Center for American Entrepreneurship

The Center for American Entrepreneurship (CAE) is pleased to submit this document in response to the request of February 2, 2021 by Senator Pat Toomey (R-PA) for policy proposals to accelerate economic growth and job creation by facilitating capital formation. We thank Senator Toomey for his leadership on this vitally important topic.

CAE is a nonpartisan, Washington, DC-based 501(c)(3) research, policy, and advocacy organization established in July of 2017. CAE's mission is to engage policymakers in Washington and across the nation regarding the critical importance of entrepreneurs and startups to innovation, economic growth, job creation, and broader opportunity – and to pursue a comprehensive policy agenda intended to significantly enhance policy circumstances for new business formation, survival, and growth.

Recent research has demonstrated that new businesses – "startups" – are disproportionately responsible for the innovations that drive productivity growth and economic growth, and account for virtually all net new job creation. Alarmingly, recent research has also demonstrated that rates of entrepreneurship in America have fallen near a 40-year low, *and that this decline is occurring in all 50 states, in all but a handful of 360 metro areas examined, and across a broad range of industry sectors*.

Given the importance of thriving entrepreneurship to innovation, economic growth, job creation, and expanding opportunity, such circumstances amount to a national emergency – particularly given the urgent need to accelerate the post Covid-19 economic recovery. Reversing the decline in American entrepreneurship requires changes in public policy, including access to capital.

Access to Capital

Starting a new business requires money. In the initial days of a startup, capital needs may be limited to the bare essentials – money to purchase supplies, computers, and other office equipment. Falling costs for computers, software, and other office technologies in recent years, together with the distributional and promotional power of the Internet, have dramatically lowered the cost of getting a new business off the ground.

But as new businesses begin to grow, capital needs multiply. Entrepreneurs need money to pay bills, move out of the garage or dining room into office space, and, hopefully, begin paying initial employees. Most importantly, entrepreneurs need capital to further develop their product or service idea, research the marketplace, and develop and implement a strategy for identifying and targeting customers. Because such costs typically arrive long before the first dollar of revenue, capital and credit are the lifeblood of any new business. Difficulties in accessing sufficient capital and credit at reasonable terms can delay or prevent the launch of a new business, disrupt the further growth and development of an existing business, or even kill an otherwise healthy and viable business.

Make the SBA More Responsive to the Unique Nature and Needs of Startups

The Small Business Administration (SBA) administers several programs to support new and small businesses, including loan guaranty programs to enhance small business access to capital; programs to increase small business federal contracting opportunities; direct loans for businesses, homeowners, and renters to assist their recovery from natural disasters; and access to entrepreneurial education to assist with business formation and expansion. The SBA also administers the Small Business Investment Company (SBIC) program (see below).
The SBA's Technology Program Office also administers the Small Business Innovation Research (SBIR) Program and the Small Business Technology Transfer (STTR) Program. Through these two competitive programs, the SBA ensures that the nation's small, high-tech, innovative businesses are a significant part of the federal government's research and development efforts. Eleven federal departments participate in the SBIR program, five participate in the STTR program, awarding $2 billion to small high-tech businesses.

Congress should instruct the Small Business Administration (SBA) to establish a formal framework for ongoing dialogue with lending institutions and startups regarding how SBA programs, products, and procedures can more clearly distinguish between existing small businesses and new, high-growth startups. The SBA should also be instructed to determine how SBA-backed lending and other programs can be tailored and made more responsive to the unique nature and needs of startups (e.g., less complex, less reliant on cash-flow and physical asset collateral). To reinforce this expanded organizational and programmatic perspective, Congress should also rename the SBA the Small Business and Entrepreneurship Agency (SBEA).

Increase the SBA Guarantee to SBICs

The SBA's Small Business Investment Company (SBIC) program – established by the Small Business Investment Act of 1958 – is designed to "improve and stimulate the national economy in general and the small-business segment thereof in particular" by stimulating and supplementing "the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply."

The SBIC program was created in response to concerns raised in a Federal Reserve Board report to Congress that identified a gap in the capital markets for long-term funding for growth-oriented small businesses. The report noted that the SBA's loan programs were "limited to providing short-term and intermediate-term credit when such loans are unavailable from private institutions" and that the SBA "did not provide equity financing." Equity financing (or equity capital) is money raised by a company in exchange for a share of ownership in the business. Ownership is represented by owning shares of stock outright or having the right to convert other financial instruments into stock. Equity financing allows a business to obtain funds without incurring debt, or without having to repay a specific amount of money at a particular time. The Federal Reserve's report concluded there was a need for a federal government program to "stimulate the availability of capital funds to small business" to assist these businesses in gaining access to long-term financing and equity financing. Facilitating the flow of capital to small businesses to stimulate the national economy was, and remains, the SBIC program's primary objective.

