Written Statement for the Record
U.S. House of Representatives, Committee on Ways and Means
April 11, 2024 - Hearing on: Expanding on the Success of the 2017 Tax Relief to Help Hardworking Americans

Introduction

The undersigned organizations representing the U.S. innovation ecosystem appreciate the opportunity to submit comments regarding the impact of the Tax Cuts and Jobs Act (TCJA) of 2017 on the innovation economy, in response to the April 11, 2024, hearing held by the U.S. House Committee on Ways and Means.

The U.S. economy is the largest, most innovative, and dynamic in the world because of the American entrepreneurial spirit and its power to drive economic growth, innovation, and opportunity. Tax policy affects nearly every aspect of the innovation ecosystem. As Congress prepares to engage on tax reform, we encourage you to bolster and expand tax incentives that promote equity ownership and drive investment to the startup and small business ecosystem. Critical to this will be driving a tax regime that maintains competitive tax rates for corporations, individuals, and pass-through entities, attracting capital to the U.S. and incentivizing investment. Beyond this, however, there are key pillars that would contribute to fostering growth: preserve and expand the innovation ecosystem; expand the value of ownership; and modernize the Internal Revenue Service (IRS).

Preserve and expand innovation ecosystem

Start-ups and small businesses are a vital part of the American economy but they depend significantly on investment capital to innovate, build a new workforce, and achieve meaningful growth. Founding, investing in, and working for a startup can be riskier by nature. In the earlier stages of a business, tax policy can be particularly impactful to affect critical decisions that would create more opportunities for companies to grow, attract resources, and boost productivity. The tax code should make it easier for small businesses to access the financing they need to succeed in today’s economy.

- *Preserve and expand QSBS treatment.*
  Congress enacted the qualified small business stock (QSBS) exclusion[1] (section 1202 of the Internal Revenue Code) to spur job creation and incentivize long-term investment in startups and small businesses, which are inherently risky. This important bipartisan provision exempts most startup investors, employees, and founders from paying capital gains taxes when selling their equity if they have met certain conditions, including a five-year holding commitment. The QSBS incentive attracts essential capital formation from early-stage investors across the country that is vital to help entrepreneurs pursue innovative ideas and companies that will fuel continued economic growth.

  Recently, policymakers have proposed rolling back the QSBS exclusion to raise revenue. The QSBS exclusion is vital to the innovation economy and American competitiveness. We urge Congress to maintain this important provision and expand eligibility to more businesses, making it easier and cheaper for entrepreneurs to raise capital and provide more flexibility in financing options.

[1] QSBS coalition letter from the innovation ecosystem, submitted April 20, 2023.

- *Preserve capital gains rate and carried interest tax treatment*.
  Long-term capital gains offer favorable tax treatment to investors that provide an extended period (greater than one year) of investment in an asset. This capital spurs job creation, new businesses, economic growth—all of which are favorable policy outcomes. We encourage Congress to maintain this lever to incentivize asset investments with longer holding periods.

  Carried interest helps align the interests of investment fund managers with investors by allowing the fund manager to share in the fund's profits. Fund managers are generally compensated in two ways: management fees and carried interest. While management fees are charged as a percentage of assets under management (AUM) (generally 2%), carried interest is the percentage of a private fund's investment profits a fund manager receives as compensation (generally 20%). Because these profits are a return on investment, they are taxed at a capital gains rate like other investments. Much like equity in a startup or other companies, carried interest is used to incentivize fund managers. This incentive is particularly critical for emerging fund managers, who have less assets under management and rely on carry to continue to grow and invest in emerging founders. Efforts to eliminate or limit carried interest tax treatment would disproportionately impact those emerging fund managers who back early-stage businesses and provide them with long-term investment horizons.

- *Promote corporate investment in innovation*.
  Restoring 100% immediate expensing for research and development (R&D) costs and making bonus depreciation permanent will boost investments in innovation and give an edge to U.S. competitiveness. The ability to deduct R&D expenses has incentivized critical investments in the advancement of research and technology, which has led to countless scientific breakthroughs and accelerated decades of economic growth. The TCJA repealed the option to expense R&D under section 174 of the Internal Revenue Code (IRC) in 2022 and required businesses to capitalize those costs—including software development costs— and amortize them over a period of five years for domestic research or 15 years for foreign research.

