Venture Capital and Tax Policy

Background

Within the past year the world of private equity has become much more public. With buyout transactions becoming extremely sizable and involving public companies such as Chrysler, Dunkin Donuts, and Hertz, private equity firms have garnered the interest of the mainstream media. Coupled with the growing size and influence of another branch of private equity – hedge funds – this awareness led to an examination in Congress of partnership tax rules and how they apply to firms that make these investments. In turn, the tax writing committees in Congress began an examination of a host of tax policies, including whether or not the "carried interest" or profit from private equity investments is appropriately taxed on a flow-through basis, generally at the long-term capital gains rate, or should instead be taxed as ordinary income.

Although the media has focused on carried interest as a tax issue for the private equity or buyout community, ***carried interest is of equal concern to the venture capital community*** and its entrepreneurs because VC firms are also structured as partnerships and employ carried interest as a means to reward long term investors.

The Levin Bill:

On Friday, June 22, 2007, Rep. Levin introduced a bill that dramatically changes partnership tax rules – not just for private equity funds seeking to go public (the focus of the Baucus-Grassley bill) but for the entire community of private partnerships. The bill creates a new category of partnerships for partners "providing investment management services" and specifically prevents those partners from receiving capital gains treatment on income except in very limited circumstances. As the press release states, the bill is purposefully broad.

The bill defines investment management services as any interest in a partnership which is held by any person if such person provides (directly or indirectly), in the active conduct of a trade or business, a substantial quantity of certain services to the partnership. These services include (1) advising the partnership as to the value of any "specified asset," or the advisability of investing in, purchasing or selling any specified asset, (2) managing, acquiring or disposing of any specified asset, (3) arranging financing with respect to acquiring specified assets or (4) any activity in support of any of the preceding services.

Why the Venture Capital Community is Concerned:

NVCA and its members strongly disagree with the characterization of venture capital as an investment management service. ***Venture capital investment is by its nature a long-term, risky investment in entrepreneurs and their fledgling companies***. We believe that this is exactly the type of investment meant to be encouraged by long-term capital gains tax policy.

Venture capital is a fully engaged, long-term, risky investment.

- Venture capital (VC) funds are organized as partnerships to invest in early-stage, high-risk start-up companies, primarily in innovative industries such as information technology and life sciences.
- Venture capitalists become actively engaged in the management of the companies, taking a seat on the Board of Directors until the company goes public or is sold.
- A venture capital investment in a company lasts from 5-13 years; sometimes more, rarely less.
- Most VC-backed companies fail. Of approximately 2040 companies funded in 2001-02, 3 percent have gone public; 21 percent have been acquired; 76 percent have either failed or are still private. ***Venture capital is not designed to*** meet short term liquidity needs, invest in public markets, securities or derivatives, take short or long positions, or be accessible through brokers.

The Elements of Venture Capital Fund Formation

Teaming up & Taking Risks in Start-Ups: Although VCs invest significant portions of their personal wealth in start-up companies, the capital needed by the emerging growth sector far outpaces individual VCs' assets.

- Institutional investors, such as pension funds, universities, endowments, and foundations, provide between 95-99% of the capital invested in VC-backed companies. The VCs and institutions join together in a VC fund as general partner (GP) and limited partners (LPs), respectively.
- After the VC fund is formed, the VCs identify promising, innovative companies to invest in, and typically serve on the companies' Boards of Directors as active members.
- The VCs provide valuable counsel regarding strategies involving financing, sales and marketing, operations, intellectual property rights, recruiting, and liquidity.
- Ultimately, after many years, the VC-backed companies, ***if successful***, are taken public or are acquired, generating long-term capital gain. ***Carried interest is never generated for VCs if a company fails.***
- The VC industry focuses on high-risk technologies; thus many VC-backed companies fail. The cost of these failures must be balanced by the successes to support a portfolio of start-up companies.

Rewarding Entrepreneurial Risk: Consistent with historical partnership tax law, the VC fund structure encourages the pooling of labor and capital by allowing its partners to divide the profits from the enterprise, whether created by the VCs' services or the LPs' capital, to reward the entrepreneurial risk taken by each partner.

- Under well-established tenets of partnership tax law, the character of that income is determined by the activities of the partnership itself, as if each partner had engaged in that activity on its own.
- Because the primary economic benefit in a VC fund arises from the value created in a long-term investment, most of the VC fund's income is characterized as long-term capital gain.
- Congress, in an effort to stimulate and encourage the job creation and economic growth that results from long-term investment activity, has determined to tax those gains at a lower rate.

US Competitiveness and the Entrepreneurial Economy:

The pooling of labor and capital in the US venture capital community has provided the form and incentives to encourage entrepreneurial risk-taking, resulting in the formation of entire industries such as biotechnology, semiconductors, and computer software.

Venture capital promotes US economic growth.

- Venture capital investment of $ 28.6 billion only accounted for 0.2% of GDP in 2006.
- Companies that received venture capital between 1970 and 2006 accounted for 10.5 million US jobs and $2.3 trillion in revenues in 2006.
- Venture backed companies accounted for 17 percent of GDP and 9 percent of US private sector jobs in 2006.
- Venture-backed companies outperformed their non-venture counterparts in job creation and revenue growth from 2003 – 2006 in nearly every industry sector.

Summary

Funding the type of entrepreneurialism that has fueled US competitiveness requires more capital than is possible to pool among venture capitalists alone – which the Levin bill would require to maintain capital gains treatment of income. For example, developing a life saving drug can take $800 million to develop and over 15 years to win approval from the Food & Drug Administration. Clearly this is more than a limited team of venture capitalists could fund without the commitment of their institutional partners. It is also clearly a long-term investment, high risk investment – the very type of investment encouraged by capital gains tax treatment. The Levin bill, if applied to venture capital, would discourage the risk taking required to make these investments and fuel an economic engine that has served the US so well for so long.