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**Ohio Venture Association  
Position Paper  
October 2008**

**Tax Rates on Carried Interest**

The Ohio Venture Association supports the position of the National Venture Capital Association (NVCA) opposing the treatment of venture capital carried interest income as ordinary income and taxing it at higher ordinary income tax rates. Companies backed by venture capital investments create a disproportionately high percentage of new high-paying jobs and wealth for their regional economies, founders, investors, and employees as has been well documented by the NVCA.

Proposals that have been advanced in Congress to tax carried interest income as ordinary income would be injurious to the nation's economy and to Ohio's burgeoning, but young and fragile entrepreneurial economy. Such an action would have predictable negative effects on those regions of the country like Ohio that are trying to catch up with the technology centers that have shown the way towards economic growth: fewer start-ups, fewer jobs, less wealth creation, less tax revenue, and less vibrant communities.

Furthermore, there may be a theory that increasing tax rates will increase tax collections, but significant evidence shows that higher tax rates often suppress economic growth, company formation, and entrepreneurial risk-taking, resulting in decreased tax collections.

**What Is Carried Interest?**

Carried interest is the percentage of capital gains earned by venture capital firms, and their partners, from successful investments they make—the ownership interest of venture capital funds in the businesses they support. Typically, a few of these investments do very well, some return the invested capital with little or no gain, and some fail—losing the entire investment. During the lifetime of the venture fund, typically ten to thirteen years, it is not possible to say what the carried interest will be worth; that is only known as the businesses in which the venture fund has invested succeed or fail.

Venture capital firms typically receive 20% of the gains from successful investments, with the other 80% going to their investors, called Limited Partners—typically the endowments of foundations and universities, banks, corporations, high net-worth individuals, and public and private pension funds. The 20% earned by venture capital firms is distributed to partners and employees of the firm, who then report the gains on their personal tax returns. Under current law, these gains are reported as capital gains and taxed at the capital gains tax rate. Under some legislative proposals in the U.S. Congress, these gains would be classified as ordinary income and taxed at much higher rates.

### **Why Is Carried Interest Taxed At Capital Gains Rates Today?**

Venture capital firms typically invest in start-up companies that take a number of years, typically five to nine, to mature before they can be sold or taken public in an IPO. Employees of venture capital firms who make and manage investments generally receive modest salaries (with the possible exception of very large venture firms) compared to what they could earn in industry. Carried interest is essentially the potential equity compensation they may receive in return for modest salaries; it's the equivalent of stock options that employees earn at many companies and is based on risk and return. If the venture fund's portfolio of businesses does well, the venture firm's partners and employees will do well; if those businesses fail, the venture partners and employees will receive little or no carried interest in return for years of effort and risk.

When a company is sold or goes public, founders' shares held by the entrepreneurs who formed the company, and options granted to employees are typically sold to the new owners or the public. Gains on these shares are treated as capital gains, not ordinary income. The value represented by those gains is usually paid in one large lump sum (and in that year the employee's earnings may be very large) but it really represents the accumulation of years of effort by the employee. Taxing those gains at the lower, capital gains tax rate, treats the gain as a store of value—like a savings plan—that the employee has built up over the years through hard work for the company. Taxing this one-time payout at the higher rate for income would penalize founders and employees due to a sale or IPO of the company.

The carried interest earned by venture capital firm employees, similarly, is earned over years of work in helping entrepreneurial companies become successful. Treating carried interest in the same way that founders' shares and employee stock options are treated reflects the equivalent nature of these gains. Treating carried interest as ordinary income, as some in Congress have proposed, would tax an equivalent gain by venture capital firm employees at a higher tax rate than that paid by employees of portfolio companies for what is, essentially, a similar circumstance. There is no justification for this different treatment. In both cases, the value being taxed is the accumulated value created over time, not the value created by current effort (which is regarded as ordinary income and taxed accordingly).

### **Why Isn't Carried Interest Salary?**

There are several tests for whether compensation is salary or capital gain, including the holding period of the gain and whether the gain is at risk. Carried interest passes both tests.

Structurally, carried interest is like stock options; they both represent sweat equity earned by employees over time. They both are granted at the time of employment and accumulate value as companies become successful. The proceeds of both typically are paid out in lump sums when portfolio companies are sold or taken public. Except on rare occasions when a start-up is sold quickly, this value generally accumulates over an extended period of time, like a 401k or savings plan.

Carried interest is very much at risk. If a venture capital firm's investments are unsuccessful, carried interest will have no value and a venture capital firm employee will have invested five or ten years of a career for nothing. This is similar to what happens when an employee holds stock options in a company that are "under water" or priced above the company's share price.

### **How Are Venture Capital Firm Employee Salaries Taxed?**

The salaries that venture capital firm employees are paid during the time that their carried interest is building are taxed at ordinary income tax rates. These salaries come from a management fee that venture capital firms receive from their investors, which typically is 2% of the amount of committed capital for larger venture capital firms, and

2.5% for smaller, early stage venture capital firms. These management fees also pay for all overhead, including rent, benefits, travel, etc. Often, these management fees must be repaid to investors by the venture capital firm before the venture capital employees share in capital gains from successful investments. What are taxed as ordinary salary compensation is actually advances against future gains from investments.

### **Don't Private Equity and Hedge Funds Also Receive Carried Interest?**

Yes, the managers of private equity and hedge funds also receive carried interest as part of their compensation. There are several differences between those funds and venture capital, however, particularly in the type of investments they make, the holding period of investments, and the risk profile of their investments.

Venture capital firms focus on the riskiest early stage companies and hold their investments for at least three years—usually closer to seven. Venture capital-backed companies have a disproportionately positive effect on the U.S. economy in terms of wealth creation, job creation, and tax base, as has been well-documented by the National Venture Capital Association.

### **Why Should Congress Care If Venture Capitalists Pay Ordinary Income Tax Rates, Instead of Capital Gains?**

It's easy to caricature venture capitalists as wealthy and caring more about personal gain than building the companies and economies in which they invest. There may be some venture capitalists like this, but the reality is more complex. Particularly in Ohio and the Midwest, venture capitalists are, first and foremost, entrepreneurs themselves. Why else would they forego high-paying jobs in industry to take profound risks in companies at the earliest stages, when they are at highest risk of failing, in places like Cleveland, Cincinnati, Columbus, Pittsburgh, Indianapolis, and Milwaukee?

People enter the venture capital industry with the hope that successful investments will generate carried interest that will provide them with retirement security, college tuition for their children, and better lives—but also with the belief that their work will create hundreds or thousands of productive, high-paying jobs for other people who are seeking the same outcomes at companies in which venture capital firms invest.

In many regions of the United States, the most critical shortage frustrating the transformation to entrepreneurial economies is not ideas, technologies, entrepreneurial

managers, or capital—but the people who bring these elements together in successful new enterprises: entrepreneurial investors, known as venture capitalists.

Early stage venture capital is a local business. It is hard, if not impossible, for a venture capitalist in Silicon Valley or Boston to identify, invest in, and manage early stage companies in other regions of the country. Early stage investing in places like Ohio and the Midwest must be done with people who are on the ground and engaged in their communities. If venture capital carried interest income is taxed punitively, there will be less incentive and hence fewer talented people who are willing to become venture capitalists in regions that are in need of economic transformation.

For these reasons, we strongly urge Congress to leave the treatment of Carried Interest as long-term capital gains, and not diminish the incentive to support early stage ventures that are our country’s economic engine for job and value creation.

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