



## **Startup-Oriented COVID-19 Relief Proposals**

Startups are major drivers of economic growth, U.S. innovation, and competitiveness. New, young firms make outsized contributions to net job creation.<sup>1</sup> It is essential we support startups now so that they are able to survive the current economic downturn and be well-positioned to expand and hire rapidly after the pandemic. But seed funding has already started to decline significantly this year,<sup>2</sup> and especially for companies that do not have established relationships with VC investors, deals are expected to continue to slow.<sup>3</sup> Female- or minority-founded companies are expected to face even higher funding hurdles.<sup>4</sup> In addition to seeing conventional sources of investment evaporate, many startups are likely to be shut out of current federal relief programs—either because they are ineligible or because the existing relief programs are not suited to their financial needs. Accordingly, this document explores alternative policy interventions that will help ensure startups have the resources they need to ultimately drive long-term economic recovery.

### **Equity Investment**

Government equity investment is one option for providing working capital to startups. There are at least three models for such an equity investment program: (1) a joint federal-state-private program, such as the New Business Preservation Act, led by Representative Phillips (H.R. 6403) and Senator Klobuchar (S. 3515); (2) a federal-private, convertible-debt model, or (3) direct federal investment.

#### 1. Federal-State-Private Partnership - The New Business Preservation Act

The New Business Preservation Act creates a joint public-private program to invest in new startups. It is designed to incentivize private investment, to promote diversity, and to be self-sustaining because the government's returns will be reinvested in future startups. As currently drafted, the bill would establish the Innovation and Startups Equity Investment Program in the Department of the Treasury and allocate an initial \$2 billion for the program. The federal funds are allocated to state programs which partner with private investors to make equity investments in startups in the state. The government can provide up to 50% of the total invested through the program. As introduced, the bill focuses on funding female- and minority-founded companies and companies located outside of major

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<sup>1</sup> *The Economic Impact Of High-Growth Startups*, Kauffman Foundation (June 7, 2016), [https://www.kauffman.org/wp-content/uploads/2019/12/PD\\_HighGrowth060716.pdf](https://www.kauffman.org/wp-content/uploads/2019/12/PD_HighGrowth060716.pdf); Arnobio Morelix, *The Impact of COVID-19 on the Global Startup Ecosystem*, Startup Genome (April 1, 2020), <https://startupgenome.com/blog/impact-of-covid19-on-global-startup-ecosystems>.

<sup>2</sup> Angus Loten, *Startup Funding Dwindles Due to Coronavirus Slowdown*, Wall Street J. (Mar. 25, 2020), <https://www.wsj.com/articles/startup-funding-dwindles-due-to-coronavirus-slowdown-11585175702>.

<sup>3</sup> Sophia Kunthara, *Vcs Share Thoughts, Advice on State of the Market During COVID Restrictions*, Crunchbase News (Apr. 13, 2020), <https://news.crunchbase.com/news/vcs-share-thoughts-advice-on-state-of-the-market-during-covid-restrictions/>.

<sup>4</sup> See, e.g., Eliza Haverstock, *Female Founders Face Funding Hurdles Amid the Pandemic*, PitchBook (May 8, 2020), <https://pitchbook.com/news/articles/female-founders-face-funding-hurdles-amid-the-pandemic>.

VC sectors in California, New York, and the greater Boston, MA area. Any money returned to states following successful exits is to be used for further reinvestment in other startups.

## 2. Federal-Private, Convertible Debt Matching Program - The U.K.'s Future Fund

Alternatively, government funded equity investment could be modeled after a recent U.K. approach. This program provides assistance via loans that convert to equity if not repaid, rather than direct equity investment. And, in contrast to the New Business Preservation Act that involves a state-level partner, the U.K. program is administered at the national government level.

The U.K. Government's 'Future Fund' program, which is slated to launch later this month, is a convertible loan program designed to ensure startups receive enough working capital during the COVID-19 crisis to stay afloat.<sup>5</sup> The program provides government loans in the amount of £125,000 to £5,000,000 (about \$156,000 - \$ 6.25 million), which must be matched by private investors. Additionally, the startup must have raised at least £250,000 (about \$312,500) in equity investment within the past five years. The loans mature after three years, at which time they may either be repaid with an interest rate of 8% per year or automatically converted into equity. Initially, £250,000,000 (about \$312.5 million) has been committed to the Future Fund, with the possibility of additional funding in the future.

## 3. Direct Federal Equity Investment

Similar to assistance provided to private companies in previous recessions where the federal government purchased direct stake in struggling companies,<sup>6</sup> the government could make an equity investment in startups struggling to meet operating demands during the COVID-19 crisis. Following the crisis, companies can buy out the government's stake. Structuring federal support as an equity investment limits the downside of the program, as the government will make a profit from successful companies that will offset losses from companies that failed in spite of the assistance.

## **Forgivable Loans**

Earlier COVID-19 relief packages include forgivable loan programs designed to help small businesses, like the Paycheck Protection Program (PPP). However, due to the program's requirements, many startups were not able to take full advantage of the PPP. Modifying the PPP and/or creating a designated "startup fund" could help to maximize the effectiveness of such a program.

