Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

To: Members, Committee on Small Business
From: Committee Staff
Date: February 13, 2017
Re: Hearing: "Start-ups Stalling? The Tax Code as a Barrier to Entrepreneurship"

On Wednesday, February 15, 2017, at 11:00 a.m. in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet to explore the effects of our current tax code on the launch and growth of new business ventures.

Small businesses are generally not in a position to have a team of tax advisors on staff or on call. This is especially true when they are first starting out, arguably when they could most benefit from effective assistance. The Committee will meet to examine the barriers to entrepreneurship posed by the tax code.

I. Introduction

On many fronts, the American economy is recovering. Hiring, wages, and the labor force are all on the rise. However, there is one area where the economy appears to be in serious trouble.[1] New business creation is still in long-term decline when compared to levels from the 1980s, 1990s, and early 2000s.[2] The rate of business owners – the percent of the adult population that owns a business as their main job – has been on a fairly steady decline since 1997.[3] The country's rate of new business creation "plunged more than 30 percent during the economic collapse" and has been slow to recover in the wake of the recession.[4] If that statistic were not stunning by itself, this trend has occurred at a time when the percentage of the U.S. population age 25-55, the prime years for starting a business, has increased.[5]

At the same time the rate of business creation has slowed, the rate of business closures – previously steady – has increased.[6] This has resulted in business deaths outpacing business creation for the first time since the late 1970s, when this data was first collected.[7] Additionally, the "proportion of companies of every age from one to five years" declined over the past 35 years.[8]

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[1] J.D. Harrison, The Decline of American Entrepreneurship – in Five Charts, THE WASH. POST, Feb. 12, 2015, *available at* https://www.washingtonpost.com/news/on-small-business/wp/2015/02/12/the-decline-of-american-entrepreneurship-in-five-charts/?utm_term=.58dc5f52af69.
[2] *Id*.
[3] EWING MARION KAUFFMAN FOUND., THE KAUFFMAN INDEX, NATIONAL PROFILE (2016), *available at* http://www.kauffman.org/microsites/kauffman-index/profiles/national.
[4] Harrison, *supra* note 1.
[5] *Id*.
[6] *Id*.
[7] *Id*.
[8] *Id*.

These grim statistics beg the question, why does this matter? The decline of entrepreneurship matters for several reasons.

First, entrepreneurship is a key driver of economic growth. Small businesses[9] with fewer than 500 employees drive the U.S. economy by providing jobs for more than half of the private-sector workforce.[10]

According to the Census Bureau, in 2010, American small businesses accounted for:

- 99.7% of U.S. employer firms;
- 64% of net new private-sector jobs;
- 49.2% of private-sector employment; and
- 42.9% of private-sector payroll.[11]

Perhaps one of the most important statistics is resilience during economic downturns. Small businesses led the way out of the recent great recession from mid-2009 to 2011 by creating 67% of total net new jobs.[12]

II. Background

The Committee has heard from a number of small-business owners and tax practitioners regarding how the tax code hinders small firms in their efforts to run their businesses. As the tax code grows more and more complex, entrepreneurship has at the same time been in decline. Not only are there fewer new establishments, but job creation by new ventures less than a year old decreased from 4.1 million in 1994 to 3 million in 2015.[13] This raises the question of whether the tax code has played a role in entrepreneurial decline, and, if so, in what ways. If the tax code is interfering with entrepreneurial startups and growth, then what are the possible solutions to make the tax code more entrepreneur-friendly?

III. Tax Barriers to Entrepreneurship

The inception and growth of new businesses is hindered by the current tax code in a myriad of ways, both specific and general. When taken together, the potential impact on entrepreneurship is significant. The following examples are a few of the obvious, identifiable barriers in the tax code:

A. Net Operating Losses

Frequently, it takes several years for a new business to turn a profit. This pattern is penalized by the "fundamental asymmetry" in how the tax code treats gains and losses.[14] A business that makes a profit is immediately taxed on that profit the same year it is earned. However, if a business loses money, recognition of that loss may be delayed.[15]

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[9] While entrepreneurial enterprises and small businesses are not exactly synonymous, it is true that most startups are small businesses. For the purposes of this discussion, small businesses are used as a reasonable proxy for the purposes of providing some statistics.

[10] Robert Longley, *How Small Business Drives the U.S. Economy* (Sept. 8, 2016), http://usgovinfo.about.com/od/smallbusiness/a/sbadrives.htm.

[11] *Id.*

[12] *Id.*

[13] U.S. BUREAU OF LABOR STATISTICS, BUSINESS EMPLOYMENT DYNAMICS, ENTREPRENEURSHIP AND THE U.S. ECONOMY (April 28, 2016), *available at* https://www.bls.gov/bdm/entrepreneurship/entrepreneurship.htm.

[14] Email from Tax Foundation staff to Small Business Committee staff (Feb. 2, 2017, 6:37 p.m. EST).

[15] *Id.*

If the business loses money one year but has been profitable in prior years, it may be able to carry back the net operating loss deduction to a profitable year.[16] This allows an immediate tax benefit for the loss.

