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THE STARTUP SLUMP: CAN TAX REFORM HELP REVIVE ENTREPRENEURSHIP?

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BEFORE THE

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TUESDAY, OCTOBER 3, 2017

UNITED STATES CONGRESS,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to call, at 10:00 a.m., in Room 1100, Longworth House Office Building, Honorable Pat Tiberi, Chairman, presiding.

Representatives present: Tiberi, Paulsen, Rooney, Maloney, and Beyer.

Senators present: Lee and Heinrich.

Staff present: Breann Almos, Ted Boll, Whitney Daffner, Barry Dexter, Connie Foster, Colleen Healy, Karin Hope, Matt Kaido, AJ McKeown, Kim Corbin, Allie Neill, and Kwabena Nsiah.

OPENING STATEMENT OF HON. PATRICK J. TIBERI, CHAIRMAN, A U.S. REPRESENTATIVE FROM OHIO

Chairman Tiberi. I call the hearing to order.

The Joint Economic Committee is holding this hearing because entrepreneurship matters. It matters because startup businesses drive the innovation that fuels economic growth and opportunity, and very importantly, entrepreneurs matter because nearly all the gains in job creation come from businesses less than a year old, true startups. The bad news is that the rate of startups has been declining over the past few decades. That decline became an outright collapse during this recovery when, for 3 straight years, as the chart shows, companies closed their doors more rapidly than they were opened.

During similar periods in recent recoveries, the greatest gains in the number of American companies occurred during the Reagan administration, perhaps not coincidentally, when tax rates were falling. In contrast, this recovery saw only about a fifth of the business growth. That has real consequences for middle-class families.

According to analysis by the Economic Innovation Group, each startup creates an average of six jobs. Plentiful startups and jobs create a cycle in which potential entrepreneurs are more willing to take a risk on a new venture. By the same token, weak levels of entrepreneurship and job creation create a downward spiral for both.

Another alarming trend is that the number of places where startup growth is actually happening is shrinking, a topic we investigated in a hearing earlier this year. From 2010 to 2014, half of all businesses' growth occurred in just five metropolitan areas.

Blighted areas across the country are desperate for new businesses and the jobs and opportunities that come with them. That is why I introduced the bipartisan Investing in Opportunity Act to attract capital and investment in distressed communities, and I hope that it becomes part of tax reform.

Tax reform is a key tool in our policy arsenal that could remove artificial barriers to starting a business and foster an environment where entrepreneurship can thrive. Truth be told, entrepreneurs probably don't think much about taxes when they launch a startup, and they shouldn't have to. But before long, they are hit with mind-numbing complexity that drains precious resources from their businesses. They may spend every dime of profit buying expensive equipment to scale up production, but the tax code may not allow them to immediately deduct the cost. That means they will owe taxes on profits they no longer have.

If they do manage to become profitable, startups that are corporate taxpayers will face the highest tax rate in the developed world. And successful startups that pay individual taxes because they are set up as pass-through businesses will face even higher individual rates that have increased dramatically over the years. The tax code also punishes success by forcing family business owners to do costly estate planning so the death tax doesn't steal their ability to pass the business to the next generation of entrepreneurs.

In this increasingly global economy, entrepreneurs can start or move a business anywhere in the world they choose. Yet, our tax system is out of step with our competitors. Tax reform done right will grow jobs and grow paychecks, helping restore the virtuous circle that gives entrepreneurs the confidence to take a risk and reach high for the American dream.

Tax reform done right will provide them more capital, the lifeblood of entrepreneurs, and it will make America the best place in the world to invest and to start a business. Our future prosperity depends on it.

I look forward to hearing the thoughts of our excellent panel of witnesses today, and I will introduce them in a moment. But I would first like to recognize our ranking member, Senator Heinrich, for his opening statement. Welcome.

[The prepared statement of Chairman Tiberi appears in the Submissions for the Record on page 32.]

OPENING STATEMENT OF HON. MARTIN HEINRICH, RANKING MEMBER, A U.S. SENATOR FROM NEW MEXICO

Senator Heinrich. Thank you, Chairman Tiberi. And thank you to all of our witnesses for being here today.

The tax reform debate is underway, and I am happy that our committee is taking this opportunity to examine the Nation's tax policy. I agree that our tax code needs to be simpler for families and for small businesses.

Where we can promote policies to make sure that the Tax Code is working for working Americans, growing the economy, creating good-paying jobs, and supporting families and communities across the country, I will be among the first to support it. Unfortunately, the Republican's starting point seems heavily focused on giving more tax giveaways to large multi-national corporations and the wealthiest among us rather than on small businesses, rural entrepreneurs, and those communities still struggling to recover following the recession. There is time to shift that focus, and hearings like this one can help.

In New Mexico, small businesses make up more than 95 percent of all businesses and employ more than 55 percent of private-sector workers. They are the heart and soul of our State's economy. They are companies like Risk Sense in Albuquerque that help firms assess and manage their cybersecurity risk.

Founded as a small business technology transfer from the New Mexico Institute of Mining and Technology, the company now has 100 employees, and earnings growing 50 percent annually. It is a great success story, and we certainly need more of them.

At the national level, startup activity has picked up in the past 3 years, but the share of startups has declined by almost half since the 1970s. New firms are increasingly concentrated in a few big cities and states. One report found that just 20 counties were responsible for half of the net increase in new businesses from 2010 to 2014. And the share of startups created by veterans and in rural areas are both down in the past two decades.

