

Written Testimony
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Before the Committee on Small Business

“The Tax Code as a Barrier to Entrepreneurship”

Thank you Chairman Chabot and Ranking Member Velazquez for the opportunity to speak about the U.S. federal tax system and entrepreneurship.

There are millions of entrepreneurs in the United States, spread across nearly every major industry.¹ While every entrepreneur has a different business model and unique concerns, there are a few key characteristics that apply to many entrepreneurs throughout the economy:

Entrepreneurs tend to run losses for some time before turning a profit, and many entrepreneurial ventures do not survive long enough to turn a profit at all.²

As a result, entrepreneurial ventures tend to be especially risky investments for outside investors, who typically see many of their investments in entrepreneurs fail.³

If they do develop a successful business model, entrepreneurs often seek to rapidly expand their operations and scale.⁴

Ideally, the U.S. federal tax code would be neutral with regard to each of these characteristics. The tax code should not punish businesses for running sizeable losses in their early years, nor should it disadvantage investors that pursue risky investments. Certainly, it should not present additional barriers to successful businesses looking to expand.

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- 1 Bureau of Labor Statistics, “Business Employment Dynamics,” <https://www.bls.gov/bdm/#data>
- 2 Bureau of Labor Statistics, “Entrepreneurship and the U.S. Economy,” April 2016, https://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm
- 3 Seth Levine, “Venture Outcomes are Even More Skewed Than You Think,” August 2014, <http://www.sethlevine.com/archives/2014/08/venture-outcomes-are-even-more-skewed-than-you-think.html>
- 4 Neil Churchill and Virginia L. Lewis, “The Five Stages of Small Business Growth,” Harvard Business Review, <https://hbr.org/1983/05/the-five-stages-of-small-business-growth>

However, this is not the case under current U.S. tax law. The federal tax code penalizes businesses with large, up-front losses; discourages investors from pursuing risky opportunities; and makes it difficult for successful companies to expand. All of these features of the U.S. tax code create disadvantages for new businesses and entrepreneurs.

Lawmakers interested in improving the tax treatment of U.S. entrepreneurs would do well to consider ways to mitigate these three distortionary features of the current U.S. tax code.⁵

1. The Tax Treatment of Business Losses

It is often the case that entrepreneurs 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.

If a 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 years’ tax returns – a provision which does allow the business to receive an immediate tax benefit. However, if the 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.⁶

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 \$1 million deduction will be worth significantly less to the business, due to inflation and the time value of money.

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.

5 However, it should be noted that entrepreneurs do not necessarily receive worse tax treatment overall than other U.S. businesses. This is, in part, because the federal tax code also contains provisions that provide benefits specifically to entrepreneurs and small businesses, some of which are detailed below.

6 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.

To summarize, 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.

It is worth noting that the recently released House GOP “Better Way” tax plan would somewhat 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.⁷ 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.⁸

2. The Tax Treatment of Capital Losses

Entrepreneurs often rely on outside investors to provide financial capital for their 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.⁹

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.

As a result, the U.S. tax code penalizes some taxpayers that make risky investments, by denying them a full, immediate deduction for their capital losses.¹⁰ This feature of the tax code makes it less advantageous to invest in entrepreneurial ventures.

7 “A Better Way: Tax,” June 2016, https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf

8 It is difficult to design a measure that would provide businesses with an immediate tax benefit for losses incurred, due to concerns that such a provision would create opportunities for gaming and tax shelters.

9 26 U.S.C. §1211, §1212

10 Here, again, there is an administrative rationale for this feature of the tax code, which closes off opportunities for gaming of the tax system.

That said, that 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.¹¹

3. The Tax Treatment of Business Investment

Entrepreneurs that develop a successful business model are often interested in scaling their operations as rapidly as possible. This expansion phase typically requires a great deal of capital investment, such as the purchase of equipment, buildings, and factories. However, the current U.S. tax code is especially burdensome on businesses that undertake significant capital investments, due to the current system of tax depreciation.