However, if the business has never turned a profit or has not done so recently, it will likely have to carry forward the loss deduction to a future tax year.[17] In this case, the business does not receive an immediate tax benefit for the loss. The farther out into the future the business has to carry the loss, the less it is worth, due to inflation and the time value of money. The result is unusually punitive for riskier ventures that take longer to turn a profit.[18]

B. Depreciation

Tax code treatment of capital investment by businesses has the most significant impact on new and expanding businesses. At inception and during growth periods, businesses tend to spend the majority of their resources investing in capital. The current tax code requires that this investment be deducted over a – frequently lengthy – period of time.[19]

In addition to not being able to deduct the expenditure immediately, there are more than two dozen depreciation schedules that govern over what period of time the investment must be recognized for tax purposes.[20] The complication inherent in this system significantly adds to the burden. While section 179 of the tax code provides full expensing for many small business investments and may alleviate the issue for some of the newest and smallest businesses, startups that are trying to expand may get hit particularly hard and may forgo otherwise profitable investment as a result.[21]

C. Capital Gains and Losses

Lower capital gains rates provide an incentive for people to become entrepreneurs. Angel investors and venture capitalists who finance young companies are also influenced by capital gains rates. In both cases, the parties are looking to maximize the returns on their investment.[22] As the tax rate on capital gains goes up, the "hurdle rate" of prospective projects increases, and fewer of these projects get done.[23]

Regardless of the capital gains tax rate, capital gains are recognized and taxed in the year earned. However, if the venture loses money, the tax code restricts the ability to deduct capital losses. Similar to the case of net operating losses, the asymmetry of treatment between capital gains and capital losses penalizes riskier investment.[24] Generally, capital losses can be deducted on a personal tax return to the extent of total capital gains for the same year, plus $3,000. Additional capital losses must often be carried forward to future tax years, with the tax benefit diminishing each year.[25]

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16 *Id*.
17 *Id*.
18 *Id*.
19 *Id*.
20 *Id*.
21 *Id*.
22 Chris Edwards, *Advantages of Low Capital Gains Tax Rates*, TAX & BUDGET BULLETIN, CATO INSTITUTE (Dec. 2012) at 4.
23 *Id*.
24 Email, *supra* note 14.
25 *Id*.

D. High Marginal Tax Rates

More than 90 percent of U.S. businesses are set up as pass-through entities – sole proprietorships, partnerships, or S corporations – rather than C corporations.[26] This means that any income or costs from the business pass through directly to the individual tax return. As a result, the marginal tax rate for the business is determined by the tax bracket of the owner, taking into account all income sources.[27] Therefore, just the federal income tax marginal rate on this income can be as high as 39.6 percent.[28] But, that's not the end of the story.

Two additional federal taxes are also levied on this income. First, the self-employment tax - which is designed to replace both the employer and employee shares of FICA that would be levied on wages – applies at a rate of 15.3 percent on the first $127,200 and 2.9 percent on anything above that.[29] Beginning in 2013, a .9 percent surtax applies to self-employment income over $200,000 ($250,000 for joint filers). This applies to aggregate self-employment income for the return, not just to an individual business.[30] Second, the Net Investment Income Tax is levied at a rate of 3.8 percent on aggregate investment income over $200,000 ($250,000 for joint filers).[31]

Of course, in addition to federal taxes, pass-throughs are also subject to state and local taxes. Taking all of these sources of taxation into account, the mean top marginal tax rate on sole proprietors is 47.1 percent.[32]

E. Estate Taxes

Many small companies and startups are family businesses. Depending on the industry, even a small company can pretty easily amass more than $5.49 million (the estate tax exemption amount applicable for 2017) in assets. In this case, if a small business owner wants his/her business to continue after his/her death, valuable resources must be diverted from the business to estate planning during the owner's life to try to prevent the necessity of selling off assets in order to be able to pay estate tax.

F. Complexity

The sheer complexity of the tax code is also a barrier. The National Small Business Association (NSBA) recently released its Small Business Regulations Survey.[33] More than half of the survey participants had less than $1 million in gross sales or revenues for the most recent tax year.[34] Seventy-five percent of participants said that federal tax code regulations are very or somewhat burdensome, and tax-related regulations led the rankings as the most burdensome of all types of regulatory compliance.[35]

Almost half of participating firms reported spending 40 hours or more per year dealing with new and existing federal regulations, and, for nearly a third, the time consumption is more than 80

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[26] Scott Greenberg, *Pass-Through Businesses: Data and Policy,* FISCAL FACT, TAX FOUNDATION (Jan. 2017) at 2.
[27] *Id*. at 7.
[28] *Id*.
[29] *Id*. at 8.
[30] *Id*.
[31] *Id*.
[32] *Id*. at 9.
[33] NATIONAL SMALL BUSINESS ASSOCIATION, SMALL BUSINESS REGULATIONS SURVEY (2017).
[34] *Id*. at 3.
[35] *Id*.

hours per year.[36] On a related point, nearly half reported spending more than $5,000 annually in direct, and another $5,000 in indirect, annual costs to deal with federal regulations. Probably most disturbing is the finding that the "small-business owner is the number one regulatory expert in most businesses and handles the bulk of federal regulatory compliance."[37] This expenditure of time and resources could be much better spent actually running and building the business.

Finally, and most relevant to this discussion, is the finding that more than half of small businesses felt the burden of regulatory compliance beginning in their first year of business. The survey also reported average regulatory start-up costs of $83,019.23 within the first year.[38] These considerations underscore that regulatory complexity and costs represent a hurdle that may be keeping would-be entrepreneurs from starting their own businesses.

III. Conclusion

As Congress and the Committee pursue overall tax reform, the goal of encouraging entrepreneurship should be kept at the forefront. Small businesses are key drivers of the economy, job growth, and innovation, and the tax code should encourage this activity. The Committee will explore some of the barriers to entrepreneurship in the current tax code and discuss possible solutions to address them.

[36] *Id*. at 5.
[37] *Id*. at 7.
[38] *Id*. at 9.