The SBA does not make direct investments in small businesses. Rather, it partners with privately owned and managed SBICs licensed by the SBA to provide financing to small businesses with private capital the SBIC has raised, along with funds the SBIC borrows at favorable rates because the SBA guarantees the loan obligation. Some SBICs specialize in a particular field or industry, while others invest more generally. Most SBICs concentrate on a particular stage of investment (i.e., startups, expansion, or turnarounds) and geographic area. Since 1958, SBICs have channeled more than $67 billion to 166,000 American businesses across a variety of industries. Some of America's most iconic companies have received investment capital from SBICs, including Apple, Tesla, Whole Foods, Staples, Intel, FedEx, and Costco.

As of September 30, 2020, there were 302 licensed SBICs participating in the SBIC program. The SBIC program currently has invested or committed about $32 billion in small businesses, with the SBA's share of capital at risk valued at $13.5 billion. In fiscal year 2020, SBICs were provided nearly $1.8 billion in SBA leverage and invested another $3 billion from private capital for a total of $4.88 billion in financing for 1,063 small businesses.

On June 21, 2018, the **Small Business Investment Opportunity Act** was enacted to modify the SBIC program, increasing the amount of outstanding leverage allowed for individual SBICs from $150 million to $175 million. While a step in the right direction, CAE is of the view that the increase of $25 million was insufficient, especially since the cap was previously raised in 2009. CAE urges Congress to increase the cap on the SBA guarantee to SBICs to $250 million.

Re-structure and Re-launch the SBA's Early-Stage Innovation Fund (ESIF) Initiative

In January 2013, the Small Business Administration (SBA) launched the Early-Stage Innovation Fund initiative (ESIF) – an offshoot of the SBA's Small Business Investment Company (SBIC) program (see recommendation above). Whereas licensed SBIC's invest primarily in the growth of existing small businesses, ESIF licensed firms were required to invest at least half their funds in early- and seed-stage startups. By guaranteeing up to $50 million in additional capital per licensed fund, the ESIF initiative was intended to help leverage private capital already raised by active funds, providing additional investment capacity to venture capital funds beyond the venture capital centers of Silicon Valley, New York, and Boston, which attract three-quarters of all venture capital. In announcing the program, the SBA said it planned to guarantee up to $1 billion in additional startup capital over five years at no cost to the American taxpayer.

On September 19, 2016, the SBA proposed changes to the ESIF program because as of June of 2016, the SBA had licensed only five venture capital funds. Then, on June 11, 2018, the SBA announced that it was withdrawing its proposed rule and ending the ESIF program. According to the SBA, the initiative failed because the SBA-backed portion of ESIF-affiliated investments were structured as subordinated debt that paid quarterly interest back to the government equivalent to the rate of a 10-year Treasury bill plus 1.5 percentage points and "debentures are not well-suited to an early stage investing strategy since many early-stage investments do not provide ongoing cash flows needed to pay the current interest an annual charges associated with SBA guaranteed debentures." Given the importance of early- and seed-stage risk capital to startups, together with the relative scarcity of venture capital in heartland states, CAE recommends that the SBA work with the venture capital community to determine a financing structure consistent with the earnings and repayment realties unique to startup and relaunch the Early-Stage Innovation Fund initiative as soon as possible.

Raise the Cap on the Reg A Exemption (or "Mini-IPO)

The JOBS Act of 2012 sought to revive the Regulation A exemption – sometimes called a "mini-IPO" – which allows public companies to raise capital through general solicitation without the full burden of disclosures typically required of a conventional initial public offering (IPO). The Act increased the amount of capital that could be raised under the exemption from $5 million to $50 million and instructed the Securities and Exchange Commission to reevaluate the cap every two years.

In 2015, the SEC adopted final rules to implement Section 401 of the JOBS Act by creating two tiers of Regulation A offerings: Tier 1, for offerings of up to $20 million in a 12-month period; and Tier 2, for offerings of up to $50 million in a 12-month period. From June 2015 through December 2019, issuers in the Regulation A market reported raising approximately $2.4 billion in 382 qualified offerings. The vast majority of capital raised under Regulation A, approximately $2.2 billion (91 percent), was raised under Tier 2, with only $230 million (9 percent) raised under Tier 1.

