Encouraging Innovation and Job Creation by Supporting Start-ups, Entrepreneurs, and Innovative Small Businesses

The Angel Capital Association (ACA), the National Venture Capital Association (NVCA), the Biotechnology Innovation Organization (BIO), and the Advanced Medical Technology Association (AdvaMed) represent key players in the start-up economy. Our members invest in and conduct early-stage research in an effort to bring to market new technologies that will save and improve lives, and these new ventures also represent the most jobs created in our economy.

The R&D undertaken by start-ups and small businesses can take decades to result in a new medical device, clean energy breakthrough, advanced computer chip, or novel medicine. Due to this extended development period, significant investment is required to form a company around an entrepreneur’s idea and then fund that company’s life-changing research. Our organizations are dedicated to creating a policy environment that incentivizes early-stage investment and supports the growth of start-ups and small business innovators. In particular, we believe that federal tax policy can play a significant role in driving innovation capital to growth-stage businesses and supporting the years of R&D necessary to bring new technologies to market.

The Tax Cuts and Jobs Act provided for a significant reduction in the corporate tax rate, which will benefit companies across the U.S. economy, including in innovation industries. The bill also retained the R&D credit, an important incentive for research-driven companies seeking solutions to some of the most challenging issues we face, including cures for cancer and other diseases, technological innovation, cybersecurity, and energy. However, we encourage Congress to directly support the growth of entrepreneurial start-ups.

These small businesses – most of which are pre-revenue, and thus see limited impact from lower tax rates or incentives designed for tax-paying companies – form the heart of the innovation economy, supporting high-paying jobs in all 50 states and conducting the early-stage research vital to 21st century technological advancements. Studies have shown that almost all net new job creation has come from the growth of young companies and that technology-based start-ups continue to make an outsized contribution to the economy once they reach maturity. For example, firms in technology-based industries account for 70% of all business R&D investment, 59% of R&D jobs, and 27% of U.S. exports – despite making up just under 4% of all U.S. businesses.

It is therefore imperative that Congress work to craft policies that will bolster the creation and growth of high-tech, R&D-intensive firms. Our plan does not call for new tax incentives. Rather, we support the following proposals to encourage start-up investment and innovation by making targeted improvements to the existing tax code.
**Section 382 Safe Harbor**

To prevent companies from buying loss companies just to take advantage of the tax benefits, Section 382 limits the use of the company’s net operating losses (NOLs) after certain “ownership changes.” An unintended consequence of these otherwise-appropriate loss trafficking rules is that they inhibit equity investment in start-ups.

- A safe harbor for start-ups can help incentivize investment in innovative new companies without undermining the purpose of the loss trafficking rules:
  - Applies only to companies less than 12 years old
  - Exempts capital contributions from ownership change calculation
  - In the event of an ownership change:
    - NOLs attributable to R&D expenses preserved in full (excess credits under Section 383 attributable to R&D are also preserved)
    - More robust formula for calculation of NOL limitations
- To prevent abuse, companies in the safe harbor would be subject to existing continuity of business enterprise requirements

**Section 1202 QSBS Reforms**

Under Section 1202, gain from the sale of Qualified Small Business Stock (QSBS) is exempt from tax. This investor incentive was made permanent in the Protecting Americans from Tax Hikes (PATH) Act in 2015 and retained in tax reform. The QSBS provision has the potential to be a highly successful tool for driving investment in innovation; the following suggested fixes could make it even stronger:

- Raise the maximum gross assets threshold for QSBs from $50 million to $100 million
- Provide greater certainty for investors by requiring qualified small businesses (QSB) to report their status to investors and the IRS
- Clarify and simplify the test that “substantially all” of the QSB’s assets are invested in the business during the investor’s five-year holding period
- Allow investors to count up to four years of the time they held LLC interests for purposes of the five-year holding period
- Increase the time to rollover gains in QSBS to 180 days or the end of the investor’s tax year
- Shorten the ban on redemptions from 4 years to 2 years

**Section 41 Payroll R&D Credit**

The Payroll R&D Credit, a new incentive in the PATH Act, allows young companies that are not yet generating income to instead receive an R&D credit against their payroll taxes. Unfortunately, the new credit is too narrowly drawn, undermining the provision’s intent.

