



Protecting N. Coast's wave of innovation

The Press Democrat

By Steve Krausz

October 21, 2007

Venture capital investors see the North Coast as a one of the country's promising regional pockets of innovation. To wit, we've seen a wave of venture capital investment in 2007, with seven innovative companies alone raising over \$128 million through the first half of the year.

In the 707 area code, this is good news as the companies receiving these investments represent some of the most promising industries today including clean tech, information technology and life sciences. My firm, based in Silicon Valley, recently invested in Petaluma's Dilithium Networks and Teknovus Inc, both which make communications faster and more efficient.

These types of investments help build companies and bring jobs to our area and throughout the country. All told, venture investments have resulted in 10.4 million jobs and over \$2.3 trillion in revenues in the United States since 1970.

Simply put, this growth has largely been the result of favorable federal tax policies that seed and nurture long-term and high-risk investments in startup companies.

However, Congress is now considering the elimination of capital gains tax treatment for the "carried interest" paid to certain investment fund managers including private equity investors, real estate partnerships and venture capitalists. Yet, the sad part is that if Congress continues to view these entities as identical, it may have destructive effects on venture capital investment and the North Bay's economy.

What this issue comes down to, from a tax perspective, is how we treat both financial and human capital. Today, those two company-building mechanisms are viewed equally under federal law.

Entrepreneurs, whose innovations form the origin of a company, are typically granted founder's stock and receive long-term capital gains treatment on that stock if the company emerges successfully from its beginning.

At the same time, venture capitalists, who provide the critical and often risky financial and strategic support needed to help grow emerging companies, also receive equity stakes. However, through the current tax code, using limited partnerships, venture capitalists are taxed at the 15 percent capital gains rate as the partnership earns income -- often referred to as "carried interest." Congress wants to raise the 15 percent rate to as much as 35 percent.

For venture capitalists, because of the risks involved with funding startup companies, a return is only seen if a number of their portfolio companies turn out to be profitable and only after subsequent outside investors are compensated.

Venture capitalists lend their expertise day in and day out to help aspiring entrepreneurs build great companies. Unlike other types of investors, venture capitalists are not silent partners -- but actively engage in helping run the companies. Venture capitalists' incentives are aligned to stay invested in the companies until they can stand on their own. Venture investors normally do not get a return on their sweat equity investment for five to 10 years, or sometimes longer.

The capital gains tax rate was intended to help promote enduring investments in value creation. As Congress engages in this tax debate, it should look at each industry separately and make policy decisions based on balancing the goal of tax fairness while also promoting tiny start-ups that truly ignite the ground-breaking ideas that grow our economy.

Congress deserves credit for raising American innovation and competitiveness to the top of the nation's political agenda but it's concerning that it is considering dramatically altering a system that has fueled America's innovation for nearly 30 years.

The proposed change in the tax code would clearly impact investment decisions here in the North Bay and beyond, most likely discouraging the riskiest early-stage startup investment. At a time when we must be investing in more start-ups, this change would pull us in a negative direction.

We all believe in paying our fair share, but in this time of financial uncertainty, discouraging the very type of investment that keeps our engine humming simply makes no sense to us. Congress must continue to support this impressive startup environment by preserving an important tool in the tax code that has seeded so much home-grown innovation and job-growth nationally and here on the North Coast.

Steve Krausz is a General Partner at US Venture Partners, a venture capital firm based in Silicon Valley which has invested in a number of startup companies in the Sonoma County area.