In March 2020, the SEC issued proposed amendments to simplify, harmonize, and improve the "patchwork" exempt offering framework under the Securities Act, with the aim of reducing potential friction points and to make the capital raising process more effective and efficient. In proposing the amendments, the Commission noted that exempt offerings accounted for more than double the new capital raised by registered offerings in 2019 – $2.7 trillion in exempt offerings compared to $1.2 trillion in registered offerings. The SEC approved the prosed amendments on November 2, 2020, which included raising the maximum offering amount under Tier 2 of Regulation A from $50 million to $75 million.

While the increase in the Reg A cap is welcome news, companies seeking to raise more than $75 million – say, $100 million, still a small amount by any standard – must resort to the conventional IPO process and the burden of standard disclosures. With this in mind, and given the expanding importance of exempt offerings to the financing of young high-growth companies, CAE urges the SEC, or Congress, to raise the Reg A exemption cap to at least $100 million.

Raise the Cap and Increase the Number of Permitted Investors for 3(c)(1) Investment Funds

On May 24, 2018, the **Economic Growth, Regulatory Relief, and Consumer Protection Act** was signed into law by President Trump. Title V of the legislation addresses capital formation – including a provision, "Supporting America's Innovators," Section 504, that had previously passed the House (H.R. 1219) and Senate (S. 444) by wide margins. The section amends section 3(c)(1) of the **Investment Company Act of 1940** by raising the permitted number of investors from 100 to 250 for investment funds not making a public offering of securities that are exempt from registration as an investment company with the Securities and Exchange Commission and from the filing of costly disclosure requirements associated with registration – provided the fund size does not exceed $10 million.

The increase in the number of permitted investors accomplished two important objectives: 1) getting more capital to early-stage companies; and 2) allowing accredited investors to allocate small amounts of capital to a potentially lucrative asset class. But limiting the increase in permitted investors to funds less than $10 million is also problematic. Funds larger than $10 million are still limited to 99 investors, meaning the average investment is much larger. In the case of a $30 million fund, for example, the average investment is $300,000 – too large for many accredited individual investors. An unintended consequence of this mathematical reality is that current limits on exempt funds reinforce deficiencies in diversity among entrepreneurs and those who invest in them. A growing body of research indicates that for entrepreneurs of color to access greater amounts of capital requires greater diversity among fund managers and their investors. Funds with higher participation by individual investors tend to be more diverse and, therefore, more willing to invest in entrepreneurs of color.

With these thoughts in mind, CAE recommends that the cap on funds exempted from registration requirements be raised to $100 million – which would be consistent with the recommendation immediately above regarding capital raises under the Reg A exemption. In addition, CAE recommends raising the number of permitted investors to at least 250 and, ideally, to 1,999, the current limit for Qualified Purchasers funds. Such consistency would simplify compliance, facilitating capital formation for all new companies. Moreover, by allowing more individual investors to participate in larger funds – and committing smaller amounts of capital – the higher cap and higher number of permitted investors would be supportive of more diverse emerging fund managers and greater investment in entrepreneurs of color and women entrepreneurs.

Pass the New Business Preservation Act

CAE supports the immediate passage of the **New Business Preservation Act**, the purpose of which is to incentivize continued and more equitably distributed venture capital investment in America's most innovative startups. The Act was introduced in the Senate (S. 3515) on March 18, 2020 by Senators Amy Klobuchar (D-MN), Chris Coons (D-DE), Tim Kaine (D-VA), and Angus King (I-ME), and was introduced in the House (H.R. 6403) on March 26, 202 by Reps. Dean Phillips (D-MN), Terri Sewell (D-AL), Ro Khanna (D-CA), and Tim Ryan (D-OH).

Despite their unique economic importance, startups are also extremely fragile because they are new – with half of all startups failing within their first five years. Because of their risk profile, many startups are unable to secure bank financing like existing small businesses and instead rely on venture capital, which has been a major source of financing for young innovative companies since the late 1940s.

Venture capital firms are long-term investors that provide early-stage capital – raised from institutional investors like pension funds, insurance companies, university endowments, and foundations – to new and rapidly growing companies in exchange for an equity stake in the company. Venture firms also assist in the management and professionalization of the young companies in which they invest, typically taking seats on the board. Venture capital has helped finance thousands of American companies, including Intel, Federal Express, Apple, Microsoft, Google, Cisco, Home Depot, and Starbucks.

