

**TESTIMONY OF
DAVID VERRILL
CHAIRMAN, ANGEL CAPITAL ASSOCIATION
FOUNDER AND MANAGING DIRECTOR, HUB ANGELS INVESTMENT GROUP
U.S. HOUSE COMMITTEE ON WAY AND MEANS
AND
U.S. SENATE COMMITTEE ON FINANCE
SEPTEMBER 20, 2012**

Chairman Camp, Chairman Baucus, Ranking Member Hatch, Ranking Member Levin and members of both committees: thank you for inviting the Angel Capital Association (ACA) to speak before this joint hearing on tax reform and treatment of capital gains. The impact of the capital gains tax rate is of significant importance to those collectively referred to as angel investors – individuals who provide most of the seed capital to the nation’s innovation economy of startup businesses.

My name is David Verrill, and in addition to my role as Board Chair of ACA, I am co-founder of the Hub Angels, a Boston-based group of nearly 100 accredited angel investors who have collectively invested more than \$24 million in 28 startup companies over the past dozen years.

The story of angel investing is a story of success, and in keeping with the entrepreneurial spirit of our nation. Here are several reasons why:

- Angel-backed companies are the wellspring of our innovation economy. Angels fund early stage high growth companies – those that will go from a few jobs to thousands – and often high paying jobs at that.
- Angels are on every Main Street, in every state and every sector.
- Angels are the only source of capital for many early stage companies, and we do it even though we know that more than half of our portfolio will fail and we will lose our money.
- Successful angel investments create a virtuous cycle – angels plow back our returns in more startups, and the management teams and employees of successful companies pay more taxes, consume more products and services, and most importantly, many become angel investors themselves.

An increase in capital gains rates will reduce angel investment in promising, job creating companies at the very time our country needs to create jobs. It would be like taking our foot off the gas pedal at the very time when we are trying to get our economy moving faster.

It is also important to note that in 2013, angels already face an increase in taxes due to new taxes that are part of the Affordable Care Act. These five percentage points alone may be the tipping point that drives some angels down a safer investment path, away from risk capital.

ACA recommends that the capital gains rate remains at 15%.

Hub Angels and Angel Capital Association

Angel capital comes from our personal pocketbooks, and is directed toward the very essence of capital formation in the US – small business startups with high growth and job creation potential. Hub Angels – like most angel groups – focuses on companies developing disruptive technologies. Companies that Hub

Angels has funded – including ZipCar, Experion Systems, Copiun, Catalyst Oncology, Daktari Diagnostics, and Intelligent Bio-Systems – have collectively created hundreds of jobs nationwide, and attracted follow-on capital in the hundreds of millions of dollars.

These efforts are not unique to Hub Angels; in fact, they are repeated among hundreds of angel networks and individuals in every state – and they represent the dominant source of funding to early-stage, high-growth enterprises.

ACA is the professional alliance of angel groups across North America. We have more than 170 member angel groups that invest in every geography and market sector, plus another 20 affiliated organizations that share our focus on seed stage investing. ACA member groups are comprised of nearly 8,000 accredited investors, for whom ACA provides professional development, public policy advocacy and other services essential to successful investment in the startup economy. As chair of the Angel Capital Association, I am here to represent this vital and growing community of sophisticated, accredited investors who not only infuse money but also their wealth of experience, knowledge and skills in high potential start-up companies. Our members invest in more than 1,000 seed stage companies per year, after screening as many as 75,000 contenders to identify the most promising ones.

Angel Investors, Job Creation, and Capital Gains Taxes

ACA has a keen interest in the capital gains tax rate, and we believe our members should rank high among capital market participants considered by Congress as it debates appropriate overall tax reform. We urge Congress not to increase the current maximum capital gains tax rate of 15%. Any increase will have a negative impact the number of seed stage investments that constitute primary capital formation for small businesses – which is the essence of the angel investing domain. And, we concurrently urge this Committee to support reinstatement of the 100% capital gains tax exemption for investments in qualified startups that was included in the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, and which is also included in the current Family and Business Tax Cut Certainty Act of 2012 marked up in the Senate in August and the Startup Act 2.0.

We understand the need for the government to identify new revenue sources as it seeks to balance the country's budget. We advocate a 15% cap on capital gains – and even lower rates (perhaps through tax credits) for the riskiest capital that directly goes to startups, because we believe such use of tax policy will help generate more tax revenues for the government than would an ill-advised tax increase.