There are a number of actions that we should take to boost startup activity, few of which have anything to do with the tax code. It is vital that we strengthen the basic economic foundation, more jobs, higher wages, and improved access to education and healthcare. And we must lay the groundwork for startup activities in rural areas. That means increasing access to capital, speeding the deployment of broadband in rural communities, and other steps, to ensure that rural and tribal areas are able to compete when it comes to startup activity.

We also should be clear about what will not help small firms. Big tax cuts for large, established companies do nothing for startups, which have little to no taxable income in those critical early years while working to get their businesses off the ground. And it does little for small businesses in need of capital to grow, capital that has been shrinking and drying up since the recession. As we have seen time and again, tax giveaways for large corporations and our highest earners do nothing to help small businesses, rural communities, and working people, get ahead, and it leaves fewer and fewer dollars to invest in roads, schools, entrepreneurs, and working families, compounding the challenges facing small cities and towns across our country.

The primary goal of reform should be to use the levers we have to level the playing field. One, because it is the right thing to do. And, two, because every American should have the opportunity to turn their dream into a reality. A zip code should not determine a child's success or her chances of starting a business.

The entrepreneurial spirit is alive and well from Las Cruces, New Mexico, to Boston, Massachusetts. It is our job to make sure we give every American the same chance to succeed, no matter their background. Two things we could do right now to boost our economy and put more money into the pockets of working families are expanding the earned-income tax credit and strengthening the child tax credit. Our focus needs to be on creating better opportunities for the folks on Main Street, not delivering more tax breaks for investment bankers on Wall Street.

We have an opportunity this Congress to work together to craft a bipartisan tax reform package that promotes entrepreneurship, simplifies our tax code, and puts more money in the pockets of working people. If we do that, we will give Main Street the boost it desperately needs. I am certainly ready to get to work, and I look forward very much to this panel's testimony.

[The prepared statement of Senator Heinrich appears in the Submissions for the Record on page 33.]

Chairman Tiberi. Thank you. Now on to our panel of witnesses.

John Dearie is founder and president of the Center for American Entrepreneurship, a nonpartisan research policy advocacy organization focused on the importance of entrepreneurs and startups, innovation, and the growth of job creation. He is the former acting CEO of the Financial Services Forum, spent 9 years at the Federal Reserve Bank in New York, and is the coauthor of "Where the Jobs Are: Entrepreneurship and the Soul of the American Economy."

Welcome.

Scott Hodge is the president of the Tax Foundation in Washington, D.C., and is recognized as one of Washington's leading experts on tax policy. During his tenure, the Tax Foundation has become one of the most influential organizations on tax policy in Washington and in State capitals. Among other things, he has authored over 100 studies on tax policy and government spending. Scott began his career in Chicago where he helped found the Heartland Institute. Before joining the Tax Foundation, Scott was Director of Policy and Budget Policy at Citizens for a Sound Economy. He also spent 10 years at the Heritage Foundation analyzing budget and tax policy.

Welcome back, Mr. Hodge.

Ms. Falon Donohue is the CEO of VentureOhio, a for-impact organization created to promote a collaborative statewide ecosystem that supports entrepreneurs, including by increasing access to angel and venture capital for Ohio startups. Prior to her tenure at VentureOhio, and while serving her country in the Ohio Air National Guard, she began her career in technology solution sales and business development.

Thank you for your service to our country and for your service to entrepreneurs. We look forward to hearing from you.

And last but not least, John Arensmeyer is founder and CEO of Small Business Majority, an organization focused on empowering America's entrepreneurs to build and thrive in an inclusive economy. In the past few years, he has spearheaded the growth of Small Business Majority's entrepreneurship program, providing resources to our Nation's 28 million small businesses. He was also the founder and CEO of ACI Interactive, an award-winning international e-commerce company.

Welcome, and we look forward to your testimony.

Chairman Tiberi. With that, Mr. Dearie, you can begin, and you have 5 minutes. We look forward to your testimony.

STATEMENT OF JOHN R. DEARIE, FOUNDER AND PRESIDENT, CENTER FOR AMERICAN ENTREPRENEURSHIP

Mr. Dearie. Chairman Tiberi, Ranking Member Heinrich, and members of the committee, thank you very much for the invitation to testify today. Your focus on tax reform and entrepreneurship hits the bulls-eye of what, in my view, is the Nation's foremost domestic policy challenge, and that is accelerating economic growth. As members of the committee are no doubt aware, the U.S. economy has been mired in a rut of subpar performance for more than a decade. After expanding at an average annual rate of about 3.4 percent for most of the post World War II era, the economy has not grown at 3 percent or better since 2005—that is for almost 13 years now—and has averaged only 2.2 percent since the end of the Great Recession more than 8 years ago.

Weak economic growth means less opportunity, diminished job creation, lower wages, increased economic anxiety, and greater dependence on government assistance. To meaningfully address these challenges and the anger, cynicism, and populism they inspire, we must accelerate economic growth back to the historical average, and on a sustained basis.

Economic growth comes principally from gains in productivity driven by innovation, which comes disproportionately from new businesses or startups. Nearly all of the major innovations that have defined the economic landscape over the past 150 years—the railroad, the telegraph and telephone, the automobile, electrification, the airplane, air conditioning and refrigeration, the computer, countless applications of the internet, and wireless communications—all came from entrepreneurs.

Moreover, recent research has shown that startups also account for virtually all net new job creation.

And, yet, as you pointed out in your opening statement, Mr. Chairman, American entrepreneurship is in trouble. From 2000 to 2006, the economy produced an average 510,000 new firms each year. Since 2009, however, the number of new businesses launched annually has dropped to about 400,000, meaning that the United States currently faces a startup deficit of almost 100,000 new firms each year.

