American Entrepreneurship (CAE)
Engine
National Association of Venture Capital (NVCA)
Technology Councils of North America (TECNA)