  As a result, businesses that may have broken even or lost money are now facing significant tax bills because of the substantial and unexpected increase to their taxable income. The nation's startups are hit disproportionately by this change, as they tend to invest heavily in developing, testing, and improving their new product or service. A significant and unexpected tax burden can be devastating for innovative but fragile new companies with small reserves to sustain a tax hike in the crucial early years. We encourage[2] Congress to restore full R&D expensing under section 174 and make 100% bonus depreciation permanent, incentivizing businesses to invest in new technology, computer software, and machinery that allow them to grow, hire, and expand.

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[2] R&D coalition letter from the innovation ecosystem, submitted January 11, 2024.

Expand value of ownership

Equity ownership drives performance, innovation, and economic opportunity. Our tax code should incentivize it and enable more employee owners to realize and optimize the full value of ownership. Employee equity helps companies attract and retain the best talent, creating a more engaged workforce that improves company performance. It also aligns interests around the long-term, innovative efforts that the most ambitious startups and small businesses undertake. Employee ownership enables the people helping build the company to participate in its profit. This can lead to uncapped upside that creates a sustainable asset for wealth creation. And when wages have not kept pace for all but the highest earners, this can help erode income inequality. Equity ownership is critical to employees, U.S. companies, and our communities. The tax code can help bolster it and make that ownership meaningful.

- *Align taxation to time of sale*.
  Taxation on equity ownership should be aligned to the year that shares are sold. Tax on equity compensation is largely applied to paper gains, not actual gains. Stock options are taxed the year the employee purchases the option; equity grants are taxed when they vest. This means the employee-owner often pays taxes before they sell any shares. Further, despite paying taxes on that share value, there is no guarantee the value will not fall in the future or that the employee will ever realize such gain. The critical roadblock to employee ownership has increasingly become a concern around the affordability of exercising these options. Whether it is making it more affordable for employees to purchase stock options, pay taxes upon equity grant, or exercise Incentive Stock Options (ISOs) within the limited 90-day (or three-month) post-termination exercise period when an employee departs a company—improvements can be made to the tax code to better support equity holders by aligning the tax liability to the year equity shares are sold.

  We encourage Congress to shift the equity ownership tax burden to the year of sale to help employees realize the full value of their hard-earned equity, and we also urge Congress to extend the duration in which former employees can exercise their options following their departure from a company.

- *Make 83(b) elections electronic*.
  Section 83(b) elections enable founders, employees, and other service providers who are granted compensatory equity (or other property), subject to vesting, to be taxed on the value of such equity on the grant date on which the equity is acquired rather than a later date when the equity vests or becomes transferable. Making a timely election can have a substantial impact on tax liability and planning for new business owners and employee-owners. Although the IRS has made improvements[3] enabling electronic signature, this highly manual process continues to create hurdles for timely filing within the short 30-day window and uncertainty around the filing status. We encourage Congress to require the IRS to provide e-filing of section 83(b) elections to ease the burden of taxpayer

[3] IRS comment letter: "Request to Make Electronic Signatures Permanent and Allow E-Filing for Section 83(b) Elections," submitted February 10, 2023.

compliance because the current paper filing process is inefficient, labor intensive, and costly.

Modernize the IRS
While the tax system has increased in complexity, and technology has become more integrated into taxpayers' lives and business operations, the IRS infrastructure has not kept pace. This has adversely impacted taxpayers, created delays, led to uncertainty, and shaped how taxpayers engage the IRS. We encourage Congress to continue to push the IRS to execute on its modernization plan. Doing so will modernize the IRS's systems and technology to improve customer experience, streamline and lower the administrative burdens on startups, small businesses, and employees, and provide greater clarity to all taxpayers.

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The tax code can hinder growth or unlock it by driving investment to the innovation ecosystem, and empowering those builders to further invest in their people, products, and the future. These principles and examples will be critical to driving American competitiveness and innovation. The list we have provided is not comprehensive, but it offers fundamental principles to inform your early deliberations on the future of U.S. tax policy.

We applaud your leadership and look forward to working together towards our common goal of creating innovation and economic growth for more Americans.

Sincerely,

AdvaMed
Angel Capital Association (ACA)
Carta
Center for American Entrepreneurship (CAE)
Engine
Financial Technology Association (FTA)
Institute for Portfolio Alternatives (IPA)
National Venture Capital Association (NVCA)
QSBS Expert
Small Business Investor Alliance (SBIA)
Technology Councils of North America (TECNA)