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April 15, 2015

The Honorable Orrin G. Hatch
Chairman
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Ron Wyden
Ranking Member
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

RE: Taxes and Investment in Young Businesses

Dear Chairman Hatch and Ranking Member Wyden:

Entrepreneurship is the fuel in America's economic engine. An abundance of research finds that the creation of new companies and the growth of young companies are the principal sources of job creation, innovation, and overall economic dynamism.[1]

Importantly, entrepreneurship is not always the same as small business, and this distinction has critical policy implications. Young companies are responsible for most net job creation[2]—these companies are generally small, but older small businesses tend not to create new jobs. New and young firms also play a key role in career dynamics—they are more likely to employ young workers, and serve as a stepping-stone for young workers in building skills and gaining experience.[3] These economic functions will only grow in importance as the so-called Millennial generation could comprise up to 75 percent of the U.S. workforce by 2025.[4]

[1] See http://www.kauffman.org/what-we-do/research for information about the Kauffman Foundation's role in entrepreneurship and economic research.
[2] Haltiwanger, John, Ron S. Jarmin, and Javier Miranda, "Who Creates Jobs? Small vs. Large vs. Young," National Bureau of Economic Research Working Paper 16300, 2009, at http://www.nist.gov/mep/data/upload/Who-creates-jobs.pdf.
[3] Ouimet, Paige and Rebecca Zarutskie, "Who Works for Startups? The Relation Between Firm Age, Employee Age, and Firm Growth," Federal Reserve Board, Washington D.C. 2013-75 at http://www.federalreserve.gov/pubs/feds/2013/201375/201375pap.pdf.
[4] Cramer, Reid, "Millennials Rising: Coming of Age in the Wake of the Great Recession," New America, (2014). Available at http://www.newamerica.org/downloads/Millennials_Rising_Coming_of_Age_in_the_Wake_of_the_Great_Recession.pdf.

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In addition to being the primary source of new job creation, startups are also responsible for a disproportionate share of innovative activity,[5,6] which creates not just wealth for the entrepreneur, but rising standards of living for all.[7]

These young firms are a critical component of the American economy. Like all firms, new businesses rely on investment to drive growth. It is therefore important to understand how taxes impact startup investment decisions and shape incentives.

To better understand the impact of federal taxes on new business investment and growth, the Kauffman Foundation recently supported a study by the Tax Policy Center (TPC), a joint venture of the Brookings Institution and the Urban Institute. The result was the February 2015 publication of *Tax Policy and Investment by Startups and Innovative Firms*, which found that much tax treatment affects young firms differently depending on several factors.[8] In the following sections, we summarize the main findings from the TPC study.

Business Structure

It is well known that C corporations can be subject to double taxation—once at the business level and then again when profits are distributed to shareholders. Businesses organized as pass-throughs,[9] however, are taxed on the profits reported on the owners' tax returns. TPC found that this difference in treatment resulted in a higher marginal effective tax rate (METR) on new investment for C corporations than pass-throughs: 26 percent for C corporations and 19 percent for pass-throughs.

This is likely to affect a small, but significant, number of young firms. A Kauffman survey of firms featured in the Inc. 5000 list of fastest growing companies in America found that 16 percent of these expanding businesses were organized as C corporations.[10]

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[5] Balasubramanian, Natarajan and Jeongsik Lee, "Firm Age and Innovation," *Industrial and Corporate Change*, 2007, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1314522.
[6] Sørensen, Jesper B. and Toby E. Stuart, "Aging, Obsolescence, and Organizational Innovation." *Administrative Science Quarterly*, 2000, at http://www.jstor.org/stable/2666980.
[7] Mokyr, Joel, *The Lever of Riches* (Oxford University Press, 1990), pages 302-303.
[8] To conduct the analysis, TPC focused on the marginal effective tax rate (METR) on capital investment. This measure is useful for comparing how all features of the tax code interact to raise (or in some cases, lower) the hurdle rate on new investment. In short, higher METRs make investment more costly. The paper, *Tax Policy and Investment by Startups and Innovative Firms*, is available at http://taxpolicycenter.org/publications/url.cfm?ID=2000103.
[9] Pass-through business structures include S corporations, limited liability companies, and sole proprietorships, for example.
[10] This data from the Kauffman Foundation is available upon request.

