

UNITED STATES SENATE
COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

**SMALL BUSINESS TAX ROUNDTABLE: SMALL BUSINESS TAX REFORM –
MAKING THE TAX CODE WORK FOR ENTREPRENEURS AND STARTUPS**

INTRODUCTORY STATEMENT
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Chairman Landrieu, Ranking Member Risch and members of the committee, thank you for inviting the Angel Capital Association today.

My name is Mike Eckert. I am Vice Chair of the Angel Capital Association, the world's largest professional organization of accredited angel investors. ACA includes more than 200 angel groups and their 10,000 individual members. I participate with angel groups in New Orleans and Atlanta.

ACA has championed the existing 100% exclusion of capital gains in qualifying small businesses—currently scheduled to sunset at year-end. The loss of this exemption would deal a heavy blow to the innovation economy. Incentives are essential to encourage private citizens to continue investing their capital, at high risk.

Angels Fund Majority of Early Stage Deals and are in Every State

Angel investors are the *only* source of capital for most startups, and supply as much as 90% of outside equity they raise. In 2012, angels invested \$23 billion in 67,000 early-stage companies. Federal Census data show that startups create *all* net new jobs. **Without angel funding, these businesses would never get off the ground.**

Angels Take Risk – and Plow Returns Back In

Angel investing also provides a “multiplier effect” to the economy. When our companies succeed, we plow our own returns back into the field. This creates even more jobs and results in a stronger, more stable tax base – a virtuous cycle.

Tax Recommendations to Ensure Continued Angel Investment

ACA believes it is essential to maintain federal tax incentives to support this high-risk investment class. The job growth and innovation that result *far* outweigh the small sliver of tax revenue that might otherwise occur.

Today, we are at a critical juncture. With new SEC rules passed last week allowing general solicitation by startups, accredited investors will already have to go through many more hoops to establish their qualifications, likely reducing investment.

ACA believes that removing existing tax incentives could result in thousands of angels backing away. Startups would have less capital, and could lose much of the invaluable advisory support angels provide.

ACA's top priority is to see this exemption made permanent. Certainty is critical. We also believe the five-year holding period is too long, and advocate lowering it to two years. Also, the exemption only applies to "C" corporations, and we recommend extending it to limited liability companies (LLCs) – a common seed-stage structure.

We also believe much can be learned from state tax credit policies that have led to large increases in startup investment.

I look forward to this roundtable and discussion. Thank you.

SUPPLEMENTAL INFORMATION FROM THE ANGEL CAPITAL ASSOCIATION

National Angel Investing Landscape

Angel investors are high-net-worth individuals as defined by the Securities and Exchange Commission, who provide money for start-up firms with growth potential. Many angels started, built and sold their own companies and are now in a position to invest their money and equally important, their time, in new or early stage businesses.

The nation's leading expert on entrepreneurship, the Ewing Marion Kauffman Foundation, estimates that angel investors may be responsible for up to 90% of the outside equity raised by start-ups after the capital resources of their founders, friends, and family are exhausted. These firms rarely have the collateral to receive bank loans and they are generally too small and too young to receive venture capital.

The University of New Hampshire's Center for Venture Research estimates that angels invested \$22.9 billion in about 67,000 companies in 2012. One of the trends in the field over the last decade is the growth of angel groups, in which investors join together to invest in and mentor companies, pooling their capital to make larger investments and developing best practices for investing and mentoring. ACA estimates there are more than 375 angel groups, located in every state, more than a three-fold increase from about 100 groups ten years ago.

The HALO Report, the leading assessment of angel investing nationwide, describes the investments angel groups made in 2012:

- Median round size of \$600,000
- 70% of investments were in healthcare/life sciences and Internet/IT sectors
- Two-thirds of the investment rounds were syndicated, often with multiple angel groups
- Investments were distributed broadly across the country – two-thirds of the deals were outside of traditional startup equity centers of California and Boston.

Angel investors are proud to be an important resource for the startup companies that have created the large majority of net new jobs in the United States over a 25 year period. Angel-backed companies have been some of the most prolific job creators and innovators in recent times: Google, Facebook, and Starbucks are just a few examples.

Thousands more companies supported by angel groups and individual angels are less known, but significant in the innovative products and jobs they have created.

For example, the South Coast Angel Fund in New Orleans, which has 46 members from throughout Louisiana, has invested in technology, life sciences, and other sectors in companies including:

- Omnicademy, a social networking platform that enables universities and colleges to syndicate their courses
- Bascom-Hunter, which produces hardware and software for the armed services and homeland security

- Camgian Microsystems, which specializes in IT solutions, from power processors to advanced sensing platforms

Angel investors provide seed-stage equity at a rate that is 20 times the number of companies financed by venture capital. In 2012, angels invested \$23 billion dollars in 67,000 early-stage companies, while venture capital in total put a few billion into less than 1,800 startups, plus another \$20 billion in about 2,000 later stage companies. According to Census Bureau Business Dynamics' data, startups comprise less than one percent of all companies, but generate 10% of all new jobs in any given year. Without angel funding, these fledgling businesses would simply never get off the ground.

Risk and Angel Investment

Returns to Angel Investors in Groups, the first ever dataset and analysis of angel group returns, confirmed what many investors thought about their success:

- 52% of all exit returns less than the capital the angel had invested in the venture (with 35% of all exits losing all of the money invested)
- 7% of the exits achieved returns of more than ten times the money invested, accounting for 75% of the total investment dollar returns
- 31% of the exits returned the investment between 1 and 5 times the investment.

The study, which looked at 1,137 exits from angel investors connected to angel groups in many areas of the United States, also provided data to support that best practices in angel investment lead to better results for investors and the entrepreneurs they invest in. This includes matching investor expertise with the company, conducting a good level of mentoring and monitoring of company progress, and conducting due diligence in reviewing investment opportunities.

It is conventional wisdom that small business is responsible for the majority of net new job creation in the country in any given year. A growing body of focused research, using the Census Bureau's *Business Dynamics Statistics* database, dramatically illustrates that it is a smaller subset of dynamic, high-growth startups that make up the vast majority of that job growth

- According to a Kauffman Foundation study, these so-called "gazelle" firms (ages three to five years) comprise less than 1% of all companies, yet generate 10% of all new jobs in any given year.
- A similar study from the National Bureau of Economic Research using the same database, found that, after controlling for age of a small business, startups account for almost 20% of gross job creation in any given year.

These are exactly the businesses that angel investors – and mostly only angel investors -- invest in. The true shift in job creation has moved away from publicly-traded companies to the realm of startups that are funded almost entirely by private capital.

State Tax Policies Catalyze Investment in Startups

Many states provide tax credits which vary according to the state, but are aimed at increasing investment appetite in startups. Senator Mark Pryor (D-AR) introduced S. 256, the American Opportunity Act of 2011 in the last Congress. This bill would provide a 25% tax credit for qualified angel investment.

Well-designed tax credits in many states have already led to increased angel investment and impact:

- Wisconsin – tax credits have increased angel network investment by more than 30 times, from \$1.7 million in 2004 to \$59 million in 2011
- Ohio – tax credits of \$28.5 million have generated \$109.8 million in private investment, a 4:1 leverage
- Kansas – in 2010, \$5.7 million in tax credits created or saved 238 jobs and an annual payroll of \$36.6 million

Sources

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