- Expanding the credit will help more companies take advantage of it, unleashing the wave of innovation the PATH Act intended:
  - Expand eligibility to companies with up to $100 million in gross assets
  - Allow credit to offset up to $1 million of employer-side payroll taxes
Section 382 NOL Safe Harbor

Tax rules relating to the treatment of losses can unintentionally punish start-ups for investing in the growth of their companies. The rules, in Section 382 of the tax code, were written in the mid-1980s with the intent of preventing loss trafficking, or the strategy of companies acquiring failing firms with enormous losses on their books for the sole purpose of using the tax losses to offset other unrelated income. While we recognize the importance of preventing abusive loss trafficking, the excessive application of these rules has created an impediment for start-ups which depend on investment capital and often accumulate net operating losses (NOLs) as a result of substantial R&D expenditures and rapid hiring. Under Section 382, accepting these critical equity investments can limit a start-up’s ability to utilize its NOLs in the future. Thus, Section 382 discourages investment in innovation and works at cross purposes with tax policy that generally seeks to encourage R&D, such as the R&D credit.

Congress can foster economic growth and job creation without creating a new tax expenditure, simply by modernizing the rules in the code to stop penalizing start-ups for investing in job creation and innovation. Congress should create a safe harbor from Section 382 NOL limitations (and related Section 383 credit limitations) for start-ups going through viable fundraising rounds and ownership changes.

We support the following safe harbor proposal that would apply to companies less than 12 years old:

• Exempt capital contributions to the company from ownership change calculations. Under Section 382, an ownership change triggers limitations on future use of NOLs. The safe harbor would allow capital contributed to the company from a fundraising round to be disregarded for purposes of determining an ownership change under Section 382.

• Exempt R&D expenses (defined as Section 174 expenses) from limitation, preserving the start-up’s ability to use its full NOLs generated from R&D expenditures.

• Exempt R&D credits from limitations under Section 383.

• Provide a more robust limitation calculation for all other accumulated NOLs by allowing an additional 5 percentage points to be added to the long-term tax-exempt rate (currently around 2%).
  o The current limitation is determined by multiplying the fair market value of the company by the long-term tax-exempt rate. This equation creates the ceiling for the amount of NOLs that can offset income per year going forward. The lower the long-term rate, the more severe the limitation will be.
  o For instance, a company that sells at a $50M valuation could see their allowance triple from an annual limitation of $1.25M to $0.375M.

• Retain anti-abuse protections. The special rules for qualified new loss corporations would not apply to loss corporations that do not comply with the existing continuity of business enterprise test in Section 382.

With this effective and tailored safe harbor, the loss limitation rules should still be able to accomplish the objective of preventing tax abuse but avoid the unintended consequences of discouraging investment in innovation and job creation.
Section 1202 QSBS Reforms

Because start-ups take investment capital to build a novel product and hire out a new workforce, they are generally not yet profitable. While they start small, their goal is significant growth – though the possibility of failure, given the intricacies of advanced science and groundbreaking innovation, is ever-present. Because this type of investment is high-risk and long-term, the economics must work for people to invest in start-up and early-stage innovators. Without a tax structure that encourages this activity, our innovators and entrepreneurs will be placed at a disadvantage at a time when the rest of the world is doing everything it can to compete with our leadership.

First and foremost, we believe that maintaining the permanent 100% exemption of gains on investments in Qualified Small Business Stock under IRC Section 1202, passed under the Protecting Americans from Tax Hikes (PATH) Act of 2015, is vital to encourage the early-stage investment necessary to spur groundbreaking innovation. We applaud lawmakers for retaining this incentive in tax reform.

This exclusion makes a real difference in investing in start-ups – and because many individual angel investors tend to re-invest their gains back in additional new companies, it leads to more capital for more start-ups. Now that the 100% exclusion has been made permanent, Section 1202 has the potential to be one of the most powerful federal policies for encouraging an expansion of entrepreneurship across the country. The fact is that many growing companies in the middle of the country – outside of coastal VC hubs – are simply too small for significant traditional institutional investment, so tax incentives like Section 1202 can drive local investors to these start-ups. QSBS is a powerful policy to encourage individuals in these communities to invest in their local entrepreneurs. In fact, we believe that Congress should build on this success by simplifying and expanding QSBS so it can encourage more investment in start-ups across the country.

Changes that would make 1202 more efficient include:

- **Raise the maximum gross assets threshold for QSBs.** The existing gross assets test in Section 1202 limits the universe of QSBs to companies with gross assets below $50 million. The high costs of innovative research, coupled with valuable intellectual property and successive rounds of financing, often push growing innovators over the $50 million gross assets limit and thus out of the QSB definition. Raising the gross assets threshold to $100 million, and indexing the threshold to inflation, would drive investment to capital-intensive small businesses conducting groundbreaking research and creating high-quality jobs across the country.