The tens of thousands of startups we fund each year are formed in every state and every industry sector. You know how important these young companies are to your state, municipal and our national tax base. Without the private investment of angel capital, most of the truly high growth companies – those that will go from a few jobs to hundreds or thousands on payrolls – would simply not get off the ground.

And, make no mistake, angel investors are the source of this capital and drivers of this growth:

- New companies are critical for job growth and economic vitality, especially in an economy struggling to combat high unemployment. There is a growing body of focused research, based on the Census Bureau's *Business Dynamics Statistics* database that dramatically illustrates that it is a smaller subset of dynamic, high-growth startups – mostly funded by angels -- that make up the vast majority of that job growth. 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.¹ After controlling for age of a small business, startups account for almost 20% of gross job creation in any given year.²

- The nation's leading expert on entrepreneurship, the Marion Ewing Kauffman Foundation, estimates that angel investors support up to 90% of the outside equity raised by startups, after they have exhausted personal resources and those of "friends and family."³ These companies are too embryonic to qualify for bank loans, and too small for most venture capital firms, which aggregate pension and other institutional dollars and must place substantial bets on later stage opportunities to efficiently deploy their funds.
- Angel investing is far more prevalent than venture capital in seed stage companies. Angel investors funded more than 66,000 companies with nearly \$23 billion in 2011 – or about \$350,000 per company on average⁴. In contrast, the National Venture Capital Association estimates that VCs invested \$28.4 billion in institutionally-raised money 2011 in about 3,800 companies, mostly at later stages.⁵ These are similar amounts of capital, but 20 times the number of companies, and most in the earliest stages of formation.

Private investment by accredited investors overall generates far more new capital than the public equity markets. The SEC recently analyzed all the Regulation D filings from 2009 through early 2011. Filings for amounts at or below the median of \$1.2 million – which is a reasonable proxy for seed-stage investment -- increased nearly 42% between 2009 and 2010 (from 10,315 to 14,635), and were on track to exceed 43% growth in 2011. This is an enormous upsurge in small business investment – most of which is in startups or very young companies seeking follow-on investments that now also increasingly come from angels. Total investments in Reg D filings in 2011 were nearly \$1.3 trillion. In contrast, total new equity capital raised in the public stock markets in the US was a mere \$250 billion in 2010.⁶ According to Renaissance Capital, a research firm in Greenwich, Connecticut, the \$1.3 trillion in private investment in 2011 is triple the total raised in all the IPOs in the US over the past ten years.

Risk is Big Part of Angel Investment

Angels who invest in startups take great risk in making these illiquid investments. A 2007 study reports data that angels already know: more than half of angel group investments lose money and just 7% of the investments account for 75% of positive returns.⁷

Angel capital is not swirling around the stock market in high speed, secondary trading. In fact, it is highly risky and extremely illiquid. Unlike almost any other tangible capital investment, the angel investor has limited practical control over the realization of a gain on these crucial startup investments. Angels give

¹ *High-Growth Firms and the Future of the American Economy*, Kauffman Foundation, 2011.

² Haltiwanger, Jarmin, Miranda, *Who Creates Jobs? Small vs. Large vs. Young*, NBER.org, August 2011.

³ Marianne Hudson, Kauffman Foundation, *Why Entrepreneurs Need Angels – and How Angels are Improving*, Kauffman Thoughtbook, 2005.

⁴ Jeffrey Sohl, Center For Venture Research, University of New Hampshire, 21012.

⁵ National Venture Capital Association/PwC MoneyTree, 2012.

⁶ Ivanov and Bauguess, *Capital Raising in the US: The Significance of Unregistered Offerings Using the Regulation D Exemption*, Securities and Exchange Commission Staff Report, February 2012.

⁷ Robert Wiltbank, Willamette University, and Warren Boeker, University of Washington, *Returns to Angel Investors in Groups* (published by the Kauffman Foundation, 2007).

their time and expertise freely, and often without compensation, but without liquidity for on average eight years, this is a market few others will support.

Angel investors are experienced in taking these risks, enduring uncertainty and foregoing the liquidity of a public stock. There is no doubt that we do this to generate returns on our investments, but we do it also to mentor young entrepreneurs, to give back to those who are giving up corporate jobs to start companies, and to support an asset class that is vital to our nation's economic health.

