Written Testimony to the
Joint Economic Committee of the U.S. Congress
by
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1. Introduction

Chairman Tiberi, Ranking Member Heinrich, members of the Joint Economic Committee, thank you for the invitation to provide testimony for this important hearing. My name is Falon Donohue, I am the CEO of VentureOhio - a non-profit organization dedicated to the growth and diversification of Ohio's statewide startup community.

I am speaking to you today on behalf of VentureOhio's membership - the entrepreneurs, innovators and investors who are creating high-paying jobs in the Midwest and changing the world we live in. And the topic of reviving entrepreneurship through tax reform is very important to the hearts and minds of the members of VentureOhio.

I am also speaking today on behalf of the larger group of Midwesterners who are most affected by the growth and development of our new tech-based economy. These are my fellow veterans seeking to transfer the technical skills acquired while serving their country into high paying jobs in their hometown. These are my young friends who want to build applications that will change the world at cool tech companies but don't want to leave their families for New York or California. Finally, these are the good people of Mansfield, Ohio, my hometown, and small towns across the Midwest who are seeking access to new technical jobs as they watch their current jobs become obsolete due to the rapid changing pace of technology.

2. Innovation Through Investment

The Midwest is in the midst of a renaissance. Abandoned warehouses in long-forgotten parts of town are being repurposed as tech incubators. Startup company successes are dominating the headlines of local newspapers while the community surrounds them and cheers for their success. Ohio's best and brightest are choosing to remain in the state and work at high-tech companies in lieu of leaving for the coasts.

These startup founders are choosing this path to create some of the most innovative and disruptive companies of our generation. In the coming decade, startups will create whole new industries that will impact millions of jobs across our country. From autonomous vehicles to artificial intelligence, the impact of these companies will be swift and complete.

3. Ohio Innovation and Investment

In Ohio, we have seen massive growth in our startup ecosystem and venture capital activity, reaching the highest point in our state's history in 2016. From our latest research released in *VentureOhio's 2017 VentureReport*, venture capital investments have increased 46% in Ohio since 2014. In 2016 alone, investors deployed $470 million into 210 Ohio startups and Ohio-based funds raised an additional $631 million in new funds, giving them the ability to deploy additional funds in the near future.

We have also seen the results of innovation and entrepreneurship through the acquisition of Ohio companies like CoverMyMeds, which was acquired last year by California-based McKesson for over $1 billion. As the largest technology acquisition in Ohio's history, this sale was a major milestone for the Ohio entrepreneurial community, setting the tone for what is to come.

Success stories like CoverMyMeds in Columbus or AssurexHealth in Mason, which was acquired in 2016, and many others each year demonstrate that it is an exciting time to create a startup in Ohio.

Startups are creating millions of new jobs, fueling research and development in the technologies of the future and continuing America's innovation dominance. Without them, we might have to imagine a world without social networks, streaming TV, or the on-demand delivery of nearly everything. But we might also have to imagine a world without life-saving drugs or the ability to more easily take drunk drivers off our roads. A future without startups would not likely include world-changing innovations like autonomous cars and artificial intelligence.

I speak with investors and entrepreneurs everyday who are taking massive risks to create jobs and grow our economy, and are very aware of the need to revamp our tax system. Our very complex system is forcing them to take their attention off of growing awesome businesses and instead worry about the tax environment in which they operate. Meanwhile, when the tax code targets high income people, it does so at the risk of funding venture backed companies, most of which operate at large losses during their most critical early years.

We believe the companies being created in Ohio today will be the next crop of the Apples, Googles, Airbnbs, and Facebooks. They will create millions of jobs and change a generation of families. This is the most exciting time Ohio entrepreneurship has seen in decades and I'm very pleased to be with you today to speak about the ways the tax code can help encourage future startups.