- Because QSBs must meet certain financial and operational requirements, we believe Congress should **direct the IRS to adopt reporting obligations for companies that make it clear to the investor whether the company is a QSB.** These can take the form of check the box certification on annual or quarterly corporate tax filings similar to REIT certifications. This would also allow Congress and the IRS to track data about the use and benefits of Section 1202 and assure investors of their ability to appropriately utilize the exemption.

- Related to the reporting recommendation, we believe the **requirement that a QSB adhere to the 80 percent value test for “substantially all” of the shareholder holding period should be updated to an annual test of quarterly averages for each year of an investor’s required holding**
period. Currently, there is no guidance on what “substantially all” means. This proposal would simplify and clarify the requirement. In addition, the 80 percent test should be revised to apply only during the required holding period. Once the holding period is met, the policy objective of encouraging investment into early stage companies is achieved and the testing for that investment should no longer be required, regardless of how long the investor holds the stock after the requisite holding period is achieved.

- **Allow investors to count up to four years of the time they held LLC interests which are then converted into C Corporations into the five-year holding period.** Many early-stage companies are started as LLCs and then later converted to C Corporations when they want to attract VC or other institutional capital. Allowing investors to count the time during which they held LLC interest (provided they otherwise satisfy the QSB requirements) to meet the five-year hold period is consistent with the policy objective to encourage investments in early stage businesses.

- **Increase the time to rollover gains in QSBS.** Currently Section 1045 allows taxpayers to rollover their gain from the sale of QSBS if the holding period has not been achieved, but Section 1045 only allows 60 days for the rollover to occur. This is an artificial and unrealistically short time frame; it not only limits investors’ ability to avail themselves of the benefit, but it also deprives other QSBs of a prime source of potential growth capital. To fulfill the policy objective of Section 1045, we recommend revising the rollover period to the later of 180 days or the end of the investor’s tax year in which the sale occurred. This allows for more reasonable amount of time to seek a suitable rollover investment using good start-up investment practices and provides for flexibility within a tax year thus reducing the need to amend or modify a prior return.

- **Shorten the ban on redemptions from 4 years to 2 years.** A common complication of a start-up’s QSBS eligibility is caused by the excessive length of the ban on redemptions. The four-year limitation can inadvertently trip up many growth companies, thus triggering uncertainty about the viability of the benefits of QSBS. A two-year ban would still provide a safeguard against abuse in a more reasonable timeframe.
Section 41 Payroll R&D Credit

We strongly supported the PATH Act’s reform to the R&D credit that allowed pre-revenue innovators to take a portion of their R&D credit against their payroll tax obligation, an important recognition that income tax credits do not yet benefit pre-revenue companies.

Under current law, companies in their first five years of operation with less than $5 million in annual gross receipts can utilize up to $250,000 in R&D credits annually under the PATH Act reforms. While we believe this change was an important first step, we also support expanding this provision to encompass a wider, more representative universe of start-ups and emerging innovators. Given the long development timelines of groundbreaking innovation and the high costs of breakthrough research, targeted expansions to the payroll credit would ensure that innovative pre-revenue companies can take full advantage of this new incentive.

Specifically, we propose that start-ups with less than $100 million in gross assets be able to offset up to $1 million in employer-side payroll taxes annually with R&D credits. The $100 million gross assets test would bring the definition of “qualified small business” under the payroll R&D credit in line with the same definition under Section 1202’s QSBS capital gains exclusion (taking into account our proposed increase of the existing gross assets test from $50 million to $100 million).

Congress made a great start in encouraging the growth of more innovative American companies when the payroll R&D credit was created as part of the PATH Act. But the size restrictions associated with the provision leave many start-ups unable to access the benefits of the payroll R&D credit. A typical start-up will still be quite early in the process of development when the size/age limits eliminate their ability to benefit from the payroll R&D credit. (Meanwhile, their pre-revenue nature prevents them from taking advantage of the traditional R&D credit). This creates a strange dichotomy where start-up companies cannot access the benefits of the R&D credit when they need it the most.

As global competition for innovative entrepreneurship continues to increase, a number of other countries, including Canada, Spain, France, and Britain, have created various forms of a refundable R&D credit. We believe that our proposed improvements to the payroll R&D credit will provide a fair and material benefit for American entrepreneurs and represent a strong step forward in shoring up our start-up leadership on the world stage.