Even more alarming, as economists Bob Litan and Ian Hathaway have shown, the number of new firms as a percentage of all firms has fallen near a 30-year low. And this decline is occurring in all 50 States, in all but a handful of 360 cities they examined, and across a broad range of industry sectors, including high technology.

Given the critical role that startups play as the principal source of innovation, gains in productivity, economic growth, and job creation, such circumstances amount to nothing short of a national emergency.

Addressing that emergency by reversing the three-decade decline in American entrepreneurship requires changes in public policy, which brings us to tax reform. The current Tax Code presents a number of challenges for startups, challenges that can amount to the difference between survival and failure. Specifically, the current code penalizes businesses with substantial early years' losses, discourages investors from backing new businesses, and impedes successful new companies from expanding.

The broad objectives of the unified framework for tax reform released by the Administration and the tax drafting committees are very promising. Simplifying the Code, broadening the base by eliminating loopholes, lowering business tax rates, allowing full expensing of business investment, and moving to a territorial system are the keys of a modern and competitive Tax Code.

But, as the unified framework itself states, it is only a template for the tax drafting committees. The essence of tax reform is the details, and we eagerly await specifics.

Our hope is that reform will address a number of tax-related obstacles to entrepreneurship, including: allowing startups to defer their income tax liability in order to conserve critical cash flow in the early years; allowing startups to carry forward net operating losses and R&D tax credits; expanding the application of R&D tax credits to startups' payroll taxes; and simplifying and expanding the favorable tax treatment of investment in new startups.

So, Mr. Chairman, economic growth comes from gains in productivity, driven by innovation—which comes disproportionately from startups. Revitalizing American entrepreneurship, therefore, is the essential pathway to faster economic growth and the opportunity, jobs, and wage growth the American people need and deserve. Tax reform that includes a special focus on the unique tax-related vulnerabilities of startups is a critical part of America's pro-growth agenda.

Thank you, again, for the invitation to participate.

[The prepared statement of Mr. Dearie appears in the Submissions for the Record on page 35.]

Chairman Tiberi. Thank you.

Mr. Hodge, you are recognized for 5 minutes.

STATEMENT OF SCOTT A. HODGE, PRESIDENT, TAX FOUNDATION

Mr. Hodge. Well, thank you, Mr. Chairman, and Senator Heinrich, members of the committee. I appreciate the opportunity to talk to 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 does not stand in the way of success. So we applaud this effort to try to remove the tax barriers to entrepreneurship. And 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 United States from every other nation on Earth. And, yet, through all the success stories that we hear, there are dozens of other firms that never got past the numerous speed bumps that the Tax Code places in front of their ambition and eventual success.

Let's put ourselves in the shoes of Maria, a young entrepreneur who has invented a smart scooter, and look at the tax issues that she faces along the way. The first thing that she has to consider is what business form to make her business. She has a choice between a traditional C corporation and a pass-through firm. Both have advantages. Both have disadvantages.

If Maria chooses a C corporation form, her company faces two layers of tax, one at the entity level, and a second at the shareholder level. If her company becomes successful enough, it will face one of the highest corporate tax rates in the industrialized world at 35 percent. If we include the shareholder taxes, the rate is over 50 percent. On the other hand, Maria could choose one of the four different pass-through business forms that face only one layer of tax.

But a successful pass-through business owner can face income tax rates as high as 43½ percent, which includes a top individual rate of 39.6 percent. If her company becomes really successful, her family business could end up facing the estate tax, which could take as much as 40 percent of everything that she built over a lifetime.

The treatment of capital investments puts another speed bump in her way. When Maria's company is young and growing, she can expense her capital investments under Section 179. After her company is no longer small, it must comply with complex depreciation schedules that not only raise the tax costs of every capital investment she makes, it adds about $23 billion to the compliance costs of businesses large and small.

There are other all kinds of arcane aspects of the Code that inhibit entrepreneurship. But let's take a minute to see what the unified framework proposes that could help entrepreneurs, starting with tax rates. Of course, the most dramatic of these changes is to lower corporate tax rates and pass-through rates that are proposed in the framework. It proposes a 20-percent corporate tax rate for C corporations and a top rate of 25 percent for pass-through business income.

The 20 percent Federal corporate tax rate would instantly lower the U.S. rate to one of the lowest in the industrialized world, making the U.S. one of the most attractive places to do business on Earth.

And the lower proposed tax rate on pass-through businesses offers some interesting issues. On the one hand, the lower rate will certainly make entrepreneurship more attractive. On the other hand, the large gap between personal wage rate and pass-through rate could encourage some business owners to reclassify their income as business income, so the committee and Congress needs to look at this very carefully and write strict rules to prevent that sort of behavior. Don't let the rulemaking—or leave the rulemaking up to the IRS.

On expensing, the framework's 5-year, temporary bonus expensing provision is certainly a step in the right direction, but it falls a little short of what entrepreneurs and the economy really need. Our economic modeling shows that temporary provisions don't deliver the economic growth of permanent provisions, not surprisingly, because they encourage capital investment today at the expense of capital investment tomorrow. The Tax Foundation's models suggests that moving toward full expensing for all businesses would encourage more entrepreneurial investment and deliver permanent economic growth.

The estate tax, the framework calls for eliminating the estate tax. Tax Foundation economists estimate that the economic benefits of repealing the estate tax will exceed any revenue losses that repeal would bring the Treasury.

So, in conclusion, Mr. Chairman, 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 more simple, less burdensome, and eliminating all the anti-growth biases that are throughout the Code.

So thank you very much for the opportunity to talk to you today about this important issue, and I look forward to any questions that you may have.

[The prepared statement of Mr. Hodge appears in the Submissions for the Record on page 51.]

Chairman Tiberi. Thank you.