4. Regulatory and Tax Changes

In 1979, regulatory changes allowed pension funds to invest in VC, creating the modern venture capital industry as we know it today. According to a recent Stanford University study, 43% of the public companies founded between 1974 and 2015 were venture-backed. These companies represent 38% of the employees and 57% of the market cap of the "new" public companies.

While lower tax rates can have a great impact on small businesses, high-growth venture-backed companies, which often operate with negative income while they use investment capital to build new products and expand their workforces, do not benefit from these changes. Venture-backed companies and the investors that support them are in need of different types of regulatory and tax changes.

Among the proposals supported by VentureOhio are allowing startups to utilize the Research and Development Tax Credit, simplifying Qualified Small Business Stock Rules, passing the Empowering Employees Through Stock Ownership Act, maintaining Carried Interest Capital Gains, and maintaining the Capital Gains Rate Differential.

Specifically, VentureOhio agrees with the following recommendations[1] from the National Venture Capital Association (NVCA) which we believe will encourage new company formation:

Expanded Research and Development Tax Credit

While current law allows very early stage startups, less than five years old and with less than $5 million in annual sales, to use R&D credits to offset up to $250,000 in payroll tax obligations, we believe Congress should expand this credit to startups with less than $100 million in assets to be able to offset up to $1 million worth of payroll taxes with R&D credits.

While the creation of this provision as part of the PATH Act was a great start to encouraging the growth of innovative American companies, the size/age limit restrictions leave many startups unable to access the benefits of their R&D tax credits at a time when they are pouring considerable resources into R&D to build the enterprise. Increasing these limits will ensure startup companies can access the benefits of the R&D credit when they need it most.

Qualified Small Business Stock Rules Changes

The Qualified Small Business Stock (QSBS) rules contained in Section 1202 are an effective motivation for investments in early stage startups, especially in non-coastal ecosystems like Ohio that are home to funds with a higher percentage of taxable investors. Unfortunately, the significant complexity of the eligibility rules and a size limit that hasn't increased with inflation or economic realities have limited the ability of Section 1202 to bolster the entrepreneurial ecosystem as well as the policy goals envisioned by those who passed the law.

VentureOhio supports the ten reforms suggested by the National Venture Capital Association (NVCA) to Section 1202 to make the eligibility rules easier to understand and increase the gross asset limit (indexed for inflation).

[1] https://nvca.org/wp-content/uploads/2017/07/NVCA-Tax-Reform-Finance-Submission-07172017.pdf

VentureOhio believes that, if Congress makes the recommended reforms, Section 1202 could become one of the most powerful incentives for venture capital fund and entrepreneurial capital formation in non-coastal regions.

Passing the Empowering Employees Through Stock Ownership Act
VentureOhio supports the passage of the Empowering Employees Through Stock Ownership Act, which would allow startup employees to defer tax liability on income arising from exercised but illiquid stock options.

Stock options are a critical tool for attracting talented individuals to work at startups across the nation, including in Ohio. Employees are often compensated with stock options as a promise that if the startup succeeds, everybody shares in the gain.

In a state like Ohio, which has experienced a 46% increase in venture capital investments into our startups in the past 2 years alone, the importance of stock option incentives is reaching a critical state. As many startups opt to stay private longer rather than pursue an initial public offering (IPO), startup employees face significant burdens when their stock options vest without a liquid market to sell their shares in order to pay the taxes that are due.

Allowing an additional period of time for employees to defer taxes on exercised stock options is a common sense solution to this challenge that will encourage more talented Americans to help build today's startups into tomorrow's Fortune 500 success stories.

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Maintaining Carried Interest Capital Gains
While many different factors have converged over time to create America's leadership in innovation, significant credit is due to our long-standing tax policy that supports the spirit of entrepreneurship. One such policy is the capital gains treatment of carried interest received by venture capitalists.

