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Written Testimony of
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"The Startup Slump: Can Tax Reform Help Revive American Entrepreneurship?"

Chairman Tiberi, Senator Heinrich, members of the Committee, thank you for the opportunity to talk with you today about how to make our tax system more friendly to entrepreneurship. The Tax Foundation's mission is to work toward a tax code that doesn't stand in the way of success, so we applaud the interest in making our tax code friendlier to entrepreneurs.

Despite our Byzantine tax code, America is a land of entrepreneurs. The dynamism of our entrepreneurs—the willingness to try and possibly fail—is what separates the U.S. from every other nation on earth.

Think about it, the most successful businesses on earth today—Apple, Amazon, Google—all started out in American garages or college dorm rooms. Yet for all of these success stories, there are dozens of other firms that never got over the numerous speed bumps the tax code places between their garage and eventual success.

Let's put ourselves in the shoes of a would-be entrepreneur named Maria, and see what are the tax issues that she faces along the way. We'll then discuss how the tax reform "Framework" would address her issues.

Maria is a young entrepreneur who has invented a smart scooter that could become the next big thing in personal transportation. Let's see how the tax code impacts her new business.

The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and local levels. We are a 501(c)(3) nonprofit organization.

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Decision of How to Organize: What Does Maria Have to Consider?

The first thing Maria needs to consider is what business form to adopt. She has a choice between a traditional C-corporation or what is known as a pass-through firm. Both have advantages, both have disadvantages.

Maria may want to choose the C-corporation form because someday she may want her firm to go public. However, she learns that a C-corporation faces two layers of tax, one at the entity level and a second at the shareholder level. The prospect of her business facing two layers of tax is not appealing to her.

On the other hand, Maria could choose one of the four kinds of pass-through business forms: an S-corporation, a partnership, a limited liability corporation (LLC), or a sole proprietor. These are called pass-through businesses because the profits pass through the entity itself and are taxed on the owner's tax return. Thus, they face only one layer of tax, which is certainly appealing.

However, S-corporations are limited to 100 or fewer shareholders, which could be an issue as the business grows. A sole proprietorship or partnership doesn't have the liability protection of a corporation, which her business will certainly need. LLCs enjoy the advantage of limited liability, but must establish their own operating agreements to provide governance and protective provisions, face various franchise fees in some states, and may be harder for lenders to vet for financing.

What Tax Rates Will She Face?

Economists have called high marginal income tax rates "success taxes" because they can be one of the biggest inhibiters of the success of a start-up business.[1] The tax rates that Maria's business will pay depends upon the business form she chooses.

If she chooses to become a C-corporation and becomes successful enough, she will eventually face one of the highest corporate taxes in the industrialized world, 35 percent at the federal level and nearly 39 percent when we add in the average state rate. If that wasn't enough of a disincentive, Maria learns that her shareholders would also face one of the highest dividend and capital gains rates in the world. When the corporate rate and the shareholder rates are combined, the total income tax on C-corporations is one of the highest among our global competitors.

Maria's firm would only be modestly better off if she organizes as a pass-through. Successful pass-through owners can face income tax rates as high as 43.4%, which includes the top individual rate of 39.6 percent, plus the net investment tax of 3.8 percent. When we add in state rates, the top marginal tax rate for successful entrepreneurs can reach over 50%.

1 William M. Gentry and R. Glenn Hubbard, "'Success Taxes,' Entrepreneurial Entry, and Innovation," NBER Working Paper No. 10551, June 2004.

Complexity and the Compliance Burden of Taxes

Despite Maria's need for a new engineer and a sales representative, her first employee may be a tax accountant. Tax compliance costs the U.S. economy an estimated $409 billion per year, and the business tax system—which requires 2.9 billion hours to comply with—is the most burdensome part of the entire tax code.[2]

The table below lists some of the most burdensome business tax forms. Leading the list is the income tax returns for S-corporations, one of the most popular small business forms in America. These businesses spend nearly 890 million hours complying with their income taxes at a total cost of more than $46 billion per year.

Most "mom and pop" enterprises file their taxes on Schedule C, which costs them 72 million hours in compliance time and nearly $2.7 billion per year in lost productivity. Tax forms for farmers require 7.8 million hours to comply with at a cost of $292 million in lost productivity.