At present, venture capital in the United States is highly concentrated, with about 80 percent of venture capital raised and invested in just three cities – San Francisco, Boston, and New York. This concentration – which has worsened by ten percentage points over the past decade – limits access to venture financing in many parts of the country with the effect of limiting the nation's innovative capacity and economic vitality.

The New Business Preservation Act would address this problem by establishing a program, administered by the Treasury Department, which would allocate $2 billion in federal dollars ($1.5 billion initially, and $500 million in follow-on investment) to the states on a straightforward population basis to attract private venture capital by offering a 1-to-1 match of federal dollars with venture capital investment in promising startups, particularly in states outside the major venture capital centers.

The legislation is modeled on Israel's "Yozma" program of the late-1990s, which successfully incentivized U.S. venture capital firms to invest in promising Israeli startups, and builds on other successful federal-state partnerships to support small businesses, such as the State Small Business Credit Initiative (SSBCI).

Importantly, the legislation is carefully structured so that the federal government will not "pick winners and losers," but rather will rely on private entities to source and manage investments in promising early-stage companies in every state. All investment decisions will be based entirely on private investor determination of the economic prospects of the new companies receiving equity capital. Finally, the program authorized by the Act is intended to be "evergreen," with any gains from investments following exits to be used to incentivize future rounds of private investment in heartland startups.

Mobilize More Angel Investors Through a Federal Tax Credit

In recent years, "angel" investors – individuals who invest in young promising companies – have become a major source of startup capital in the United States. Like venture capitalists, angels invest in new, high potential companies in exchange for an equity stake in the business. As with venture capital, angel capital is recovered and returns realized when financed firms either go public or are bought by another company.

Many angel investors – particularly those who are current or former entrepreneurs – also provide advice, mentoring, and other support to the management team of the new businesses in which they invest. Perhaps for this reason, research has shown that angel investment significantly increases a startup's chances of success. A study conducted by William Kerr and Stanislav Sokolinski of Harvard University and Antoinette Schoar of MIT found:

> "Startups funded by angel investors are 14 percent to 23 percent more likely to survive for the next 1.5 to 3 years and grow their employment by 40 percent relative to non-angel funded startups. Angel funding affects the subsequent likelihood of a successful exit, raising it by 10 percent to 17 percent. Having angel funding also seems to matter significantly for the ability of a firm to obtain follow-on financing."

Angel investors also differ from venture capitalists in significant ways. For example, unlike VCs, who invest institutional capital in amounts of $1 million or more, angels invest their own money, typically in amounts between $25,000 and $250,000. Despite smaller individual investments, aggregate angel capital rivals that of venture capital. In 2019, angels invested a total of $24 billion in 63,730 companies. For every new company that receives venture capital, nearly 20 others receive angel capital. Amazon, Home Depot, and Uber are just a few of the thousands of companies launched with angel capital.

Perhaps most importantly, whereas venture capital is typically invested during a later growth phase after initial financing has helped create a viable company, angel investors have emerged as the principal source of outside "seed" or early-stage funding critical to the formation, survival, and growth of new businesses – providing 90 percent of such capital once entrepreneurs have exhausted their own resources and those of family and friends.

According to the Center for Venture Research (CVR), there are currently about 335,000 active angel investors in the United States. According to the SEC*, another 12 million American households* meet accredited investor criteria. Most are likely unaware of what angel investing is and of the opportunity to participate in financing the next generation of great new companies.

To be sure, angel investing is risky and not appropriate for every accredited investor. More than half of all angel investments lose money, and just 7 percent of all investments generate 75 percent of returns. But given the importance of angel investors to startups – and the importance of startups to economic growth and job creation – the formation and commitment of angel capital should be responsibly incentivized. If only 3 percent of the 12 million additional potential angels chose to allocate a portion of their financial portfolios to promising new companies launched in their cities and towns, the number of active angel investors would double to 650,000 – and, presumably, the amount of capital invested would double to $50 billion annually.

In CAE's view, this objective can be best achieved by way of a federal tax credit, coupled with relief from taxes on any gains in the value of angel investments held for at least five years. Twenty-six states have enacted tax credits to incentivize angel investing. Details vary from state to state regarding the size of the credit, limits per investment, caps on total investments, and qualifying businesses. Most states offer credits of between 25 and 35 percent.