Carried interest is the *primary* economic incentive for participation in venture capital. Venture capitalists create partnerships with institutional investors (e.g. pension funds, endowments, foundations) and individual investors. This partnership marries the talent, expertise, and personal capital of the venture capitalist with the capital of the institutional or individual investor to make risky, long-term equity investments into innovative startups. These are generally partnerships that last ten to fifteen years. Carried interest is the VC's share of gains (if there are any) from the partnership in accordance with the partnership agreement. Capital gains treatment of carried interest is an important feature of the tax code that properly aligns the long-term interests of investors and entrepreneurs to build great companies together since the creation of the modern venture capital industry. Venture capital activity is entirely consistent with the core concepts of a long-term capital gains tax rate. As such, partnership gains attributable to the general partners of a venture capital partnership should continue to be afforded capital gains treatment.

If one were 'white boarding' the best public policy solutions to encourage new company creation, they would be hard pressed to find a more perfect alignment of interests than the carried interest capital gains a venture capitalist receives from a successful startup investment. When a startup fails, the carried interest on a deal is zero. In fact, carried interest is only realized if one or more startups in a venture capital fund are so successful as to offset the inevitable failures in the fund. Carried interest tax policy is defined by a simple equation, which holds that no benefit is extended unless and until our country receives the benefit of greater economic activity through company and job creation. This policy has been critical to our country's economic success.

A tax increase on carried interest capital gains would have the most severe impact on the venture capital business model for several reasons, which include:

- Venture capital is the smallest asset class of investment partnerships and because management fees are a far less significant source of compensation for VCs, the potential for carried interest is far more critical, and in fact is the primary economic incentive for participation in venture capital.

- Venture capitalists hold assets for the longest, and therefore wait the longest to realize carried interest if their fund is successful. The *typical* VC partnership agreement runs a decade, with options for extensions for further years that are commonly exercised. The net result of a tax increase on carried interest capital gains would be a shift away from riskier investments with greater promise for breakthrough innovation and towards safer investment strategies that favor incremental progress. This is not what policymakers should be encouraging because our country needs bold investments by VCs into areas like new drug discovery, quantum computing, and energy solutions.

- A tax increase on carried interest earned by venture capitalists would have its most severe impact on new fund formation, particularly in underserved regions of the country. Setting aside California, Massachusetts, and New York, the median size venture capital fund in the remaining 47 states is about $15 million. The 2 percent management fee on a fund of that size means that, after fund expenses, there might be little or nothing remaining for general partner salaries. In these cases, carried interest capital gains can be the *sole* economic incentive for participation in venture capital.

In a state like Ohio, which saw more than $600 million in new funds raised last year, a tax increase on carried interest could be devastating for our recently burgeoning venture capital community. Rather than harm capital formation in places like Ohio, we encourage policymakers to embrace and support the entrepreneurial ecosystem that has developed in Ohio.

Maintaining the Capital Gains Rate Differential

U.S. capital gains tax policy has been critical to the success of the U.S. entrepreneurial ecosystem. Primarily, the policy has facilitated patient capital formation for high-risk enterprises and encouraged entrepreneurship.

A competitive capital gains tax rate with a meaningful differential from the top ordinary income tax rate is fundamental to fostering a climate where entrepreneurship and risk investment can continue to flourish. The business model of venture capital is to invest for longer periods (5-10 years on average) in risky companies with little track record but strong growth potential. The long-term and high-risk nature of venture capital make it particularly sensitive to tax policy.

Angel and venture capital are the only significant sources of patient capital available to startups and entrepreneurs. America is the global leader in innovation—a critical component in a globally competitive economy—in large part because of our entrepreneurial capital formation climate.

If venture capital isn't around to support an entrepreneurial ecosystem, no other investment class, nor government spending, can fill this gap.

6. Conclusion

Our society and the future of innovation in America depends on startups and entrepreneurs who take significant risks to start their companies. When startups succeed, they produce the most significant and generation-changing innovations that impact not just our nation but the world. I hope Congress continues to create and strengthen the policy environment to allow America's entrepreneurial ecosystem to thrive and have the greatest chances for success.