Estimate Hourly and Compliance Costs of IRS Business Paperwork in 2017

Form/Title	Total Annual Hours	Total Annual Cost in Dollars
Income Tax Returns for an S Corporation	889,393,518	$46,292,932,612
Form 4562—Depreciation and Amortization	448,368,447	$23,337,577,666
Employer's Quarterly Federal Tax Return	388,256,964	$20,208,774,976
Form 940, FUTA Tax Return	105,295,370	$5,480,624,009
Form 4797—Sales of Business Property	100,633,248	$5,237,960,558
Schedule C (Form 1040): Profit and Loss from Business	72,201,704	$2,691,679,525
Form 7004, Application for Automatic Extension to File Certain Business Income Tax Returns	44,324,250	$2,307,077,213
TD 8864, Taxation of Fringe Benefits	37,922,688	$1,973,875,910
Form 8941—Credit for Small Employer Health Insurance Premiums	34,278,346	$1,277,896,739
Form 944, Employer's Annual Employment Tax Return	15,702,300	$585,381,744
Employer's Annual Tax Return for Agricultural Employees	10,880,812	$405,636,671
Form 3800, General Business Credit	8,345,000	$311,101,600
Profit or Loss from Farming	7,845,596	$292,483,819
Form 8903, Domestic Production Activities Deduction	7,398,000	$275,797,440
Form 5300, Application for Determination for Employee Benefit Plan	7,201,200	$268,460,736
Form 8825—Rental Real Estate Income and Expenses of a Partnership or an S Corporation	6,288,600	$234,439,008

2 Scott A. Hodge, "The Compliance Costs of IRS Regulations," Tax Foundation Fiscal Fact No. 512, June 15, 2016. https://taxfoundation.org/compliance-costs-irs-regulations/

Debt Versus Equity Financing

Maria wants to expand her business, but doesn't necessarily want to take on debt to do so, but the tax code encourages borrowing over equity financing. She learns that her firm will be able to deduct the interest payments on a loan, whereas she would not be able to deduct the dividends that she pays her investors. Naturally, this makes debt financing of her expansion slightly cheaper than equity financing so she reluctantly takes out a loan.

Depreciation and 179 Expensing

Maria's firm is growing quickly and is in a major expansion mode. She foresees buying new equipment and, perhaps, buying a warehouse building to make and distribute her growing product line. Cash flow is critical for her business, and she is pleased to see that the tax code is not an obstacle to recovering the cost of those investments while she is still a small business, but disappointed to learn that the code makes it harder to recover those costs when she grows beyond a certain size.

Section 179 of the tax code allows small businesses like Maria's to write off 100 percent of the cost of their capital investments up to $500,000 in the year the investment is made. However, once firms like hers begin to grow and have more than $2 million in qualified investments, the tax code begins to reduce those deductions gradually to zero once the firm reaches $2.5 million in investments.

After the firm grows beyond the "small business" level, its capital investments must be deducted over long periods of time, according to a set of over two dozen depreciation schedules.[3] Maria is confounded by which depreciation schedule governs the new conveyer belts she purchased, and she is shocked that the company will have to write off the new warehouse over 39 years. She hopes her business lasts that long.

Not only does this arcane cost recovery system disincentivize capital investment, it is very burdensome. As the table above indicates, businesses spend about 448 million hours each year complying with depreciation and amortization rules at a cost of $23 billion annually.

Treatment of Losses

Entrepreneurs like Maria tend to run losses for several years before turning a profit. However, the current federal tax code is particularly detrimental to businesses whose earnings fall into this pattern, and imposes a larger tax burden on businesses that take longer to turn a profit.

The reason for this is the fundamental asymmetry in the U.S. tax code between the tax treatment of business profits and business losses. A business that makes a profit is subject to an immediate tax liability, in the same year the profit is earned. However, a business that turns a loss is not always entitled to an immediate tax benefit.

3 26 U.S.C. §167

If Maria's business has a net operating loss in a given tax year, but has made a profit in previous tax years, the business is often eligible to "carry back" a net operating loss deduction to its previous two years' tax returns—a provision which does allow the business to receive an immediate tax benefit. However, if her business's losses exceed its recent profits, then it is required to "carry over" the net operating loss deduction to a future tax year—meaning that the business does not receive an immediate tax benefit.[4] If she cannot use the loss within 20 years, the loss expires.