Ms. Donohue, you are recognized for 5 minutes.

STATEMENT OF FALON DONOHUE, CHIEF EXECUTIVE OFFICER, VENTUREOHIO

Ms. Donohue. Thank you, very much, Chairman Tiberi, Ranking Member Heinrich, and members of the Joint Economic Committee. Thank you for the invitation to provide testimony for this important hearing. And thank you, Chairman, for the kind introduction.

I am speaking to you today on behalf of VentureOhio's membership. We are the entrepreneurs, innovators, and investors, who are creating high-paying jobs in the midwest, and changing the world we live in. And the topic of revising entrepreneurship through tax reform is very important to the hearts and minds of the members of VentureOhio. But I am also speaking to you today on behalf of a larger group of Midwesterners who are most affected by the growth and development of our new tech-based economy.

These are my fellow veterans seeking to transfer the technical skills acquired while serving their country into high-paying jobs in their hometown. These are my young friends who want to build applications that will change the world at cool new tech companies, but don't want to leave their families for New York or California.

And, finally, these are the good people of Mansfield, Ohio, my hometown, and small towns across the midwest, who are seeking access to new technical jobs as they watch their current jobs become obsolete due to the rapidly changing pace of technology.

The midwest is in the midst of a renaissance. Abandoned warehouses in long-forgotten parts of town, in forgotten parts of the country, are being repurposed as tech incubators. Startup company successes are dominating the headlines of local newspapers, while the community surrounds them and cheers for their success. Ohio's best and brightest are starting to remain in the State and work at high-tech companies in lieu of leaving for the coasts.

These startup founders are choosing this path to create some of the most innovative and disruptive companies of our generation. In the coming decade, startups will create whole new industries that will impact millions of jobs across our country. From autonomous vehicles, to artificial intelligence, the impact of these companies will be swift and complete.

In Ohio, we have seen massive growth in our startup ecosystem and venture activities, reaching its highest point in history in 2016.

From our latest research released in VentureOhio's 2017 report, venture capital investments increased 46 percent over the past 2 years. And in 2016 alone, $470 million were deployed in the 210 Ohio startups. In addition, $631 million were raised by institutional investors to be deployed into Ohio companies in the near future.

We have also seen the results of innovation and entrepreneurship through the acquisition of Ohio companies like CoverMyMeds, which was acquired earlier this year for over $1 billion. As the largest tech acquisition in Ohio's history, the sale was a major milestone for the Ohio entrepreneurial community, and is setting the tone for what is to come.

Success stories like CoverMyMeds in Columbus or Assurex Health in Mason, which was acquired in 2016, and many others each year, demonstrate that it is an exciting time to create a startup company in Ohio.

Startups are creating millions of new jobs, fueling research and development in the technologies of the future, and continuing America's innovation dominance. Without them, we might have to imagine a world without social networks, streaming TV, or the on-demand delivery of nearly everything. But we might have to imagine a world without lifesaving drugs, or the ability to more easily take drunk drivers off our roads.

I speak with investors and entrepreneurs every day who are taking massive risks to create jobs and grow our economy. These people are doing everything that they can to revitalize communities, create high-paying jobs in their hometowns, and they need our support. They need support from their communities, and they need support from their leaders, from you. They need a simplified Tax Code and access to capital.

We believe the companies being created in Ohio today will be the next crop of the Apples, Googles, Airbnbs, and Facebooks. They will create millions of jobs and change a generation of families. This is the most exciting time Ohio entrepreneurship has seen in decades due to the hard work of the innovative entrepreneurs in our State, and I am pleased to be with you today to speak about the ways that the Federal Government and a simplified Tax Code can help encourage future startups.

Thank you. I look forward to answering your questions.

[The prepared statement of Mr. Donohue appears in the Submissions for the Record on page 60.]

Chairman Tiberi. Thank you.

There is under a minute left. That is pretty impressive.

Senator Heinrich. That is a record.

Chairman Tiberi. I think it is a record. Very good.

Last, but not least, Mr. Arensmeyer, you are recognized for 5 minutes.

STATEMENT OF JOHN ARENSMEYER, CEO AND FOUNDER, SMALL BUSINESS MAJORITY

Mr. Arensmeyer. Chairman Tiberi, Ranking Member Heinrich, Vice Chair Lee, and members of the committee, thank you for inviting me to speak with you today about policies that can help promote entrepreneurship, and to offer testimony about the major issues facing America's small businesses.

I spent many years as a small businesses owner. I was the founder and CEO of ACI Interactive, an award-winning interactive communications company which I ran for 13 years. Then, 12 years ago I founded Small Business Majority to empower America's entrepreneurs to build a thriving and inclusive economy. We have a network of more than 55,000 small business owners across the country with offices in Washington, D.C. and eight States. We interact daily with small business owners to conduct scientific research on a wide variety of topics.

In order to ensure our Nation's job creators can thrive and help grow our economy, it is crucial that Congress focus on policy solutions that are targeted to help our Nation's entrepreneurs succeed. Most particularly, the need for access to responsible credit and capital, affordable and quality health coverage, and tax reform that directly benefits Main Street small businesses. Regarding tax reform, we need a tax system that benefits small business owners who are focused on growing their enterprises, satisfying their customers, and making payroll. Right now, according to our polling, 90 percent of small business owners feel that our tax system primarily benefits wealthy corporate interests at their expense. We don't want special treatment. We just want a level playing field. That is why we are concerned by the current proposal for tax reform. While some are touting the plan as a boon for small businesses, the reality is it will not actually benefit most Main Street businesses while adding at least $2.4 trillion to our budget deficit over the next 10 years.