And the evidence to date is clear – tax credits work. For example, after Ohio created its Technology Investment Tax Credit in 1996, the program was used by 4,800 angels to invest more than $160 million in 668 companies through 2013, according to the state economic development agency. Similarly, after Wisconsin enacted a 25 percent tax credit in 2005, total angel investments jumped more than 10 times and the number of angel investor groups in the state increased from just four to more than 20. Other states have experienced similar success.

A federal tax credit equal to 25 percent of investments in startups would lower investment risk to angels by providing an immediate return. While tax credits encourage investment, the majority of the angel's money remains at risk, preserving the investor's incentive to carefully examine potential projects and ensuring that scarce investment capital will be directed to only the most promising business ideas.

Exempting any returns on investments in startups held for at least five years from federal capital gains tax would maximize the pay-off on any successful investments. Since total capital gains tax revenues have historically represented less than 5 percent of federal tax revenues, exempting gains on angel investments from taxation would have almost no impact on federal tax revenue while having a potentially dramatic effect on new business formation and growth. Moreover, because most angel investors reinvest most or all of their returns into the next generation of innovative new companies, exempting such gains from federal taxes would have the further benefit of increasing the amount of seed capital available to startups.

Pass the IGNITE American Innovation Act

To respond to the capital needs of new and small businesses amid the Covid-19 pandemic, Congress created the Paycheck Protection Program (PPP) in March of 2020 and the Federal Reserve Board later established the Main Street Lending Program. Unfortunately, due to their unique financial and funding circumstances, thousands of fragile startups have been shut out of PPP and the Fed's lending facility, with many forced to lay-off employees or close their doors permanently.

With these realities in mind, CAE strongly supports the immediate passage of the **IGNITE American Innovation Act**, introduced on August 5, 2020 by Rep. Dean Phillips (D-MN) and Rep. Jackie Walorski (R-IN). The legislation would amend the U.S. tax code to permit pre-revenue startups to "monetize" tax assets on their balance sheets – principally net operating losses (NOLs) and research and development credits – as a means of getting badly needed capital to promising young companies as the pandemic continues.

Allow Startups to Carry Forward Operating Losses and R&D Credits

Most new businesses lose money in their initial years – sometimes for many years – before hopefully becoming profitable. Such losses are often due to substantial research and development (R&D) investments, salaries, and other expenses that exceed earnings. For many startups, R&D and salaries can be the primary expenses of the new company in its early years. Whatever the cause, startups, because they are new, have no previous income against which to apply current operating losses. Moreover, income against which losses can eventually be deducted might not materialize for years.

Even more problematic, two aspects of the current tax code that restrict loss and credit carry-forwards – Sections 382 and 383 – can have the effect of virtually eliminating any carry-forward tax benefit for startups. Sections 382 and 383 were written in the mid-1980s to prevent "loss trafficking" – companies acquiring failing firms with large losses solely to use the acquired company's tax losses to offset other unrelated income. Section 383 pertains to tax credits, while Section 382 pertains to net operating losses. The rules can virtually eliminate the use of net operating losses and credits following transactions perceived as a change in ownership.

Startups often depend on outside investments – from venture capital firms or other sources – to finance R&D and other expenses, sometimes for many years. Such investments are critical for the survival and growth of new firms – but often trigger 382 and 383 change-of-ownership restrictions, potentially nullifying net operating loss carry-forward tax benefits, including for R&D investments. In other words, Section 382 and 383 carry-forward restrictions actually punish startups for incurring the very kinds of investments that federal tax policy explicitly encourages for older established firms.

With this policy inconsistency in mind, CAE recommends that a safe harbor be created for startups to protect them from the unintended consequences of Sections 382 and 383 limitations.

Enhance the Payroll Tax Provisions of the PATH Act

The Research and Development tax credit is particularly relevant for startups, which often incur substantial losses in their early years due to research and development of new products and services, methodologies, and techniques – and for whom preservation of cash flow and operating capital is crucial to survival. And yet, until recently, startups were largely shut out of any benefit associated with the credit because startups often have no taxable earnings (for years) against which to apply the credit.

The Protecting Americans from Tax Hikes ("PATH") Act of 2015 made a number of improvements to the application of the R&D tax credit, perhaps most notably finally making the credit permanent after numerous extensions and expirations since its creation in 1981. Now certain of the credit's availability, businesses can make investment decisions more effectively and efficiently.