It takes a great deal of energy, ongoing learning and time to for angel groups to identify great start-up investments. Hub Angels looked at more than 250 companies last year and invested in two. And it takes even more time, energy and experience to nurture these tiny teams of entrepreneurs to become powerhouses in their markets. Many startups will fail entirely due to a host of market circumstances. Some will do well. A few will succeed brilliantly and return many times the investor's initial capital. Angel investors endure a lot of losses in order to arrive at a net gain – in a cycle estimated to take anywhere from 3-10 years per company on average.

Angel capital represents the dominant and primary engine of new business development in the country. It is very risky, and the rewards are intermittent and unpredictable. Despite this, when angels do realize a gain, they routinely put much of it back into funding more startups. But more than just the investors, the management teams of successful companies very often become active angel investors themselves. It is a virtuous cycle.

Allow me to digress ever so briefly on the difference between angels, venture capitalists and private equity. Angels invest their own money in management teams and technologies they like, typically where they live. So angels are on Main Street of every state in the US. Venture capitalists typically invest institutional capital from endowments, corporations and family offices. In 2011 VCs invested some \$28.4 billion dollars in 3,752 companies⁸ – the vast majority in the major metropolitan regions. They must invest their capital, and given the growth in the average fund size for VCs, they tend to skew their investments toward later stage companies that have revenues. Private equity, much like VCs, invest institutional money but their focus is on mature companies. Each of these members of the venture community invest tens of billions of dollars each year. We need each other. Angels fund companies that act as deal flow for VCs. VCs grow companies such that private equity has opportunities to invest. My point is, angels invest their own money – but they don't have to. They invest largely where they live – not just in the tech centers of the US. They invest in the earliest stages of a company's life – when nobody else will.

We believe that the country needs this type of investing, with its very high chance of failure and uncertainty in both the degree and timing of reward. And a higher tax rate would simply make this type of investing uneconomic.

Raising Capital Gains Rate Will Reduce Angel Investment in Small Businesses

Here is the dilemma. Raising the capital gains tax rate significantly will force many angels to broadly turn away from an asset class in which they are the most experienced, recognized experts and dominant players. At a time when crowdfunding and general solicitation by issuers are about to come into play under the JOBS Act, the wisdom of angels is going to be needed more than ever to maintain discipline and order in this market.

⁸ National Venture Capital Association/ PwC MoneyTree, 2012.

Angels rely on such a small percentage of startup investments to be successful and provide the majority of their return, that a higher capital gains tax could very likely be the tipping point that drives them down a safer path – towards tax advantaged vehicles like municipal bonds rather than the risk capital so much needed for job creation.

As one of my ACA co-board members told me: *“A significant increase in the capital gains tax rate lowers the potential for an overall positive return on a well-diversified, early-stage portfolio. The small percentage of successful companies that generate positive returns will not generate after-tax returns that make up for accumulated losses. A higher capital gains tax rate would provide undeniable evidence that there is very little opportunity for a positive return on the total startup portfolio. As much as I enjoy working with startup companies and placing investments for growth, I would have little option but to reduce my startup investment activities.”*

As another ACA member put it: *“My asset allocation will shift from early stage companies to tax favored investments such as municipal bonds. For those companies that I do invest in, I will look toward safer later-stage companies, further exacerbating the funding gap for small companies.”*

And I would note that there are other pending changes to the tax code that would already impose a significant increase in the effective tax rate on angel investors, including health care legislation which imposes a 3.8% tax on some capital gains by income earners above \$250,000; and the Pease amendment, which limits the deductions itemizers can claim, effectively a 1.2% tax. These five percentage points alone could be the tipping point that drains seed stage investing of viable returns to angel investors. Add anything more, and you start to shoot yourself in the foot.

Both of these shifts would strike a blow to entrepreneurship and job creation that is essential to our nation’s economic health. It would stifle innovation by diminishing its likelihood of it being commercialized to the benefit of society. I would note that angel groups as a class focus on the development of disruptive technologies in areas such as technology and medical breakthroughs. These sectors currently are not being funded by the large corporations until well after first funds have been raised from angel investors, and later stages from venture capital. Without angel investing available to prime this engine of innovation, many breakthroughs will simply never realize their potential.

Focusing on the combination of keeping capital gains taxes to a minimum, and developing well thought-out income tax incentives could ensure that more deserving small businesses get the capital they need, especially during our current tough economic times.

Supporting Policy Recommendations

Before I conclude my remarks, I would like to make a case for a few other tax opportunities that would be very valuable in helping maintain the vigor that exists today in the seed stage investment arena.