Specifically, some claim that the current proposal to cap the tax rate for pass-through entities at 25 percent would be a boon for America's entrepreneurs. In fact, this would impact only a handful of small firms. More than 87 percent of pass-through entities already pay a marginal tax of 25 percent or less. Moreover, if individual tax brackets of 12, 25, and 35 percent are passed, as is proposed, the pass-through entities that would benefit from the pass-through cap rate would include only the 1.8 percent earning $425,000 or more.

And last but not least, a tax code with a large gap between top individual rates and top pass-through rates can potentially encourage wealthy individuals to game the system by simply declaring themselves pass-through entities. I think we have seen this in the experiment that Kansas ran.

If Congress wants to offer a responsible tax cut for most Main Street small businesses and offset that cut with a reduction in existing loopholes, allowing all businesses to deduct a modest amount of their profits from the bottom up would have a much greater impact. As for corporate taxes, cutting the top rate would certainly help some of the minority of small businesses that are organized as C corporations, but doing so without getting rid of corporate tax loopholes would greatly increase the deficit. Economists from the Tax Policy Center estimate that reducing the corporate rate to less than 26 percent would be impossible to offset with just a reduction of loopholes. And the reduction as proposed to 20 percent would reduce Federal tax revenue by $1.6 trillion over 10 years. We have a set of specific tax proposals that are included in my written testimony.

A more critical issue for entrepreneurs is access to capital. Unfortunately, too many businesses, especially women- and minority-owned firms, and entrepreneurs in distressed and rural communities, are struggling to gain the capital they need to launch or grow their businesses. According to our scientific opinion polling, 90 percent of small business owners agree that access to capital is a problem. Statistics on lending to women and minority business owners are included in my written testimony, as are the specific reasons that small business borrowing has gotten so much more difficult since the recession.

Small business owners need reliable and affordable healthcare so they can invest their time and resources into growing and expanding their businesses. Prior to the implementation of the ACA, entrepreneurs and their employees comprised a disproportionate share of the working uninsured. Post ACA, the uninsured rate for small business owners, and employees, and self-employed individuals, has fallen dramatically, and millions of them have gained coverage from the marketplaces and from Medicaid expansion.

Finally, the ACA has greatly reduced so-called job lock, a phenomenon where people are tied to their jobs, as opposed to striking out on their own, simply due to their inability to get health coverage. We have a set of specific access to capital and healthcare proposals that are included in my written testimony.

Thank you, again, for inviting me to appear today. I look forward to your questions.

[The prepared statement of Mr. Arensmeyer appears in the Submissions for the Record on page 66.]

Chairman Tiberi. Thank you.

Mr. Dearie, you made a great point in your testimony about how world-class tax systems that promote economic growth lead to more entrepreneurship, and often more jobs and more revenue. Can you expand upon that, how strong growth and more startups become self-reinforcing?

Mr. Dearie. They are related. I didn't have time in my oral testimony to mention that a lot of the testimony and a lot of the agenda at the Center for American Entrepreneurship is based on roundtables that I and a colleague conducted—as you know, Mr. Chairman, you attended the roundtable in Columbus, Ohio. We did them in 12 cities around the United States, asking entrepreneurs, very simply, what is in your way? And trying to get at why this decline is happening. And one of the things that they told us over and over again is that the economy simply isn't growing fast enough.

Now, that has a lot to do with the fact that entrepreneurship is down. But there is this symbiotic, you know, feedback loop kind of relationship between entrepreneurship and broader economic conditions. So to the extent that we can achieve tax reform that puts the American economy on a much more competitive posture, vis à vis our American—sorry, our foreign counterparts, to the extent that we can achieve tax reform that gets out of the way of American business and increases the rate of economic growth, that, in and of itself, improving the broad economic circumstances into which entrepreneurs are trying to launch their businesses and grow will have this very positive feedback effect on entrepreneurship.

Chairman Tiberi. Thank you.

Mr. Hodge, you and I have talked about full expensing for years, and we both agree that it is a good thing. But we are in a situation right now where there are limits to small business expensing, and bonus appreciation under current law will ultimately go away. Can you talk about what we would be foregoing in terms of simplicity, in terms of boosting job growth and economic growth, if we simply left the current path on depreciation rules in place, in your opinion?

Mr. Hodge. Well, let me just put it in a positive sense that moving to full expensing, our models indicate, would be the most powerful tax change that you could make to, number one, spur economic growth, increase productivity, increase investment, and ultimately, increase wages for working-class Americans. And what we find that is that a secondary benefit of full expensing is that it does something that rate cuts don't do. It removes dozens, if not hundreds, of pages from the Tax Code, greatly simplifying the amount of complexity that entrepreneurs and businesses have to face.

We estimate that—actually, the IRS estimates—that businesses spend about 448 million hours complying with depreciation schedules because they are so arcane at a cost of about $23 billion a year. So if you were to include that with the economic benefits that you get from full expensing, this is a very, very powerful tool, an engine, for restarting economic growth and investment.

Chairman Tiberi. Thank you.

Ms. Donohue, I am thankful to VentureOhio for its support of the Investing in Opportunity Act, and for your support as well.

VentureOhio has been an incredible success story in our State of Ohio. But I know that there are challenges in terms of capital. And I would like you to expand on the challenge of venture capital being so concentrated on both the left coast, and the right coast, and the impact that has on startups in the midwest. If you could just expand on that.

Ms. Donohue. Absolutely. It has had a tremendous impact. While we are very proud that over the last 2 years, capital has increased by 46 percent, that still only accounted, in 2016, for about a half a percent of venture capital distributed nationally. And as the seventh largest State in the United States, that is just not good enough. We are tracking a lot of really good data. But what we are not able to track is how many incredible entrepreneurs left Ohio, how many of them have left the midwest and started their company in California or New York. It is stories that I hear on the ground all of the time, you know, "I reached out for capital, there just wasn't enough."

