Recommendations for increasing the availability of capital*

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INTRODUCTION

Mark Twain's proverbial statement about the weather—"Everybody talks about the weather but nobody does anything about it"—might be equally applicable to small businesses. Everyone seems to be talking about small businesses** these days, but is there really enough that is being done to help them? There are, to be sure, a number of organizations that work on their behalf such as the Small Business Administration in the government sector and venture capital firms in the private sector. There has also been, in recent years, a rapid increase in the number of small business investment companies (SBIC's) as well as minority enterprise small business investment companies (MESBIC's) both federally licensed under the Small Business Investment Act of 1958. More encouraging than the increase in the number of these organizations is the increase in investment funds that they have made available to small businesses: $33 million for MESBIC's and $255 million for SBIC's as of March 31, 1979.

While all of this is very good and while it can be argued that it is extremely encouraging, I would ask again, is it sufficient? Small businesses are, after all, a major source of jobs and organizations that work on their behalf such as the Small Business Administration in the government sector and venture capital firms in the private sector. There has also been, in recent years, a rapid increase in the number of small business investment companies (SBIC's) as well as minority enterprise small business investment companies (MESBIC's) both federally licensed under the Small Business Investment Act of 1958. More encouraging than the increase in the number of these organizations is the increase in investment funds that they have made available to small businesses: $33 million for MESBIC's and $255 million for SBIC's as of March 31, 1979.

The present level of capital gains taxation has become a very critical constraint on the founding and expansion of small, technically oriented firms. Increases in capital gains taxation are probably more responsible than any other factor for the gradual deterioration in technological entrepreneurship that has occurred in the United States during the last decade. Such changes have successively lowered after-tax returns for investors in successful innovation to a level where now, technologically innovative firms no longer are able to attract adequate investment.

Engaging in industrial innovation has always been inherently risky because the uncertainties associated with new technology developments are always compounded by the uncertainties of market acceptance of the new products and processes that result from such developments. At the same time, innovation is usually a capital intensive activity, not so much because it requires a massive investment as do steel and chemicals, but because of the extensive time lag between the launching of the development and the establishment of its large scale acceptance in the marketplace. During this time, capital is required to cover the expenditures for start-up costs before the revenues have begun to be realized. Such capital is forthcoming only when potential investors believe that the after-tax returns will be adequate to cover their risks. The problem of adequate rewards, however, is not just one for capital. Traditionally, key management and technical personnel have been compensated for the personal risks in joining uncertain ventures by sharing in the fortunes of the firm rather than by receiving salary payments. In our free enterprise system successful entrepreneurship creates the economic values. These, in turn, are reflected in the rise in stock prices of the enterprise and are realized by investors and key individuals in the sale of their stock in such enterprises. Thus the after-tax capital gain is of critical importance if we are to have innovation by small firms.

In looking back over the last decade, the tax on capital gains from 1969 to 1977 increased dramatically. Prior to 1969, the maximum capital gains tax rate paid by individuals was 25 percent. The Tax Reform Act of 1969 increased that rate...
to a maximum of 40 percent—a 35 percent rate on the capital gains and an additional 5 percent from the operation of the minimum tax. Legislation also reduced the tax on earned income from a maximum rate of 70 percent to 50 percent. Thus the differential between the taxation of salaries and capital gains narrowed from 70 percent on salaries and 25 percent on capital gains to 50 percent and 40 percent respectively.†

The Tax Reform Act of 1976 provided for further increases in the minimum tax as well as raising the maximum rate on capital gains to approximately 49.0 percent. These changes virtually eliminated the differential between the rates on earned income and capital gains that existed prior to 1969. The effect of these changes was further compounded by the high rate of inflation which produced significant capital gains in current dollars, and hence capital gains taxes, for assets whose value after adjustment for inflation had actually declined. The impact of such changes in taxation has been dramatic for the small technically oriented firms in which the prospect of capital gains has been the major incentive for investors. The 95th Congress recognized the negative consequences of the high rate of capital gains tax by passing significant rate reductions. The legislation did not, however, restore the rates to the 1969 level. Given the risks of small, technically oriented businesses, a further rollback is necessary for these firms to realize their growth potential in such vital areas as job creation. It is also necessary to consider an even lower rate of 10 percent to attract investment in the smallest of businesses; for example, application of the lower rate should be determined by the size of the businesses at the time the investment is made and thus serve to attract capital to new firms and to recognize the higher degree of risk in the smallest firms.

Therefore, our highest priority is for a capital gains tax reduction that is targeted for small, technically oriented firms. Such a tax reduction would be a superior method of improving the availability of capital. By increasing the rewards for successful ventures, an incentive could be provided to manage such enterprises in an efficient way, leaving to the marketplace the distribution of these incentives among the various firms. This approach would be superior to providing loans, or other federal financing to small firms; approaches that would thrust upon the federal government the difficult task of deciding among the different loan applicants. This proposal might result, at least initially, in revenue loss to the federal government, but given the narrowly limited target of the proposed tax reduction, it would be a minimal one, and losses would be offset by the gains in employment and output from the successful firms.‡

**Recommendation 1**

That the capital gains tax rate be reduced to 25 percent (the pre-1969 rate) on the capital gains realized from the sale of stocks of small businesses whenever such stocks have been held for three years or more, with a rate of 10 percent for the capital gains of investors in the smallest of businesses. This reduced rate would not be applicable to any capital gains realized from real estate sales.