The PATH Act also addressed the disconnect between the policy intention of the R&D credit and startups by allowing new businesses to apply the credit against payroll taxes, rather than income taxes, up to $250,000 annually. To qualify, companies must have had gross receipts for five years or less and gross receipts of less than $5 million for the tax year the credit is applied.

CAE recommends enhancing the PATH Act's tax provisions for startups by: 1) aligning the criterion for eligibility with that of Section 1202 of the tax code; 2) raising the eligibility threshold; and, 3) increasing the deduction limit.

First, CAE recommends that the eligibility criterion be changed from gross *receipts* to gross *assets*. This change would make the PATH Act provisions consistent with the tax code's definition of "Qualified Small Business," (QSBs) which are currently defined as businesses with "less than $50 million in gross assets." This consistency would simplify and harmonize related provisions of the tax code, facilitating compliance and reporting by investors and, thereby, promoting capital formation.

Second, CAE recommends that the eligibility threshold for the PATH Act's payroll tax provisions be raised from the current definition of QSBs of "less than $50 million in gross assets" to "less than $100 million in gross assets." The current gross asset limit is too restrictive, as the high costs of innovative research, coupled with valuable intellectual property and successive rounds of financing, often push new innovative companies over the $50 million limit (see recommendation regarding Section 1202 below).

Finally, CAE recommends that the payroll tax credit deduction limit be raised from the current $250,000 to $1 million. Doing so would align U.S. policy with similar policy in Canada, a major innovation competitor to the United States.

Incentivize the Formation and Commitment of Angel Capital

Section 1202 of the tax code was enacted in 1993 to incentivize investment in "qualified small businesses" (QSBs) by excluding 50 percent of capital gains on investments held for at least five years from federal income tax. The PATH Act of 2015 made permanent a 100 percent exclusion from capital gains tax for any gains on long-term investments in qualified small businesses, up to

$10 million or ten times the original investment, whichever is greater. Previously, the American Recovery and Reinvestment or "Stimulus" Act of 2009 raised the excluded portion from 50 percent to 75 percent, and exempted any gains from the Alternative Minimum Tax (AMT). Subsequent legislation raised the exclusion to 100 percent and extended the AMT exclusion temporarily. CAE recommends that this full exclusion from federal income tax of any gains on angel investments in startups held for at least five years be retained in order to maximize the pay-off on any successful investments.

CAE also recommends that the Section 1202 gross asset definition for QSBs be raised from the current "less than $50 million in gross assets" to "less than $100 million in gross assets." The current gross asset limit is too restrictive, as the high costs of innovative research, coupled with valuable intellectual property and successive rounds of financing, often push growing new companies over the $50 million limit and, therefore, out of Section 1202's favorable treatment of capital gains.

Finally, at present the Section 1202 exclusion only applies to investments in companies organized as C corporations. Because most new businesses are launched as S corporations, partnerships, or limited liability companies (LLCs) – "pass-throughs" – CAE also recommends that the 1202 exclusion be applied to any startup that converts to a C corporation within five years, and that the period of time spent as a pass-through count toward the five-year holding period required by Section 1202. In other words, angel investors would not have to hold the investment for five years beyond conversion to a C corporation, but only five years beyond the original investment in the company.

<u>Improve Treatment of Startup Investment Losses</u>

As a counterpart to the Section 1202 tax treatment of angel investment *gains*, Section 1244 of the tax code allows investors in qualified small businesses to deduct *losses* on such investments as an ordinary loss (deducted from ordinary income) rather than as a capital loss. Normally, the tax code treats equity investments as capital assets and, therefore, losses are deducted as capital losses to offset capital gains. If capital losses exceed gains in a particular year, remaining losses are deductible up to a limit of $3,000 annually, with any additional remaining losses carried forward to subsequent years. By contrast, a loss on a Section 1244 investment is deductible from ordinary income up to $50,000 for individuals and $100,000 for couples filing jointly.

To qualify for Section 1244 treatment, the issuing company's aggregate equity capital must not exceed $1 million at the time of issuance, the company must have derived more than 50 percent of its income from business operations rather than passive investments for the previous five years, and the shareholder must have purchased the stock directly from the company and not received it as compensation. Startups generally don't issue stock for years after launch, if ever – nor have they been in existence for five years – and, therefore, currently don't meet the requirements of qualifying small businesses.

To further incentivize seed-stage investments in start-ups, CAE recommends expanding Section 1244 to permit losses sustained by angel investors on investments in new companies held for at least 5 years to be deductible from ordinary income up to $250,000 annually.