

Cooley Proposes Tax Stimulus Measure to Benefit Startups and Their Investors

In connection with current efforts in Washington to stimulate the economy, Cooley Godward's Tax Group has proposed a stimulus measure that would make investing in and acquiring startups more attractive as well as eliminate a flaw that exists in the tax law.

Under current law, most of the tax incentives directed at businesses, including, for example, special deductions and credits for research and development ("R&D"), do not benefit venture-backed startups in any meaningful way as a result of existing limitations on the ability of a startup to carry forward these deductions and credits. **In effect, the current tax incentives for R&D are, ironically, nullified for R&D startups—the chief engine of R&D in this country.**

Drawing upon the experience of two former Treasury Department officials who are members of Cooley's Tax Group, and on the previous successes of group members in lobbying successfully on behalf of the venture capital and high-tech industries, Cooley's Tax Group has crafted a solution to this problem that is fair to investors and their startups, and is consistent with existing bipartisan tax policy initiatives.

The proposed solution focuses on the limitations that preclude a startup from carrying forward its R&D-related tax deductions and credits. These limitations are generally triggered following an equity financing or an acquisition.

The Cooley proposal would remedy this problem so that financings and acquisitions

would no longer eliminate the R&D deductions and credits of most startups. The resulting valuation increase in connection with a later sale or IPO would, we believe, serve as an added incentive to invest in such startups. Given the marked slowdown in capital flowing to startups during the last three years, we believe this is the time to remedy this problem. Because startups are a critical driver of economic activity and job creation, we also believe this proposal is a worthwhile addition to broader stimulus efforts currently under consideration.

Cooley's Tax Group has submitted a letter describing the issue raised above and our proposed solution to various officials with the Treasury Department and Congress (letter follows; complete addressee list at <http://www.cooley.com/TaxProposal.html>). We have also published an article in a leading tax policy magazine describing this issue in greater detail and providing additional background: http://www.cooley.com/TaxNotes_v8.html.

If you have any questions or would like to help support this initiative, please contact the authors: Glen Kohl [gkohl@cooley.com or 650-843-5457], and Dan Meehan [dmeehan@cooley.com or 720-566-4061], or any member of the Cooley Tax Group. ■

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January 29, 2003

The Honorable Pamela F. Olson
Assistant Secretary, Tax Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

RE: An Economic Stimulus Proposal

Dear Assistant Secretary Olson:

Cooley Godward LLP is a Silicon Valley law firm representing many of the country's premier emerging growth companies and venture capital investment firms. Many of our clients are startup high-tech and life sciences companies with a historically heavy emphasis on research, development and innovation. Over the past three years, we have seen our startup clients struggle to obtain financing to pursue their R&D activity and grow their businesses.¹

Accordingly, we read with interest the recently proposed tax provisions of the President's Growth Package and in particular the Treasury's background materials describing the anticipated impact of the Growth Package on small business. In furtherance of the national discussion about these and other ideas for stimulating the economy, we respectfully submit the proposal summarized below. The attached memorandum [<http://www.cooley.com/TaxAlertMemo.pdf>] contains a more detailed explanation of the proposal. We are sending similar letters to certain members of Congress, their staff and the Small Business Administration.

Proposed R&D Exemption

We propose that the net operating loss and credit carryforwards ("NOLs") generated by qualified small business corporations be excluded from certain provisions of Sections 382 and 383 of the Internal Revenue Code (the "NOL Limitations") to the extent the NOLs are comprised of deductions and credits generated by the Section 41 credit for increasing research activities and the Section 174 deduction for research and experimental expenditures (the "R&D Incentives"). Thus, under this proposal, the R&D-related deductions and credits of qualified small businesses would survive an outside financing transaction or a business combination and be usable to offset taxable income generated after the financing or business combination. We propose to limit the suggested relief to only the R&D expenditures incurred by those corporations classified as qualified small businesses under Section 1202(d) (generally defined as C corporations with less than \$50 million in gross assets).

The Problems Addressed by the R&D Exemption

The proposed R&D Exemption is aimed at two problems. First, it addresses a fundamental inefficiency in the R&D Incentives as they apply to high-tech startup companies. The NOL Limitations effectively render the R&D Incentives unavailable for startups. If a startup with R&D-related NOLs requires outside investment to continue its R&D activity and is financed by investors who acquire a large portion of the company's stock, the NOL Limitations drastically limit – and in some cases virtually eliminate -- the amount of the company's NOLs that can be used by the company after the transaction. This was undoubtedly not intended by Congress in enacting and extending the R&D Incentives numerous times. While we are not the first to identify this problem,² we believe that the time is

¹ Much to our dismay, but consistent with our clients' current travails, we have neither asked nor been offered payment in connection with this submission.

² See the attached memorandum for references to others who have identified and proposed solutions to this problem.

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particularly ripe to fix it. In the current economic climate, the flow of investment capital to, and job creation by, startups has slowed to a trickle. The extraordinarily high valuations for startups prevalent during the late 1990's are no longer available to mask the problem. Thus, as foreshadowed by earlier commentators, the effective denial of the R&D Incentives for startups now serves as a real economic drag on efforts to jump-start small business R&D and job creation.

Benefits of Proposed R&D Exemption

Our experience with small business clients suggests that there is no shortage of ideas or desire to innovate and develop new technologies. But startups currently lack the investment capital necessary to pursue those ideas and innovations. The proposed R&D Exemption would reassure small businesses and their investors that the tax benefits originally intended by the R&D Incentives are not illusory. We believe this would have a beneficial effect on the flow of investment capital to startups engaged in R&D activity. To summarize, we believe the R&D Exemption would:

- Fix a fundamental inefficiency in the R&D Incentives as they apply to startups;
- Promote a much-needed increase in the flow of investment capital to R&D startups;
- Target small businesses in a very direct way, both in effect, and by limiting the exemption to corporations classified as qualified small businesses;
- Promote job creation by small businesses; and
- Promote the most desirable type of small business spending -- on high-wage jobs and R&D.

Conclusion

We believe a proposal that modestly seeks to ensure that small businesses can enjoy the benefits of the R&D Incentives could have a direct impact on increasing the flow of capital to startup enterprises as well as fix an existing flaw in the Code's R&D incentive structure. If you have any questions or would like to discuss this proposal further, please feel free to call Glen Kohl at 650-843-5457, or Dan Meehan at 720-566-4061.

Sincerely,

Glen Arlen Kohl
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Daniel P. Meehan
Cooley Godward LLP, Broomfield, Colorado

Enclosure

cc: Gregory F. Jenner, Deputy Assistant Secretary (Tax Policy), Department of Treasury
Jeffrey H. Paravano, Senior Advisor to the Assistant Secretary (Tax Policy), Department of Treasury
Eric Solomon, Deputy Assistant Secretary (Regulatory Affairs), Department of Treasury