ANGEL CAPITAL ASSOCIATION

October 18, 2021

The Honorable Richard Neal
Chairman, House Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Nancy Pelosi
Speaker
U.S. House of Representatives
Washington, D.C. 20515

Dear Speaker Pelosi and Chairman Neal:

As the leading professional association representing accredited investors and aligned advocates committed to advancing the start-up ecosystem, we are writing to you to ask that you remove provisions from the Build Back Better Act that would curtail the effectiveness of Qualified Small Business Stock (QSBS) in incentivizing investment in innovative small businesses and startups.

The Angel Capital Association represents more than 14,000 accredited investors who invest their own money in early-stage start-up companies. Our members are traditionally the first source of early-stage funding for nascent companies, and our resources help successful entrepreneurs and their ideas grow their businesses into some of the leading companies of today.

Startups are at the heart of the American economy, driving the majority of all new job creation, innovation, and opportunity for their employees.[1] As the United States seeks to build a broad-based economic recovery that expands opportunity to more people, our country's tax regime should advance that goal.

The Qualified Small Business Stock rule has proven effective in promoting investment in startups and early-stage growth companies in regions and communities across the country. QSBS limits capital gains taxes for founders, employees, and investors in qualified small businesses. The QSBS exclusion encourages investment at the earliest stage of a company's life cycle. It enables employee-owners who take higher risks to join an early-stage company to receive returns commensurate with that investment of time, expertise, and hard work. This is why bipartisan policymakers have supported this provision over the years.

Developing and investing in startups and early-stage growth companies carry substantially more risk than investing in more mature companies. These companies fail at higher rates, and even those that succeed do not provide employee-owners and inventors substantive access to liquidity, meaning that any investment of time, resources, or capital must be for the long-term. The QSBS framework incentivizes that long-term investment and employee retention in startups and early-stage companies. Recent data indicates that QSBS shares are present in over 50 percent of seed-stage and Series A deals.[2]

Angel investors are dedicated investors who want to put their own money to work to effect change in their local community and in industries where they bring substantial knowledge and contacts. Their resources cannot be easily replaced by Institutional investors such as pension funds, endowments, or foundations. These institutions are often too large to devote capital to small companies in rural and underserved communities. Early-stage technology companies are also too risky for debt financing. This means that taxable investors are central to any effort to increase economic opportunity through the growth of nascent companies.

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[1] U.S. Congressional Research Service: Small Business Administration and Job Creation (R41523; updated June 23, 2021), by Roger Jay Dilger. https://sgp.fas.org/crs/misc/R41523.pdf
[2] Harvey, Chris. "Top 3 Mistakes VCs Make with QSBS." Aumni. May 6, 2021. https://www.aumni.fund/blog/top-3-mistakes-vcs-make-with-qsbs

The Ways and Means Committee recently approved a provision curtailing the QSBS exclusion as part of the Build Back Better Act, and applied the tax change to sales of stock, rather than to new investments. This change would not only diminish the incentives that successfully bolster small businesses and their employees, but would also punish taxpayers who invested in or earned QSBS shares years ago by changing the treatment for existing shares and imposing a tax on them. Employee-owners, founders, and investors made economic decisions in the past based on the QSBS construct, which was supported on a bipartisan basis. This policy would change the rules on them after they followed the rules applicable at the time and held up their end of the bargain.

The proposed change would include an arbitrary income threshold to determine a taxpayer's eligibility, further complicating the purpose of the incentives. Given the long holding periods, this change would mean that employees receiving QSBS in year 1 cannot know whether their future personal circumstances will preclude them from realizing the full benefit of section 1202 at the time of stock sale. This uncertainty means that the section 1202 capital gains exclusion will no longer be a robust inducement for joining a startup over an established company. Thus, if this provision is enacted, section 1202 will lose much of its intended value to help attract employees to small startups.

Similarly, investors abhor uncertainty, and uncertainty about whether the full benefit of section 1202 capital gains exclusion will be available to them at the time of exit from an investment will substantially diminish the effectiveness of section 1202 in attracting capital as well. As a result, this proposal will have the effect of substantially reducing, if not eliminating, the effectiveness of a longstanding provision of the tax code to drive capital to small businesses and startups.

Finally, it is important to measure the ramifications of such a change against the revenue Congress is seeking to raise with the provision. The Joint Committee on Taxation's own estimate is that the tax revenue gained by this change to QSBS will generate only approximately $570 million in additional tax revenue per year. In addition to the negative impact on the small business ecosystem, this fails to consider the risk of losing investment in many early-stage companies and the potential tax revenue those businesses can generate.

We appreciate the objectives of the Build Back Better Act and policymakers' desire to expand economic opportunity and accelerate domestic innovation. Small businesses and startups are essential economic engines to realize that vision. We encourage House Members to preserve the current treatment and the related positive impacts on the startup ecosystem, the employee base, and the broader economy.

Thank you for your consideration.

Sincerely,

Marcia Dawood
Chairman, ACA

Pat Gouhin
Chief Executive Officer, ACA