Type of Investment

Effective tax rates vary by industry due to the different assets in which firms invest—meaning some new businesses face higher METRs simply because of the business type. Investments in research and development (R&D) are taxed more favorably than investments in equipment or structures—thanks in part to the research and experimentation (R&E) tax credit and immediate expensing. As an example of this preference, a TPC model found that businesses in the pharmaceutical or chemical industry face a METR on their investments of 11 percent. Construction firms, on the other hand, which rely more on equipment than intellectual property, face a METR of 28 percent.

Certain tax provisions that target young and small businesses can reduce METRs, but to differing degrees, again based on how the firm uses the capital. Section 179, which allows new and small businesses to immediately expense the cost of qualifying investments, is more valuable to firms in some industries than others. TPC found that this provision is more valuable for transportation or telecommunication firms that invest heavily in "long-lived equipment" than young chemical or pharmaceutical firms that already can expense their R&D investments. While a large and established construction firm faces a METR on new investment of 28 percent, a small, young construction firm sees its METR drop to 26 percent thanks to Section 179.

Through our work, we have identified diversity as one indicator of vibrant entrepreneurial ecosystems.[11] A diverse range of companies engaged in different industries creates economic resiliency. Section 179 benefits new and small firms by lowering METRs, but differential tax treatment based on the industry of the business still exists. Though policymakers may seek to promote certain industries, research shows that there is value in entrepreneurial diversity.

Method of Financing

Businesses finance investment in two primary ways—debt and equity. The tax code seems to acknowledge the important role of debt for financing young companies but neglects the role of equity, particularly for those companies most likely to be in growth mode.

To illustrate the difference in treatment, TPC analyzed the METR on two C corporations—one financed solely with debt and the other solely by equity. In this hypothetical scenario, the corporation financed by debt has a METR of -6

[11] Stangler, Dane and Jordan Bell-Masterson, "Measuring an Entrepreneurial Ecosystem," (March 2015). Available at http://www.kauffman.org/what-we-do/research/2015/03/measuring-an-entrepreneurial-ecosystem.

percent. The corporation financed by equity, however, faces a METR of 33 percent. Similar preferences exist for businesses organized as pass-throughs, though to a lesser extent.

Empirical data reveal that most new businesses seek debt financing instead of equity. Data from the Kauffman Firm Survey[12] shows that one-quarter of new businesses relied solely on equity, while the rest used a combination of personal, business, and other credit.[13]

Research shows that equity investments play a particularly useful role in growth firms. Businesses that receive venture capital investment, for example, tend to grow faster and are more likely to go public (IPO).[14] This subset of new businesses, which grow quickly and create many jobs, is especially important to the economy. The tax code might foster more growing companies and more investment in them if METRs on equity investment were lower.

In recent years, Congress has sought to encourage equity investments in new and young firms.[15] Yet, tax policy still disfavors equity investments.

Business Profitability

Finally, the tax code treats firms differently based on profitability. Although the tax code allows firms to reduce their taxes when profitable by deducting past loses, many young firms have no prior years of profitability. They are thus unable to take immediate advantage of many of the depreciation allowances, deductions, and tax credits profitable firms use to lower their METR. This neglects the realities of young firms in two ways.

First, carry-forward provisions tend to lose value over time.[16] "Fail fast" is a popular saying among entrepreneurs and reflects the rapid pace of business

[12] The Kauffman Firm Survey is a longitudinal study of 5,000 firms started in 2004 across all business sectors. More information is available at: http://www.kauffman.org/what-we-do/research/kauffman-firm-survey-series/an-overview-of-the-kauffman-firm-survey-results-from-2011-business-activities.

[13] Cole, Rebel A. and Tatyana Sokolyk, "How Do Start-Up Firms Finance Their Assets? Evidence from the Kauffman Firm Surveys," (March 15, 2013). Available at SSRN: http://ssrn.com/abstract=2028176.

[14] Hellmann, Thomas, Puri, Manju, and Da Rin, Marco, "A Survey of Venture Capital Research," (2011).

[15] In 2012, Congress passed the Jumpstart Our Business Startups (JOBS) Act (P.L. 112-106). This legislation sought to increase access to equity investment by modifying several existing securities regulations.