To launch a company, you are talking hundreds of millions of dollars, billions of dollars, to get to the level of a Facebook or LinkedIn. Six hundred thirty-one million raised in Ohio last year is pretty incredible, but that is nothing compared to what one company in California would raise to get to exit. So we still have a very long way to go.

Chairman Tiberi. Thanks.

Senator Heinrich, you are recognized for 5 minutes.

Senator Heinrich. Thank you.

Mr. Arensmeyer, you mentioned that there are a number of small business and Main-Street-focused tax reform proposals. I noticed there is a long list in your written testimony. Do you want to talk a little bit about what you think is most important from that list?

Mr. Arensmeyer. Sure, Senator. Thank you.

I think, you know, as Congress considers, you know, making changes to the Tax Code, you have to make some tough decisions. I mean, obviously, tax breaks for everybody, people would love them. But I think—you know, our opinion is you need to focus on what is going to have the biggest impact at the most reasonable cost. And, for example, we have proposed instead of cutting the top—you know, the pass-through rates down to 25 percent, why not give small businesses the opportunity to deduct the first 25,000 of their income? That is going to impact every small business that actually pays taxes which is about 70, 75 percent of businesses in any given year.

There is also, you know, the Investment Opportunity Act that the Chairman mentioned. You know, definitely some of the proposals from the other witnesses about targeted benefits in the Tax Code for very specific types of investments, particularly in distressed communities, we definitely support that; changing the law allowing self-employed individuals to deduct the FICA portion of their healthcare cost before they—right now they have to pay the tax on that when they earn it, and they don't get the benefit that a regular company does.

So there are a whole host of—expanding the small business tax credit under the ACA. So there are some very targeted things that can be done that are going to have a much broader impact on the majority of Main Street small businesses than what is being proposed right now.

Senator Heinrich. So, generally, I want to ask a question about whether or not we should pay for tax reform. Should it be revenue-neutral? And I will start with Mr. Arensmeyer, and I will just go down the list.

Mr. Arensmeyer. We believe it should be revenue-neutral. I mean, right now, we have reduced our deficit in recent years. But I think to turn that around is going to have long-term disastrous effects on our economy. Ultimately right now, we benefit from low interest rates. But, ultimately, the interest rates are going to go up if we continue this. And there is really no reason to do that. I mean, most decisions that businesses make, quite frankly, are actually not based on taxes. They are based on access to capital. They are based on whether they have adequate healthcare to go out and start businesses. They are based on the availability of qualified workers, including immigrants, in their community, which have really driven—a lot of the startup success stories, you have heard from the other witnesses, are being driven by more expansive immigration laws. So there is a lot more going on than just taxes. Again, it comes down to a set of priorities. What is going to have the biggest impact? And how can this be done in a way that is not going to hurt the deficit?

Senator Heinrich. Ms. Donohue.

Ms. Donohue. Since my members have not formalized a position on this issue, I prefer to defer to my fellow witnesses.

Mr. Hodge. There is nothing magical about revenue-neutral tax reform. As we saw a few years ago, when Congressman Dave Camp put together his tax reform blueprint, which was revenue-neutral, the choices he made in order to make it revenue-neutral actually neutralized the economic benefits that came from the plan. What you need to focus on is economic growth. And don't get focused on the deficit, because that will lead you down the wrong path. The key is identifying the right policies that create economic growth. And, over time, a lot of those policies can create the kind of growth that can claw back some of the revenue loss that might come from the tax cuts.

Senator Heinrich. Wouldn't the flip side of that be the kind of tax cuts we did in 2001 and 2003, which didn't really create a situation where we were more competitive, ended up driving up our deficit? Gave a way a lot of goodies, but didn't provide a fundamentally more competitive United States business environment.

Mr. Hodge. Right. Because they were too focused on individual tax cuts and things like child credits, which do very little for economic growth. The key policies for creating economic growth are, one, moving to full expensing for capital investment, lowering the corporate tax rate to competitive level, lowering individual tax rates so individual businesses are more successful, and making all of that permanent. That will achieve the kind of economic growth that the economy needs. And, as a result, it will be budget friendly in the long term as well.

Senator Heinrich. We certainly hope so.

Mr. Dearie——

Mr. Dearie. I would——

Senator Heinrich [continuing]. Should we pay for tax reform?

Mr. Dearie. I would agree with Scott that growth ought to be the top priority. But I would hope that tax reform would be deficit-neutral. Chairman Tiberi asked me about the impact on entrepreneurship, of broader economic circumstances, and I mentioned these roundtables that I and a colleague did around the country. Over and over and over again, at virtually all the roundtables, among the problems, among the policy failures that they mentioned that comes out of Washington, is the inability or unwillingness to deal with the national debt, which, at that time, was much lower than it is now. It plays into their overall confidence about business conditions and their confidence in the economy.

We had folks tell us, you know, when we look at the deficit, we see it, sort of as a proxy for future taxes, assuming we are ever going to pay this off.

So it does feed into the confidence of entrepreneurs, their outlook as to economic strength, their willingness to launch businesses, to take risks, to hire. So I would hope that it would be, at its best, would be deficit-neutral.

Senator Heinrich. Thank you.

Chairman Tiberi. Thank you.

Mr. Paulsen is recognized for 5 minutes.