Importantly, the longer a business has to wait to deduct its net operating losses, the smaller a tax benefit the business receives. A business that has a $1 million loss in its first year of operation, and does not turn a profit until its tenth year of existence, will not be able to deduct its $1 million loss until the tenth year. By that time, the tax benefit from a $1 million deduction will be worth about 40 percent less to the business, due to inflation and the time value of money (about $600,000 at 2 percent inflation at a 3 percent real interest rate).

As a result, the U.S. tax code is inherently disadvantageous to businesses that run losses for many years before turning a profit. As soon as these businesses become profitable, they are subject to an immediate tax liability—even though they did not receive an immediate tax benefit for all of the losses they incurred. Furthermore, if a company fails before it can ever turn a profit, then it will never receive a tax benefit for the losses it incurred, even though it would have been subject to a tax liability if it were profitable.

In short, the longer it takes for a business to turn a profit, the greater the tax penalty for that business. This is a feature of the U.S. tax code that is likely very disadvantageous for many entrepreneurs.

Treatment of Capital Losses

Like many entrepreneurs, Maria relied on outside investors to provide financial capital for her businesses. Investments in entrepreneurial ventures tend to be risky, and investors may experience a long string of capital losses before finding an investment that produces a substantial capital gain. However, under the current tax code, these capital losses are not always immediately deductible, creating a situation that penalizes risky investment.

In general, taxpayers are only allowed to deduct their capital losses in any given year to the extent of their total capital gains in that year; individual taxpayers are also allowed to deduct up to $3,000 in capital losses beyond this limitation ($1,500 for married individuals filing separately). Otherwise, taxpayers are often required to "carry forward" all other capital losses to future tax years, when they can be deducted against future capital gains. In the case of corporations, capital losses can also generally be "carried back" up to three years.[5]

4 26 U.S.C. §172. It should be noted that, in the case of pass-through businesses, owners are often able to deduct the net operating loss from one business against other personal income.

5 26 U.S.C. §1211, §1212

Here again, the tax code contains a fundamental asymmetry: capital gains are subject to an immediate tax liability, while capital losses do not necessarily yield an immediate tax benefit. To the extent that taxpayers are required to carry their capital losses forward many years before they are able to deduct them, the tax benefit of these losses diminishes each year that they are carried forward, due to inflation and the time value of money.

As a result, the U.S. tax code penalizes some taxpayers who make risky investments, by denying them a full, immediate deduction for their capital losses. This feature of the tax code makes it less advantageous to invest in entrepreneurial ventures.

That said, the tax code does allow households to deduct up to $100,000 of capital losses on certain "small business stock" immediately against their ordinary income ($50,000 for non-joint filers). This provision provides an incentive for taxpayers to invest in risky small business ventures.[6]

The Estate Tax

As Maria's company becomes more successful—and more valuable—she worries about her legacy and the survivability of the business. Should something happen to her, would her children be able to continue to run the company? The estate tax is a real threat. It falls on the assets, not just the income of the business. Even if Maria owns the business for 40 years before passing it on, the estate tax could be as damaging as having had to pay about another 10 points on the income tax all that time.

Another reality is that Maria is not necessarily cash-rich because most, if not all, of her savings have been plowed back into growing the business. At night, she wonders how much of the business would be potentially lost to estate taxes after her death. Not willing to leave it to chance, she hires the best legal and accounting team in town to plan around this eventuality.

Entrepreneurs face many tax challenges as they build their business, but they also face the long-term prospects of the estate and gift tax destroying what they spent a lifetime building. The estate and gift tax, which will only collect approximately $20 billion in federal revenues this year, has a compliance cost of $19.6 billion because successful people like Maria must pay expensive lawyers and accountants to find creative ways to avoid the tax.

6 26 U.S.C. §1244

How Does the Tax Reform Framework Fix These Issues?

Although it is missing some key details, the recently released tax reform Framework does propose a number of policies that will improve the tax code for entrepreneurs.