- As I noted, we ask your support for reinstatement of the 100% exclusion of capital gains tax on Qualified Small Business Stock (“section 1202”) that is currently included in the House Finance Committee’s mark-up of the tax extender bill. Further tweaking 1202 to have a shorter holding period and to cover additional corporate structures would generate far more uses of the bill.
- Additionally, we recommend Congress consider instituting tax credit policies support of angel investors. 22 states have tax benefits for angel investors – for good reason, as the companies they

invest in generate new jobs. For instance, ACA members have seen this in Wisconsin, Ohio, Kansas and Oregon. Senator Pryor's S.256 or the American Opportunity Act would go a long way toward helping all 50 states – including my Commonwealth of Massachusetts which currently has no state tax credit – to provide angel investors with more incentive to invest more money in more companies to create more economic benefit.

Final Thoughts

The question about how much to change the capital gains rate is not an easy one, and as a member of the angel community I understand that. However higher taxes will always cause behavioral change. My argument is that we have found a rate that works. At a time when small businesses and startups are still having trouble accessing capital, this is not the time to increase the capital gains rate for individual investors who take great risks in supporting job creating businesses.

Our overall recommendation is that the best way to ensure a strong flow of angel capital into innovative small businesses throughout this country is to provide tax incentives and education to allow and encourage private citizens to risk their own capital to support start-ups and early-stage businesses.

Thank you for the opportunity to speak today. I would be happy to answer any questions about angel investing, Hub Angels, and ACA, and to stay involved in your process to ensure that angel investing— which is a critical driver of our innovation economy is stimulated to create new, high value jobs.

MORE INFORMATION AND RECOMMENDATIONS

National Angel Investing Landscape

Angel investors are high-net-worth individuals⁹ as defined by the Securities and Exchange Commission who provide money for start-up firms with growth potential. Many of them 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.¹⁰ These firms rarely have the collateral to receive bank loans and they are generally too small and too young to receive venture capital.

The Center for Venture Research estimates that angels invested \$22.5 billion in 66,230 companies in 2011. 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 350 angel groups, located in every state, compared to about 100 groups ten years ago. The new HALO Report¹¹ describes the investments angel groups made in 2011:

- Median round size of \$700,000;
- 58% of investments were in healthcare/life sciences and Internet/IT sectors;
- Two-thirds of the investment rounds were syndicated, often with multiple angel groups; and,

⁹ www.sec.gov/answers/accred.htm

¹⁰ Marianne Hudson, Ewing Marion Kauffman Foundation, *Why Entrepreneurs Need Angels – and How Angels are Improving*, Kauffman Thoughtbook, 2005.

¹¹ www.angelresourceinstitute.org/halo-report, Angel Resource Institute, Silicon Valley Bank, and CB Insights

- Investments were distributed throughout the country – two-thirds of the deals were outside of traditional equity centers of California and Boston.

Hub Angels' experience fits within these national statistics. About 25% of our investments are in life sciences, with the remainder in a variety of high tech industry sectors ranging from financial services software to transportation to water resources to mobile to information technology. We are active investors and tend to take a board seat and otherwise help portfolio companies in any way we can - whether it is finding the next customer, a service provider, space, hiring, strategic advice and of course help in the sale of the company. We are seed stage investors, typically taking a 5% to 10% stake in each company, and continuously investing in the portfolio as it grows. We syndicate most of deals with other angel groups - there are more than 20 in the New England region - and smaller venture capital firms. The New England angel groups meet regularly to share best practices, deals, and provide education.

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 period¹². 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.

Risk and Angel Investment

The *Returns to Angel Investors in Groups*¹³, 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 at least a minimum amount of due diligence in reviewing investment opportunities.

Angel Investors, Entrepreneurs and Capital Gains Taxes

A preferential capital gains tax rate for seed-stage investing is essential for the continuing economic recovery and health of the economy. It is a foundational element of what makes this type of high risk, illiquid investment a viable option for accredited investors. And, without a robust capital market for startup entrepreneurs building innovative, disruptive businesses, we believe the country would face an inescapable decline in the job market and economic growth.

There is a great deal of data indicating how a change in the capital gains tax rates impacts when gains are realized (i.e., if there is a rate change, there is a spike either up or down in the amount of gains realized either just before (if the rate change is up) or after (if the rate is reduced).

¹² John Haltiwanger, University of Maryland, Ron Jarmin, U.S. Bureau of the Census, and Javier Miranda, U.S. Bureau of the Census, *Business Dynamics Statistics: An Overview*, 2009.