Representative Paulsen. Thank you, Mr. Chairman, for holding this hearing today on a topic that I think is so important to thousands and thousands of entrepreneurs across the country, as well as Minnesotans, obviously. Just last week, I received an email from a constituent, Paula in Plymouth, Minnesota, who articulated what I have actually heard countless times. She writes, "I, along with America's small businesses and other hard-working taxpayers, have been struggling under high tax rates for years. It is time that we rally together to change that. Tax cuts for small businesses will do a substantial amount of good for the U.S. economy and everyone in it. Businesses would be able to use these savings to create more jobs, increase wages, and expand to new locations, which would provide a boost to the economy and ensure continued economic growth."

I couldn't have said this better myself. I strongly believe we owe it to Minnesota's innovators, startups, and small business owners to fix the broken Tax Code. So, with that in mind, Mr. Dearie, maybe I will just start with you. You noted in your testimony that 95 percent of all businesses, and 85 percent of small businesses are pass-throughs, which means they are paying those taxes at an individual rate instead of the corporate rate. How important is it to have lower rates for both C corporations and for those successful entrepreneurs who are pass-throughs, especially since pass-throughs saw a massive increase in their top tax rate from 35 percent to up to 44.6 percent recently?

Mr. Dearie. It is very important. As a matter of fact, I will introduce another way to think about this that we have learned from a few entrepreneurs who brought it to our attention. They have said, you know, we talk a lot about access to capital. How am I going to get a bank loan? How am I going to attract angel investment or venture capital investment to my firm? Tax policy is an access-to-capital issue. Every April, the tax man comes and takes a third, or 44—as you just mentioned—percent of my operating capital and walks away. That can be the difference, they have told us, between failure and success.

So holding on to what little revenue, or profit, or money, that startups are making in those critical early years is absolutely vital to the chances that that startup is going to survive and be able to grow and create jobs. So certainly, tax rates, or what the government takes away, is a major determinative factor as to the survivability of startups.

Representative Paulsen. Sure. And just to follow up on that, we live in this global economy where Americans can start up and move a business almost anywhere in the world. You can move capital at the click of a mouse. If you do an internet search today for starting a business overseas, you will find a lot of advice on how to do exactly that, and why it might actually benefit a startup to look overseas. So as we are looking at reforming the Tax Code and helping entrepreneurs, is it important to not only consider how we tax them here in America, but also how our competitors are approaching taxation to attract companies.

Mr. Dearie. That is absolutely right. And it is not just on tax reform, it is also on immigration policy; it is on education, et cetera. The rest of the world gets it. The rest of the world has figured out how important startups are to economic growth, that winning the 21st century in terms of economic competition is about attracting the best firms, the best new ideas, the best talent, and they are rolling out the red carpet for entrepreneurs all over the world, including ours. So you are absolutely right, that we have got to get our game squared away, or we are going to lose this battle.

Representative Paulsen. Mr. Hodge, do you have a perspective on that, as well, in terms of the competition we face and the actions we should take?

Mr. Hodge. Well, the United States has the highest corporate tax rate in the industrialized world. There are only four small jurisdictions that have slightly higher tax rates than us. But the rest of the world, as Mr. Dearie said, has gotten it. And as we stand still, we fall further and further behind. And it is not just on the corporate side. It is the individual rates as well.

And it is interesting to note that because we had high tax rates before the 1986 Tax Reform Act, the number of pass-through, or small businesses, was declining each and every year. And after tax rates fell from 50 percent to 28 percent in 1986, we saw an explosion in the number of pass-through businesses, because tax rates simply matter to entrepreneurship and business startups. And so the more that we move in that direction, I think the more that we are going to see entrepreneurship, the more we are going to see business startups, and the economy will begin to boom again.

Representative Paulsen. Ms. Donohue, do you see competition in the State of Ohio and other parts of the midwest, like Minnesota, from around the world?

Ms. Donohue. Absolutely. I don't believe that entrepreneurs in Columbus, Ohio, or in Ohio, or in the midwest, see each other as competition. Their competition is global. We live in a global economy. And, as you stated, access to capital can occur all over the world. So anything that we can do to keep our innovative entrepreneurs in our State, in our country, we are absolutely in support of.

Representative Paulsen. I see I am out of time. Mr. Chairman, I yield back.

Mr. Arensmeyer. Mr. Chairman, if I could just add one thing?

Chairman Tiberi. Quickly.

Mr. Arensmeyer. Yes. Just, I want to remind the committee on the pass-through rates, when you are talking about 39.6 percent, and adding on State tax, et cetera, on top of that, you are talking about a small sliver of small businesses. Only 1.7 percent of pass-through entities pay at the 39.6 percent rate; 87 percent pay 25 percent or less; 70 percent pay 15 percent or less. So there is not a really close connection between the taxation faced by most Main Street small businesses and the individual rate structure at the upper levels.

Chairman Tiberi. All right. I am going to allow Mr. Hodge just to have a little bit of rebuttal since we are both out of time.

Mr. Hodge. No rebuttal, just some clarification. Over 55 percent of all pass-through business income is taxed at the highest tax rate. So while, yes, there are millions of small businesses who do pay at the lower rates, the majority of pass-through business income is taxed at that higher marginal rate.

Chairman Tiberi. All right. With that, I am going to recognize Representative Maloney for 5 minutes.

Representative Maloney. Thank you, Chairman Tiberi, for holding this hearing, and all our panelists. I wholeheartedly agree that small businesses and startups are truly the lifeblood of our economy, and that the metrics clearly show that there has been a startup slump. The Kauffman Foundation found, between 1978 and 2012, the number of companies less than a year-old, as a share of all businesses, declined by nearly 44 percent, astonishing number.