Tax Rates

The most dramatic of these changes are the significantly lower tax rates for C-corporations and pass-through businesses. The Framework proposes a 20 percent tax rate for C-corporations and a top tax rate of 25 percent for pass-through business income.

The 20 percent federal corporate rate would instantly drop the U.S. rate below the global average, making the U.S. one of the most attractive places anywhere to do business. This is the kind of leapfrogging change the economy needs to become more competitive globally.

The lower proposed tax rate on pass-through business income raises some interesting issues. On the one hand, we know that high marginal income tax rates are harmful for entrepreneurship—they are "success taxes." On the other hand, because they face only one level of income taxes, pass-through businesses already have a small tax advantage over traditional C-corporations. Thus, cutting their tax rate to 25 percent, which is only five percentage points above the proposed C-corporation rate, could give them an even bigger tax advantage.

Another consideration is the challenge of preventing business owners from reclassifying personal wage income as "business" income. If the personal wage tax rate remains relatively high compared to the new business tax rate, there will be ample incentive for a dentist to reclassify wage income as business income to take advantage of the lower rate. The IRS already issues rules to prevent this type of income reclassification. Lawmakers should write rules into law to prevent such behavior rather than leave the rulemaking up to the IRS.

Expensing

The Framework calls for five years of 100 percent bonus expensing, which applies to all capital investments other than buildings and structures.

There are a couple of aspects of this policy to be concerned about. First, temporary provisions don't deliver the economic growth of permanent ones. Indeed, temporary expensing could encourage capital investments today at the expense of future investments. This can cause a short-term boost in economic activity, which then leads to a severe drop-off in activity after the policy ends. A temporary provision, if not renewed, would boost GDP, capital formation, employment, and wages only for a short time, after which the gains would be undone.

A better policy would be to move to permanent full expensing for all businesses and all capital investment. This was the most pro-growth policy in the 2016 House GOP "Better Way" Blueprint tax reform plan. It is important to include buildings and structures because they are two-thirds of the capital stock. Better Way did so.

Lawmakers should focus some attention on removing the expensing "cliff" that happens as small businesses grow out of the Section 179 expensing regime, and have to comply with the immensely complex depreciation regime. Tax Foundation models suggest that moving toward full expensing for all businesses would encourage more entrepreneurial investment and remove barriers to the growth of start-ups.

Interest deductibility

The Framework calls for the partial limitation of the deductibility of interest for C-corporations, with no additional details. It is silent about the treatment of interest paid by pass-through businesses.

If tax writers decide to limit interest deductibility for all business types, some worry about the impact on start-ups that may have limited access to equity markets. One way to maintain the preference for truly small businesses would be to mirror the eligibility for deducting interest to Section 179's rules governing the amount of capital investments eligible for immediate expensing. Such a policy would at least apply similar standards to both debt and equity funding.

Losses

The Framework is silent on this issue, but it is worth noting that the Better Way tax plan proposed a policy that would mitigate this issue by allowing businesses to increase their carried-forward net operating loss deduction by a factor reflecting inflation and the real return to capital, and with no 20-year time limit on taking a loss. This measure should, in theory, make the net operating loss deduction equally beneficial to businesses whether claimed immediately or claimed far in the future. However, it would not provide any relief for companies that go out of business before they ever turn a profit.

The Estate Tax

The Framework calls for eliminating the estate tax. This policy would have a major impact on improving the survivability of family-run businesses and farms, while eliminating billions of dollars' worth of economic costs on the economy and business owners. Moreover, Tax Foundation economists estimate that the economic benefits of repealing the estate tax well exceed any revenue losses the repeal might cause the government.[7] Long term, the larger economy would generate more federal tax revenue without the estate tax.

7 Alan Cole, "Modeling the Estate Tax Proposals of 2016," Tax Foundation Fiscal Fact No. 513, June 14, 2016. https://taxfoundation.org/modeling-estate-tax-proposals-2016/

Conclusion

There is a tendency among lawmakers to want to "do something" to help entrepreneurs like Maria. You should avoid the urge to subsidize them or give them special treatment. Instead, you should aim to get the tax code out of the way of entrepreneurs by making it simpler, less burdensome, and eliminating its anti-growth biases. Get rid of the success taxes and fix the quirks in the code that punish firms as they grow, and then tax them in a normal fashion when they succeed.