¹³ Robert Wiltbank, Willamette University, and Warren Boeker, University of Washington, *Returns to Angel Investors in Groups* (published by the Kauffman Foundation, 2007).

But, the importance here is how the capital gains tax rate affects where money is invested in the first place. It is conventional wisdom that small business is responsible for the majority of net new job creation in the country in any given year. But there is a growing body of focused research, using the Census Bureau's *Business Dynamics Statistics* database that 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 Kaufman 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.¹⁴
- 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.¹⁵

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. And, reductions in the capital gains tax rate over the past decade directly correspond to the increase in angel capital investment over the period.

Historically, until 2009, non-corporate taxpayers were permitted to exclude 50% of the gain from the sale in startups if the investments were held for five years. American Recovery and Reinvestment Act of 2009 increased the exclusion of capital gains from the sale of certain small business stock held for more than five years from 50% to 75% through 2010. The Small Business Jobs Act raised this exclusion to 100% through the end of 2011.¹⁶

However, unless Congress reinstates the 2011 exclusion, beginning in 2012, it appears that startup investments no longer receive any special capital gains treatment.¹⁷ **This is a dramatic and perhaps cataclysmic event for seed-stage investing.** It means that, for the first time in recent history, there would be no preferential capital gains treatment for this high risk, highly illiquid nascent type of investment that stokes innovation and entrepreneurship in our country.

While the improvement in the capital gains tax exclusion is not the only reason for this surge (which also reflects technological change that makes it easier for entrepreneurs to start a business and because higher unemployment rates may encourage more people to do so), it is a significant contributing factor.

What happens if these preferential gains tax rates are not reinstated – or worse, if they not only are abolished but the standard capital gains taxes is increased from its current 15% rate? Angel investing could become almost universally uneconomic. And, rational accredited investors will greatly reduce or even stop participating in this market sector.

A reasonable assumption in the current interest rate environment is that the baseline real pre-tax return on a carefully selected portfolio of startup investments approximates 10%.¹⁸ This implies that \$100,000 invested in a diversified portfolio of startup companies would be worth \$161,100 in five years – although there is no assurance that these gains, or even the initial invested amount, could be monetized and realized in that timeframe. In theory, under the exemption for capital gains taxes on certain classes of startups, this would be a reasonable return. However, since not all these seed investments would necessarily qualify for the exemption (those in health care, law, finance, etc., that are not QSBs), and since it is unlikely that all the investments would find an exit in exactly five years – many will take longer -- actual returns would vary.

¹⁴ *High-Growth Firms and the Future of the American Economy*, Kauffman Foundation, 2011.

¹⁵ Haltiwanger, Jarmin, Miranda, *Who Creates Jobs? Small vs. Large vs. Young*, NBER.org, August 2011.

¹⁶ Litan and Robb, *A Market-Based Approach for Crossing the Valley of Death*, Kauffman Foundation January 2012.

¹⁷ Litan and Robb, *A Market-Based Approach for Crossing the Valley of Death*, Kauffman Foundation January 2012.

¹⁸ Litan and Robb, *A Market-Based Approach for Crossing the Valley of Death*, Kauffman Foundation January 2012.

If the gains are taxed at the current standard 15% rate, the tax reduces the gain to \$136,850 over five years, and the annual return drops to barely over 7% -- or a 30% reduction in the expected rate of return. If the capital gains tax is actually increased, and there is no preferential treatment for private, seed stage investing, these returns will shrink further, with no reduction in risk or illiquidity of the asset class. And, as I noted earlier, other changes to the tax code could add five percentage points to the effective tax rate on angel investors – health care legislation and the Pease amendment.

Overall, capital gains tax revenues have been a fairly small source of total government revenue, averaging about 5.2% of all taxes and 4.2% of total Federal revenues (including licensing, fees, etc.) from 1995 through 2009.¹⁹

The amount of tax revenues generated from gains on start-up investments is far lower – and would constitute a rounding error in filling the void to reduce the deficit. Yet, to shut off this vital flow of innovation capital would deal a devastating blow to high-growth innovative startups and the massive economic benefits that result.

Higher taxes cut into the cash angels have available to reinvest in additional startups. Many ACA members re-invest most or all of their returns into the next crop of innovative entrepreneurs. The surge in new angel investment after a great exit is tangible in many communities. For example, the success of Living Social has led to more investment in the Washington, DC area.