- Fix affiliation rule. Many VC-backed startups would be excluded from the PPP program due to the SBA's affiliation rule. This rule, which is highly fact- and context-specific and can be difficult to apply, requires VC-backed startups to count the employees of every other company in the VC's portfolio as their own employees—putting them over the 500 employee threshold. Congress could

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<sup>5</sup> *Apply for the coronavirus Future Fund*, Her Majesty's Treasury (April 20, 2020), <https://www.gov.uk/guidance/future-fund>

<sup>6</sup> *See, e.g., TARP Programs*, U.S. Treasury (November 15, 2016), <https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx>

amend and simplify the rule to waive it for (many) VC-backed startups, for example by narrowing the definition of affiliates to those that own more than 50% of a company at present.

- Expand scope of forgivable purposes.
  - Allow companies to use funds to pay independent contractors and other employees not formally on their payrolls. Many early stage companies are not yet able to hire employees, and instead pay their teams through the 1099 independent contractor mechanism.
  - Expand the scope of costs and payments that are eligible for forgiveness. Additional forgivable purposes could include all (or at least more) of a company's basic operating costs, such as cloud-computing contracts, accounting and bookkeeping services, marketing expenses, or attorneys fees.
  - Do not impose a strict requirement that a specified percentage of loan funds be spent on payroll. While the Paycheck Protection Program Flexibility Act reduced the initial 75% threshold, any percentage requirement may not suit the realities facing startups. For early-stage companies with few employees, payroll makes up only a small portion of total operating expenses.
- Create a startup fund. Early stage startups have had to compete with more established businesses for PPP funds. Congress could allocate a portion of future loan funding for high-growth startups (e.g., founded in the last ten years, fewer than 100 employees, technology-enabled companies).

## Tax Credits

Extending tax credits is a third option for providing financial relief to startups.

- Investor tax credits. These credits are designed to spur private investors to continue funding startups. Congress could build on existing models to create new or expand current programs. For example, a number of states have enacted angel investor tax credits, through which the state government subsidizes and encourages individual investors by offering tax breaks for qualifying investments.<sup>7</sup> Congress could enact a federal counterpart, allowing individual investors a credit of 20-50% of the amount invested in startups (e.g., new investments in recently established businesses with a smaller number of employees). Opportunity Zones provide another model. Congress created this program to provide tax benefits to individuals or corporations that invest in financially distressed regions.<sup>8</sup> Congress could expand this program to either cover more areas or create a similar program to provide tax benefits to investors who invest in qualified startup incubators or accelerators.
- R&D tax credits. These credits are designed to encourage companies to invest in research and development,<sup>9</sup> and can be suited to support innovative startups.<sup>10</sup> Congress could expand existing

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<sup>7</sup> *Everything You Need to Know About Angel Investor Tax Credits*, Startups.com (July 3, 2019), <https://www.startups.com/library/expert-advice/angel-investor-tax-credits>.

<sup>8</sup> *Opportunity Zones Frequently Asked Questions*, IRS, <https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions>.

<sup>9</sup> Yair Holtzman, *U.S. Research and Development Tax Credit*, CPA J. (Oct. 2017), <https://www.cpajournal.com/2017/10/30/u-s-research-development-tax-credit/>.

tax credits to offset income and payroll tax liability for small businesses who spend on R&D. And Congress could also expand the definition of what counts as R&D to include common software development activities like user experience (UX) research and design.

## Grants

Finally, grants are an attractive, certain, and lower-risk option for providing financial relief to startups. Congress could allocate additional funding to existing programs like SBIR/STTR or the NSF's I-CORPS. The existing SBIR/STTR programs were created to fund R&D at innovative small businesses.<sup>11</sup> SBA coordinates the programs, but individual research funding agencies (e.g., NSF, NIH, DOD) implement them. The NSF's I-CORPS program is designed to support the commercialization of new technologies, reducing the risk and time required to translate new ideas to the market.<sup>12</sup>

In addition, Congress could instruct the agencies to speed or streamline the review and approval process. Applying for grants is usually a lengthy and time consuming process, in which applicants are often competing for set amounts of money. This may not be suited to the startup lifecycle, where companies often need more flexibility and (a potentially smaller amount of) capital quickly. In addition to traditional SBIR/STTR funding, the government could also provide funding to incubators, accelerators, and innovation intermediaries who have more familiarity with the startup ecosystem in their communities and the individual needs of the companies they serve. Those entities could in turn award funding directly to startups in their networks.<sup>13</sup> Congress could also instruct agencies which issue SBIR/STTR grants to modify the review process, review criteria, and composition of review panels to focus on commercialization and entrepreneurship.<sup>14</sup>

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<sup>10</sup> Jeff Haskett, *8 Reasons Startups Miss Out on the R&D Tax Credit*, Gust (Jun 19, 2018), <https://gust.com/launch/blog/reasons-startups-miss-out-rd-tax-credit>.

<sup>11</sup> *SBIR-STTR, America's Seed Fund*, <https://www.sbir.gov/about>.

<sup>12</sup> *National Science Foundation Innovation Corps*, [https://www.nsf.gov/news/special\\_reports/i-corps/about.jsp](https://www.nsf.gov/news/special_reports/i-corps/about.jsp).

<sup>13</sup> *See, e.g., Engine Letter to Members of the Subcommittee on Innovation and Workforce Development of the House Committee on Small Business* (Feb. 27, 2020), <https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/5e582a468fa56521103d6600/1582836294242/House+Small+Business+Committee+Feb+27.pdf>.

<sup>14</sup> *See, e.g., Scientific Management Review Board, Report on Optimizing the NIH Small Business Innovation Research and Small Business Technology Transfer Programs* (Aug. 2013), [https://smrb.od.nih.gov/documents/reports/SBIR\\_STTR.pdf](https://smrb.od.nih.gov/documents/reports/SBIR_STTR.pdf).