Venture Capital Researcher: Federal Tax Credit For Angel Investors Would Encourage Funding For Entrepreneurs When They Need It Most

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DURHAM, N.H. -- Federal legislation that would provide a tax credit to angel investors could substantially help entrepreneurs secure much needed seed capital for their ventures and stimulate growth in moving ideas from the laboratory to the marketplace, according to Jeffrey Sohl, professor of entrepreneurship and decision sciences, and director of the Center for Venture Research at the University of New Hampshire.

Sohl recently was invited to testify in support of HR 5198, The Access to Capital for Entrepreneurs Act of 2006, authored by U.S. House Small Business Committee Chairman Don Manzullo (R-IL) and U.S. Rep Earl Pomeroy (D-ND). The legislation would create a 25 percent tax credit for individuals and groups that make equity investments in small early-stage companies.

"The tax credit proposed in HR 5198 is a judicious use of public policy since it targets the incentive at exactly the time it is needed by both the entrepreneur and the angel investor. For the entrepreneur, HR 5198 increases the potential for securing seed capital and for the investor, the act indirectly provides a slight reduction in the risk of seed stage investing. For the entrepreneurial economy, HR 5198 mitigates, in part, the primary seed stage capital gap," Sohl said.

The UNH Center for Venture Research is the only independent source of reliable statistics on the angel market in the United States. The center has been conducting research on the angel market since 1984. Its mission is to provide an understanding of the angel market and the critical role of angels in the early stage equity financing of high growth entrepreneurial ventures.

As director of the center, Sohl has conducted more than 15 years of research on the angel market. According to Sohl, a tax credit at the time of the seed investment provides the entrepreneur with capital exactly when it is needed, during product and firm development – the "front end" of the start-up stage. Previous research conducted by Sohl and the center indicates that reducing the capital gains tax as an incentive for investors is ineffective, since the tax savings is realized at the time of exit.

"In essence, the venture needs to survive the critical seed stage and expand into a viable business with reasonable market share before an exit (merger, acquisition or initial public offering) can take place. As such, a capital gains reduction, which occurs at the exit event, is only realized if the venture survives the seed stage. Thus, the proper tax incentive program is

one that is targeted at the 'front end' during the start-up stage, when the risk of failure is the greatest and the capital gap is the most severe," Sohl said.

Angels (private investors) are the oldest and largest source of seed and start-up capital for entrepreneurs. In the United States angels invest more dollars in more companies than the formal, or institutional, venture capital market, according to Sohl.

In 2005, in the United States, angels invested $23.1 billion in 49,500 ventures, or approximately $470,000 per deal. In contrast, during this same period venture capital funds invested $22.1 billion in 3,008 deals, for an average of $7.4 million per deal. In the seed and start-up stage, the difference between angels and venture capitalists is even more stark. Close to 55 percent of angel deals in 2005 were in the seed and start-up stage, while venture capitalists allocated a mere 6 percent of the deals to these stages. Even during the best of times venture capitalists, over the last decade, have never invested more than 15 percent of the deals in the seed and start-up stage.

Although angel investors have been in existence for many years, Sohl said that they are in many ways our nation's least understood and most underutilized economic resource. Quietly providing the majority of the seed and start-up capital for high tech entrepreneurial ventures, the angel market of today faces some significant challenges. The angel market is in constant flux, and the recent volatility of the private equity market has provided additional motivation to understand the role of these critical early stage investors and to facilitate their investment activity.

"High growth entrepreneurial ventures hold the greatest potential for innovation, commercialization of technology and sustainable economic development. However, entrepreneurial ventures face significant financial hurdles in the early stage of their development. Unable to attract debt capital in the early stage, and the mismatch between the need for growth capital and the short-term financial requirements of debt financing, contributes to the importance of equity financing," Sohl said.

Without angel investors, perhaps some of the greatest advances in technology and commerce may not have come to pass. In 1874, a young Alexander Graham Bell was searching for money to complete his early experiments on the telephone. Most investors adopted the prevailing opinion, as summarized in an editorial in the Boston Post, "well-informed people know it is impossible to transmit the voice over wires and that were it possible to do so, the thing would be of no practical value." Besides, Bell did not have a company with any tangible assets to provide collateral.

"Recognizing an opportunity, Boston attorney Gardiner Green Hubbard and leather merchant Thomas Sanders of Salem, Mass., put up the equity capital to start the Bell Telephone Company of Boston. The rest is history," Sohl said.

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