Senate Committee on Finance

Carried Interest II

Hearing July 31, 2007

Testimony of:

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Introduction

Chairman Baucus, Ranking Member Grassley, and Members of the Committee, my name is William Deming Stanfill, founding partner and head of the Denver office of Trailhead Ventures, a private venture capital partnership whose investment focus is information technology. At the outset, I would like to make clear that I speak not on behalf of my firm and certainly not on behalf of the industry. Rather I speak as a private citizen who has been involved in the venture capital industry for 25 years.

I joined the Centennial Funds of Denver in 1982 and was responsible for a fund of funds activity wherein we invested in thirty venture partnerships around the United States. The venture partnerships collectively invested in 600-700 portfolio companies including telecommunications, medical, and information technology. Those portfolio companies were scattered across the U.S., from Massachusetts to California, Florida to Oregon, Colorado and Utah, Arizona, Texas, and New Mexico, Alabama and Georgia, Idaho and New Hampshire.

What We Do

In 1995, I left the Centennial Funds, purchased the fund-of-fund activity and formed Trailhead Ventures to invest directly in early stage information technology enterprises. By industry standards we are a small fund. Our advantage is our ability to provide seed and early-stage capital of $2-4 million to start-up companies. A $500 million partnership, by contrast, cannot manage 125 to 250 investments of $2-4 million each. Our limited partners include state and corporate retirement funds, university endowments, and the occasional high net worth individual.

Basically we back entrepreneurs who have good ideas and an obsession to bring them to market. We help surround the entrepreneur with a world-class management team. If the team performs well, we have the good sense to stay out of their way. The last thing most venture capitalists want is for the management team to hand them the keys to the enterprise. That said, we serve on boards, assist with business strategy, help interview and select members of the senior leadership team, and introduce the entrepreneurs to professional and other service providers who can bring value to the enterprise.

How We Are Compensated

We receive a management fee, based on a percentage of committed capital, to cover salaries and expenses. After payback, when limited partners have recouped their investment, we then share in the profits on an 80/20 split. This is the "carried interest." Both the management fee and the carried interest represent compensation for the work that we do. The general partners also invest at least 1% of the fund's capital. The earnings on that 1% are, of course, not compensation, but qualify for capital gains treatment along with our investors' earnings.

How Our Compensation is Taxed

Our management fee is taxed as ordinary income. However, the carried interest, even though it is compensation, is primarily taxed at capital gains rates. I can understand why many in my industry want to preserve this special tax advantage. Clearly, it has served US and ME well. The tax subsidy each year to private equity fund, hedge fund, and venture capital fund managers is in the *billions* of dollars. But I think this special tax break is neither fair nor equitable. After all, a gifted teacher who is training and inspiring and challenging our children and enriching *human* capital gets no such special treatment.

All workers add value—to a greater or lesser extent. Greg Alvarado, the landscaping artist who maintains my yard, brings beauty and order to my home and the neighborhood. But the tax rate on my carried interest is less than the tax rate on his earnings. Or how about the veterans of the Iraq war, in particular the 26,000 casualties? Do I deserve a tax break more than they do? Ben Stein doesn't think so. Nor do I.

Many Americans invest sweat equity in their jobs and their businesses, take risks, contribute to the economy, and may have to wait a long time before their hard works pays off. But they still pay ordinary income tax rates on their compensation. To the extent we take risk, we take it with other people's money. As Bill Gross, the managing director of PIMCO Bond Fund noted, "[w]ealth has always gravitated towards those that take risk with other people's money but especially so when taxes are low."

Consequences of Changing the Tax Treatment

I don't think that changing the tax law to require me and other managers of venture capital firms, private equity firms, and hedge funds to pay tax on our compensation like other working taxpayers would have the dire consequences that some are predicting.

Many predict that firms will locate overseas, taking jobs and tax revenue out of the country. My firm is too small to play in the international field—the learning curve is too steep and the expenses are too high. And if you are doing seed investing, we've always found sufficient deals in our own backyard. And my accountant advises me that, even if we did move our fund offshore, as a U.S. citizen I would still be subject to U.S. tax on my income.