[16] Marron, Donald and Joseph Rosenberg. "Tax Policy and Investment by Startups and Innovative Firms." (February 9, 2015) Tax Policy Center.

development. For these firms, time is of the essence as they seek to establish a viable market position. Carry-forward provisions are of less value to young businesses than immediate tax savings, as entrepreneurs operate in an environment in which every dollar counts more now.

Second, firms are limited in their use of net operating losses (NOL) if they are acquired or receive capital investments that involve a material change in ownership.[17] Acquisition can be a successful exit strategy for some startups, especially those that are growing. According to TPC, in cases of acquisition or ownership change a business may lose some or most of the tax savings it would have received from the carry-forward provisions.

Tax Reform and Business Investment

After analyzing how various aspects of the tax code affect firm investment, TPC examined how several tax reform options would affect a range of businesses.[18] Each of the scenarios they considered would reform the tax code by lowering the corporate tax rate and offsetting the revenue loss with reduced tax preferences.

As the chart from TPC (reproduced below) shows, in all three scenarios, the METR on startup firms would increase over current law. While these stylized reforms would each reduce the *difference* in METRs between startups and established businesses, the startups would still face higher METRs than established firms organized as pass-throughs. Only when compared to established C corporations would profitable startups have an advantage. Capital is a critical ingredient in launching a new venture. More information is needed to understand how higher METRs on investments would affect new business creation.

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[17] Allen, Eric J., "The Information Content of the Deferred Tax Valuation Allowance: Evidence from Venture Capital Backed IPO Firms," (September 30, 2012). Available at SSRN: http://ssrn.com/abstract=2161340.

[18] In this model, TPC compared an older C corporation, an established pass-through business, a taxable startup, and a startup that does not have positive tax liability. The "non-taxable startup" describes a business unable to use all credits and deductions associated with the new investment.

Marginal effective tax rate on new investment by type of firm

	Marginal Effective Tax Rates			
	Established		Startup	
	Corporate	Pass-through	Taxable	Non-taxable
Current Law				
METR	25%	19%	23%	34%
Variation (s.d.) across industries	4.8%	4.3%	5.0%	3.9%
Variation (s.d.) across assets	10.3%	9.8%	10.3%	4.2%
Reform Option #1: Reduce corporate rate to 32%; Replace MACRS with ADS				
METR	28%	23%	26%	35%
Variation (s.d.) across industries	4.0%	3.7%	3.8%	2.8%
Variation (s.d.) across assets	9.1%	9.7%	9.1%	4.0%
Reform Option #2: Reduce corporate rate to 30.5%; Replace MACRS with ADS and limit interest deductibility				
METR	30%	25%	28%	36%
Variation (s.d.) across industries	3.5%	3.6%	3.6%	2.7%
Variation (s.d.) across assets	8.4%	9.5%	8.8%	3.9%
Reform Option #3: Reduce corporate rate to 28.5%; Replace MACRS with ADS, limit interest deductibility, and capitalize R&D				
METR	30%	27%	28%	35%
Variation (s.d.) across industries	3.4%	2.7%	3.2%	2.9%
Variation (s.d.) across assets	4.6%	5.3%	5.1%	3.2%

Source: Urban-Brookings Tax Policy Center Investment and Capital Model, version 1.0.

The task before the Committee is unenviable, but necessary to ensure the U.S. tax code is structured in such a way to encourage competition, growth, and job creation. There may be valid reasons why the tax code treats young firms differently based on the factors discussed above. But it might also be the case that these preferences are not warranted and were enacted for reasons no longer deemed economically beneficial.

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At the Kauffman Foundation, we continue to study how taxes impact entrepreneurs and the young firms that create jobs and drive our economy. We look forward to sharing new information with you and the Finance Committee as it becomes available. Please consider us a resource as you work to develop tax reform proposals.

Sincerely,

Dane Stangler
Vice President, Research & Policy
Ewing Marion Kauffman Foundation

Jason Wiens
Policy Director, Research & Policy
Ewing Marion Kauffman Foundation

About the Ewing Marion Kauffman Foundation
The Ewing Marion Kauffman Foundation is a private, nonpartisan foundation based in Kansas City, Missouri that aims to foster economic independence by advancing educational achievement and entrepreneurial success.