Under the current U.S. tax code, businesses are generally not allowed to deduct the full cost of their capital investments in the year that they are made. Instead, businesses are required to deduct their investment cost over long periods of time, according to a set of over two dozen depreciation schedules.¹² This system is quite complicated: the federal government estimates that businesses spend about 448 million hours each year complying with depreciation and amortization rules.¹³

According to standard economic theory, the federal tax depreciation system is an important determinant of the overall level of U.S. business investment. Because businesses value immediate deductions more than deductions in the future, the longer a business has to wait to write off the full cost of its capital expenses, the less likely the business is to undertake a new investment. In fact, there is evidence that small and cash-strapped businesses, such as startups, are particularly responsive to changes in depreciation schedules: in a recent paper, Eric Zwick and James Mahon show that small firms responded 95 percent more to the introduction of bonus depreciation than large firms.¹⁴

In fact, the tax treatment of capital investment has the highest stakes for entrepreneurs, who often spend a significant portion of their profits on the capital investments needed to establish and grow their operations. It is new and expanding businesses that stand to gain or lose the most from changes to the tax treatment of capital investment.

¹¹ 26 U.S.C. §1244

¹² 26 U.S.C. §167

¹³ Scott A. Hodge, “The Compliance Cost of IRS Regulations,” Tax Foundation, June 2016, <https://taxfoundation.org/compliance-costs-irs-regulations/>

¹⁴ Eric Zwick and James McMahon, “Tax Policy and Heterogenous Investment Behavior,” *American Economic Review* 107: 217-248, <http://www.ericzwick.com/stimulus/stimulus.pdf>

For the smallest businesses, the tax treatment of capital investment is generally favorable, due to section 179 of the tax code, which provides full expensing for many investments of small businesses. However, the rules for deducting capital investments can become much more burdensome for startup businesses in the “expansion phase,” during which new businesses try to scale their model to new markets and broaden their offerings. During this phase in a business’s lifecycle, the lengthy depreciation schedules of the tax code can serve as a barrier to investment, inducing businesses to pass up otherwise profitable investment opportunities due to tax considerations.

As a result, there is strong reason to believe that moving toward full expensing would encourage more entrepreneurial investment and remove barriers to the growth of startups. Notably, the House GOP “Better Way” plan would do just this, allowing both small and large businesses to deduct the full cost of their capital investments immediately.

4. High Tax Rates on Business Income

All three of these distortions in the U.S. tax code are exacerbated by the high marginal tax rates on businesses in the United States today. In general, if a business faces a high marginal tax rate on its profits, it will also be subject to a higher tax penalty for running losses for many years, and the depreciation system will pose a larger barrier to its new investment. Similarly, the higher the tax rate on capital gains, the greater the tax disadvantage will be for pursuing risky investments.

As such, it is important to note that income earned by U.S. entrepreneurs is generally subject to higher marginal tax rates today than in recent years past.

Entrepreneurs that choose to set up pass-through businesses, such as S corporations or partnerships, face a higher top federal tax rate (44.6 percent) today than at any point since 1986. As a recent Tax Foundation report shows, the top tax rate on pass-through business income can exceed 50 percent when state and local income taxes are taken into account.¹⁵

Other entrepreneurs choose to organize their businesses as C corporations. These businesses can be subject to taxation on both the entity level and the business level. The corporate income tax, on profits earned at the entity level, is levied at a 35 percent rate, the highest in the developed world.¹⁶ Meanwhile, the top tax rate on capital gains (25.0 percent) is the highest since 1997, while the top tax rate on dividends (25.0 percent) is the highest since 2002.

15 Scott Greenberg, “Pass-Through Businesses: Data and Policy,” Tax Foundation, January 2017, <https://taxfoundation.org/pass-through-businesses-data-and-policy/>

16 Kyle Pomerleau and Emily Potosky, “Corporate Tax Rates Around the World, 2016,” Tax Foundation, August 2016, <https://taxfoundation.org/corporate-income-tax-rates-around-world-2016/>

It should be noted, however, that for some entrepreneurs and investors, the high tax rates on capital gains can be mitigated by the favorable tax treatment of qualified small business stock. Since 2010, entrepreneurs and investors who hold “qualified small business stock” for more than five years are granted a 100 percent exclusion on the capital gains from their shares. This provision was made a permanent part of the tax code in 2015.¹⁷

Conclusion

As this testimony has shown, the U.S. tax code tends to impose higher burdens on businesses that run losses for many years, businesses that are risky investments, and businesses undergoing rapid expansion – all of which are typical characteristics of entrepreneurial ventures.

Lawmakers interested in removing these barriers to entrepreneurship should consider ways to mitigate these three distortions in the U.S. tax code: the limited deductibility of business net operating losses, the limited deductibility of capital losses, and lengthy depreciation schedules.

¹⁷ 26 U.S.C. §1202