Increases and differences in long and short term capital gains may also distort investor behavior in the coming months. Angels and entrepreneurs could try to accelerate to an exit in 2012 to lock in a known capital gains rate. In 2013 angels could become even pickier in their investments and perhaps lengthen the investment evaluation process. Or they could turn to more tax advantaged instruments like municipal bonds or cash. The first quarter of 2013 could be a desert for financing new businesses simply due to the uncertainty around rates.

The short term versus long term rate is also likely to have an impact on investors' decision-making related to exits. With big differences between the two, some investors would seek stall an “early exit,” so that none of the investments would receive short-term tax treatment. This would change the risk profile of the entrepreneurial companies involved and possibly decrease chances of success for these businesses.

Balanced Strategies to Catalyze Early-Stage Investment

Our overall recommendation is that the best way to ensure a strong flow of angel capital into innovative small businesses throughout this country is to provide tax incentives and education to allow and encourage private citizens to risk their own capital to support startups and early-stage businesses.

In addition to favorable capital gains treatment, we recommend that Congress consider the very successful tax credit programs now in 22 states. States offer a variety of tax benefits for angel investors – for good reason, the companies they invest in generate new jobs. I would point you to the legion of great examples of economic growth that have resulted from these state policies.²⁰

For example, Wisconsin's Qualified New Business Venture (QNBV) program – also known as the Angel Investment Program, has become a model of success. Since 2005, the QNBV program has driven investment in early-stage businesses, creating jobs and stimulating Wisconsin's economy. More than 216 companies have been certified through the QNBV program, helping leverage \$637 million in investments. Among those companies still certified as QNBV businesses, reports show that the program has helped create 1,112 Wisconsin jobs. But this number is

¹⁹ Hungerford, *The Economic Effects of Capital Gains on Taxation*, Congressional Research Service Report for Congress, June 2010: www.crs.gov R40411.

²⁰ *Act 255: Early Stage Business Investment Program 2012 Annual Report*, Wisconsin Economic Development Commission.

actually much higher because successful companies eventually “graduate” from the program and no longer report employment numbers to the commission.²¹

In addition to Wisconsin, states with angel investment tax credits include: Arizona, Arkansas, Connecticut, Georgia, Illinois, Ohio, Kansas, Louisiana, Maine, Maryland, Minnesota, Nebraska, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, Vermont, and Virginia.

The American Opportunity Act, S.256, includes many of the components of the successful Wisconsin legislation.

Another recommendation is to reinstate the 100% tax exemption on gains in Qualified Small Business Stock (QSBS). The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 included a provision that provides a 100% exemption for gains made in Qualified Small Business Stock for investments made before December 31, 2011. The exemption has expired and ACA recommends that this exemption be made permanent. When the 100% exemption was first announced in another bill in September 2010, it caught the attention of angel investors. ACA found several examples investments that happened more quickly because of the new exemption. While the QSBS or 1202 program has been around for some time, the program was not well known or used by private angel investors until the 100% exemption became law.

Several updates are needed so that QSBS stimulates even more angel investment in innovative early-stage companies. The recent acts making the 100% gain and AMT exclusion a reality have generated interest and impact in the angel investment community. The changes we recommend, in priority order are:

- Extend Section 1045 roll-over period. With regard to Section 1045, increase the roll-over period from 60 days to a year. The issue arises because QSBS exits are unpredictable and 60 days is simply not enough time to re-invest in new deals. Startup deals are not like real estate; they require locating the deal, due diligence and negotiating terms, and often deals don't close. Extending the period will encourage more investment.
- Shorten the hold period on 1202. Currently, it requires holding the stock 5 years before exit to qualify for the exclusion. Given the trend toward earlier exits these days (eg, gaming, consumer internet), a two-year holding period would be more appropriate to create incentives for investment.
- Allow Limited Liability Companies to qualify. Many startups are organized this way to minimize their initial costs.
- Make clear that stock acquired on convertible notes and warrants and options qualifies. Right now this is not 100% clear.
- Fix working capital and redemption limitations. Down in the details of the definition of QSBS there are some things that could be improved, such as removing the working capital requirement and clarifying that all startups qualify without regard to how long their R&D process is, and broaden the redemption triggers. These are traps that can inadvertently eliminate the exemption.
- Allow “tacking” of QSBS status for transfers, even if for value. Right now, if the stock is transferred for value, it loses the exemption. Allowing QSBS treatment to tack would improve early stage investor returns (albeit taxed) because the stock will have more value to a secondary buyer.

²¹ Act 255: Early Stage Business Investment Program 2012 Annual Report, Wisconsin Economic Development Commission.