**Tax-free exchange of stock**

Continuous investment holdings are risky even in small, technically oriented firms whose stock has risen in value. The reason being that stockholders have a propensity to diversify their investments. Under existing tax laws the most profitable way to diversify is through a tax-free reorganization with a large firm carried out through a tax-free exchange/transfer of stock. Investors oftentimes find that equity shares of large firms are likely to be more liquid and represent a diversified set of economic activities. On the other hand, this method of diversification tends to concentrate capital in the larger firms.

It is important, therefore, to have tax policies that encourage the continuous use of capital in the start-up of new firms. At the same time the investor’s desire for diversification of risk is a legitimate one and must be recognized. Accordingly there is a need to establish an alternate route for tax-free diversification of risk that would encourage the formation and growth of small firms but allow the tax free roll-over of investment from one small firm to another. Such a provision—similar to the roll-over provision on sale of homes—would make funds available to new, small, technically oriented firms, from the most knowledgeable and receptive of investors—those that have already participated in such ventures. It would remove, moreover, the tax incentive for the sale of the successful small firms to the large ones, thus preserving the small firms as independent business entities. It would also allow the investor to diversify his holding in several small, technically oriented firms.

Essentially this same proposal was made in 1976 by the Tax Policy Task Force of the Small Business Advisory Committee on Economic Policy.

**Recommendation 2**

That appropriate changes be made in the tax code to permit deferral of capital gains taxes on the sales of shares in small businesses if the proceeds are reinvested within one year in one or more other small, technically oriented firms.

**Taxation of corporate income and tax treatment of start-up losses**

**Taxation of corporate income**

Small businesses frequently experience great difficulty in obtaining capital not only in their early, formative years, but also during the years of their rapid expansion. Firm data are not readily available, but capital shortages during this period

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are believed to contribute greatly to the high failure rates of small businesses. Causes of capital shortages cover a broad spectrum, but in the case of the small, struggling companies that bring new products or services to the market, current tax rates on net earnings are so high as to preclude the establishment of a solid, financial base that is attractive to investors. The best and easiest way for small firms to achieve a sound financial basis, and hence adequate funds to support expansion, is, of course, through retained earnings. Current tax rates on corporate earnings are not, however, sufficiently differentiated between the small firms and the larger, more established corporations. Net earnings of all domestic companies (other than mutual savings banks, life insurance companies, or regulated investment companies), regardless of size and age, are subject to a tax of 17 percent on the first $25,000 of net income, 20 percent on the next $25,000, 30 percent on the next $25,000, 40 percent on the next $25,000 and 46 percent of that portion of the taxable income that exceeds $100,000. And yet, the tax bite doesn’t end there. Most states also collect income tax on small businesses, and many impose taxes on dividends to stockholders. Small businesses would have a better chance for survival, as well as growth, if the tax rates on net earnings were also reduced.

Start-up losses

The well established corporation is also provided a tax incentive for innovation insofar as its expenses for the early phases of innovation are a deduction from its corporate income tax. The new, small firm cannot obtain this tax benefit since it lacks the profits from which such losses can be deducted. Then too, such losses (incurred after December 31, 1975) can be carried forward seven years and charged against income. Before 1976, net operating losses could be carried forward for only five years. It is common knowledge that some of the most advanced and promising technology has a longer gestation period than seven years and hence does not yield profits within a seven-year period in which to take advantages of earlier losses through offsets. In short, there is a tax bias against the smaller firm that is developing technology when compared to the larger firm. This unfavorable tax bias should be eliminated.

Recommendation 3

That the threshold for the application of the full corporate tax rate of 46 percent be raised from $100,000 to $250,000 of annual net income; and for annual net income below $250,000, a progressive rate schedule be established beginning at 10 percent on the first $20,000, and increasing in 10 percent increments to a ceiling of $250,000 on each additional $40,000 until $100,000 is reached and then no increase until $250,000; in addition, the carry-forward provisions for start-up losses of small businesses be extended from seven to ten years.

Qualified stock option plan for key employees

Small, innovative companies frequently depend upon stock incentives to attract, and retain, key employees because they cannot afford to pay the high salaries customarily paid by the large firms. Small companies also tend to go through a growth cycle where, in the early stages, technical know-how is the dominant skill required. In due course, commercial products or services are produced from this know-how, but the number of customers remains small. Later, as market opportunities expand and production grows, new requirements develop. The need to manufacture and market products on a larger scale emerges and the need to organize and operate more efficiently begins to rise. This stage requires managerial talents that are oftentimes unavailable in the smaller companies but are plentiful in the larger firms.