I don't see why my limited partners would stop investing in our fund just because my tax treatment changes. It doesn't affect their taxes—most of them are non-taxable entities anyway. If my investors ask me what this tax change means to them, I'm going to tell them "nothing." And I'd still have a strong incentive to do the best for my investors. After all, I don't earn profits until they do.

What limited partners should expect from a venture capital investment is a 500 basis point (5%) premium over a portfolio of publicly-traded securities. And that premium is not a risk premium, but a premium for illiquidity. Why? Because we are a 10-year partnership. But in addition to that premium, the investor gets a lottery ticket and the results can be substantial. In the first Trailhead Fund, we have produced a 54%

internal rate of return net to the investor and if we liquidated the remaining public securities today, we would return 10 to 11 times our partners' capital.

I have read Kate Mitchell's testimony from the first hearing about the wonderful things we venture capitalists do. I think this is an idealized view of our industry—a vision of the Wizard of Oz comes to mind. Am I the only one who found her remarks just a bit self-serving? But we don't lead every deal in which we invest. Occasionally we are followers, along for the ride. Ms. Mitchell and I do the same kind of work—we just come to different conclusions about the tax treatment of our earnings.

What is interesting about early-stage venture investing is the rewarding collaboration between the limited partners who bring dollars and trust, the venture capitalist who brings judgment and experience, and the entrepreneur who brings an idea and a fire in his or her belly. That combination can create wonderful, profitable results. But there is a first among equals here that we should never forget, and is the key to the equation, and that is the entrepreneur.

I have loved my work over the last 25 years and I would not stop doing it because my tax rate was adjusted to the level of other citizens'. And I don't think losing the carried interest tax break would drive other venture capitalists out of the field. We like the excitement and satisfaction of assisting management in transforming good ideas into successful businesses. We get ample compensation, financial and psychic, for the work we do and the risks we take, in the form of a share of the profits. There is more than a hint of Chicken Little here. But our industry won't end or be significantly disrupted if this legislation is enacted any more than the auto industry's dire predictions of doom came to pass after mileage standards, seatbelts, and air bags were mandated.

<u>Does Venture Capital Deserve Special Tax Breaks?</u>

I could make a public policy case for excluding venture capital from this legislation. For unlike private equity and hedge funds, the venture capital industry does create jobs. We fund small start-ups rather than restructure huge companies. And we don't use leverage to pay ourselves back and leave the portfolio companies saddled with debt. But I won't. I still think our earnings are compensation and should be taxed the same as the compensation of everyone else in this country—from teachers and firefighters to athletes and movie stars. I don't think it is fair for those teachers and firefighters to subsidize special tax breaks for me and other venture capitalists. Or for private equity and hedge fund managers.

Wealth Inequality

How long will we tolerate the ever-widening gap between rich and poor? Though my preference is for major tax reform—increased standard deductions, a base rate for all income: wages, salaries, dividends, royalties, and capital gains with some progressivity built in – major tax reform is not on your agenda. However, I do believe it is fair, equitable, and appropriate to attack the issue of tax equity at the margins. We should not do nothing because we can't do everything. I am especially disturbed by suggestions that we can't afford to provide health insurance for low income children, first rate medical care for our injured soldiers or fund – at the federal level – the mandates of No Child Left Behind. I am disturbed that these and other human priorities are unaddressed while we pretend we can afford to continue these tax breaks.

Conclusion

I'm delighted to be part of the venture capital business—it's been a wonderful 25 years. We funded a lot of companies—many of them successful. We've worked hard and I think we've earned our compensation. My point simply is that fairness and equity dictate that we pay ordinary tax rates on that compensation.

Was Ben Franklin prescient when he warned us that our republic would fail because of corruption, greed, and, dare I say it, special interests? Doesn't gross inequity in our tax code, maintained by the very people who benefit from it, come close to the same thing? We and our representatives have a choice. We can change the tax code in favor of equity and fairness. Or we can come to the same conclusion reached by Walt Kelly and his mouthpiece, Pogo, "we have met the enemy and he is us."

Thank you and I would be pleased to answer any questions.