The problem for the smaller firm is how it should work to attract more experienced operational managers from the larger companies. Prior to 1976, a widely used and highly successful incentive was the Qualified Stock Option, which allowed a key employee the following choice: if the person chose not to be taxed in the year of grant on the current value of the stock, the person could defer payment of the tax from the exercise date of the option to the earlier of: (1) the year of sale of the underlying stock; or (2) ten years after the grant of the option. The Tax Reform Act of 1976 eliminated this option. As a result, the current law unduly penalizes key employees of smaller firms who must sell their optioned stock at the time of exercising the option in order to pay the required tax. At the same time the individuals are precluded from selling the stock obtained from exercising their options because of the limited or highly illiquid market for such stock.**

That restoration be made of the Qualified Stock Option Plan for Key Employees of small businesses.

Access to capital markets

Traditionally, small, technically oriented firms have relied on external financing from the public capital markets to support their streams of new products and services that have given vitality and buoyancy to the U.S. economy. In recent years there has been a sharp reduction in the number of firms successfully obtaining funds in the capital markets. The reason is readily apparent to anyone watching the stock market today. Equally illustrative of the venture capital shortage is the recent survey commissioned by the National Venture Capital Association. The report states that in 1975 the bulk of the venture capital industry’s investments were in “non” venture businesses. Only 4 percent of the money went to the start-up of new ventures and only 2 percent went to fi-

To prevent small firms with growth problems from being precluded entirely from the public securities market, the SEC created Regulation A. This regulation facilitates securities offerings of $500,000 and less, by exempting them from the costly and time-consuming requirements of a full registration. In today’s economy, the value of this exemption has been reduced significantly due to inflation. At the same time, the need for increased dollars from the venture capitalists has increased substantially. Both trends emphasize a real need to raise the Regulation A limit to reflect the current realities of our existing capital markets.

Another cause of the current shortage of capital for new ventures is the extreme difficulty of investors to liquidate their venture capital investments once they are made. The basic objective of an investor has always been to realize substantial gains once the venture becomes successful. Not only does this produce a profit that is commensurate with the risk, but it also enables the venture investor to recycle his capital back into other new ventures. If investors cannot realize a profit from their venture capital investments, they will stop making the investments. Then too, gains from successful investments must be sufficient to offset losses, which, in many cases, frequently represent a significant percentage of the total capital invested.

Finally, severe impediments to achieving liquidity have been caused by recent changes in SEC regulations that force investors to urge young and successful innovative firms to seek mergers with larger companies that have broader markets for their shares. This has the counter-productive effect of stifling small promising businesses before they have had a chance to prove they can thrive on their own, let alone making large corporations even larger. In the final analysis, innovation is discouraged and job creation is diminished.

Therefore, liquidity restrictions on venture capital investors should be eased by modifying SEC Rules 144 and 146 so as to facilitate the sale of equities in thriving businesses, as well as the reinvestment of the proceeds in new and growing businesses. Such modifications would be consistent with the needs and protection of the investor as well as the reinvestment of the proceeds in new and growing businesses. Such modifications would be consistent with the needs and protection of both the investor and the securities markets. This would also serve to reduce the liquidation of investments through large corporate takeover.

Recommendation 5

That the Security Exchange Commission’s Regulation A exemption be increased to include all issues under $3,000,000 and that SEC regulation procedures for small issues be streamlined; further, that SEC procedures be modified to facilitate the sale of stock in small businesses by major stockholders up to the amount of $100,000 per year.

Pension fund investment

Pension funds provide the primary pool of investment capital today. Their asset are generally estimated to range between $200 and $400 billion. The managers of such funds are subject to ERISA regulations. A conservative interpretation of the ERISA regulations requires that the fund managers limit their equity investment to stocks of blue chip firms frequently traded in large volumes on the public exchanges. Therefore, by simply amending ERISA regulations, a new source of funds could be made available to small, technically oriented firms. The Labor Department found considerable merit in the recommendation of a 1976-77 Small Business Administration Task Force on Equity Finance that ERISA be amended in such a way as to increase the availability of capital to small, small, innovative firms without jeopardizing the safety of pension plan investments. On July 23, 1969, a new regulation went into effect that removed the personal liability of a pension fund manager if a particular investment turned sour, provided the manager had followed department guidelines. Although this change will prove beneficial, we believe a further change should be made.

Recommendation 6

That ERISA’s prudent man standard be restated so that it is clearly applicable to the total portfolio of pension fund investments rather than individual investments; and further, that pension fund managers explicitly be permitted to invest up to 5 percent of pension fund assets in small, technically oriented firms.

CONCLUSION

New jobs, especially skilled jobs; better solutions to our national problems of urban decay, pollution, steeply rising costs of food and housing, and health care; and increased competitiveness in international markets—all depend upon our ability to stimulate the rate of technological innovation in the United States. Small businesses are the “well spring” for this innovation and small businesses, in turn, depend upon the availability of capital to sustain them.

The recommendations contained in this paper are suggested as one possible course of action that will lead to increasing the availability of capital through changes in direction and thrust of our corporate tax laws. The changes as recommended would not result in any material loss of revenue to the government and yet would restore the vigor and vitality of our small businesses. Without small businesses we cannot hope to solve some of the economic problems confronting our society today. With them we can ensure our place of leadership in the world economy.


‡ Pages 14 and 15 of the cited report.