And I agree that there is a great deal that we can do to improve the situation. But I am particularly optimistic about a new approach to speeding up the creation of new startups in the district I am privileged to represent where we literally, just a month ago, opened a new school called Cornell Tech, which is a partnership between Cornell University and Technion-Israel, with the total and sole purpose of training entrepreneurs, innovators, tech firms.

Cornell Tech is a new model for innovation incubators which connects science, technology, and engineering researchers with venture capitalists looking to speed the application of new discoveries in labs to applications in the real world, thereby growing our economy. We have already had—before they even opened up, and they were planning it—several startups that have come out of this initiative.

But I would like to say that it is not just taxes, although everybody would like to get a tax cut. There are other factors, such as immigration and health insurance.

And I would like to ask Mr. Arensmeyer, I would like to ask you about health insurance. I noticed a very interesting post on your Small Business Majority website that was titled “Defeat of the Affordable Care Act Repeal Measure is a Big Victory for Small Businesses,” noting that if the bill had passed, people would likely have lost their healthcare coverage thanks to the measure’s gutting of Medicaid and the subsidies that were the primary driver of coverage expansion under the Affordable Care Act. And you noted and estimated it would cost our economy over 580,000 jobs. Could you expand on your concerns for us? This is an ongoing debate before Congress.

Mr. Arensmeyer. Sure, Congresswoman. The marketplace as an expansion of Medicaid has made it possible for millions of not only small business owners and small business employees who were not receiving job-based healthcare to get coverage, and millions of self-employed entrepreneurs. In fact, last year, in the California exchange alone, 25 percent of all people who signed up for Cover California were self-employed individuals. So, for the first time—you know, I talked about job lock in my testimony. For the first time, you have the situation where the ability to get health coverage is not driving decisions to start or grow small businesses. So we have seen a huge boon in entrepreneurial activity as a result of the Affordable Care Act, allowing people to simply get healthcare when they couldn’t before.

Representative Maloney. I would like also to question Mr. Dearie on immigration. And a report on your website, Center for American Entrepreneurship, notes that immigrants are twice as likely as native-born Americans to start businesses. And you noted a study by the Partnership for New York American Economy found that 40 percent of Fortune 500 companies were founded by foreign-born entrepreneurs or a child of immigrants. And a 2012 study found that foreign-born researchers were involved in more than 75 percent of the patents awarded at the Nation's top 10 research universities.

So it would seem to me that current efforts to cut back on immigration that would supposedly help spur job growth is actually more like cutting off our nose to spite our face. Your piece is titled "Robust Immigration: Is America First?"

Could you expand on that for us?

Mr. Dearie. Thank you.

That piece is commenting on the RAISE Act that was recently introduced, as you know, by Senators Cotton and Perdue. One thing the Senators are trying to do, and they are absolutely right about, is, that we need to—we do need to achieve a shift in our immigration system to attract more high-skilled immigrants. Right now, about 80 percent of about a million green cards that we allocate each year go for purposes of family reunions, asylum seekers, et cetera. Only about 15 percent go to high-skilled immigrants. The rest of the world is exactly the opposite. I personally am of the view that those humanitarian aspects of our immigration policies are very important. It is part of what the United States is about. But I am in agreement that we do need to do a better job and achieve something of a shift toward more high-skilled immigrants, a better balance, if you will.

The problem, in my view, and the view of my coauthor of that piece, Doug Holtz-Eakin, is that, number one, the RAISE Act does not raise the number of high-skilled immigrants. It keeps the cap, the current cap, at 140,000, and it simply slashes everybody else. Senator Cotton himself said that within a few years of enactment of the Act, that 80 percent that I referred to would be cut in half. That is absolutely anti-growth. Growth in our labor supply is a very important part of economic growth, and the largest part of our growth in our labor supply, because of demographic tendencies, and the retirement of the baby boom generation in recent years has been growth in immigration. Moreover, as you point out, we want to attract the best and the brightest, and it is in our interest to do so.

Representative Maloney. My time has expired.

Chairman Tiberi. Thank you.

Before I recognize Mr. Rooney, Mr. Arensmeyer, the topic of healthcare for small business is a bit off topic but has come up a couple times now. Would you be willing to meet with me afterwards? I would like to share with you a true story of a woman-owned business in Ms. Donohue's hometown who is a small business owner and manufacturer with less than 50 employees in a small group health insurance market. Her healthcare costs have tripled over the last 3 years. And the impact that has had, not only on her small business, but to her employees, is that they are paying more and getting less health care. So as a guy who represents small businesses, I would like you to hear this story. It is pretty amazing.

With that, Representative Rooney, back on topic, is recognized for 5 minutes.

Representative Rooney. Thank you, Mr. Chairman. I appreciate the chance to speak and for you holding this great hearing. As the House cosponsor of the RAISE Act, I would just like to say why I did it. I think it is very important that we focus on skills. I have thousands of employees. We need low-skilled and high-skilled workers in this country to drive it, because no country has ever improved itself and grown economically without higher productivity driven by more productive and young workers. So Tom's view of how many refugee or immigrant visas should be allowed would be debated, I would hope, by our colleagues and modified. But the principle of ending chain migration, I think, is critical to accomplishing the things you all have talked about.

Since the comment was also made about that people don't locate their business because of taxes, and I would just like to say that if you believe that, then look at Texas, Florida, and Ireland. I have businesses in all of those places.

Now, I would like to ask a question about the pass-throughs, because I think the pass-throughs are critical. You know, when you have billion dollar companies that are pass-throughs, and they are willing to pay the extra 5 or 6 percent asymmetry, they must have a lot of value to the economy, as well as for startups. And so we know that small businesses are the job creators and that they use pass-throughs. But, also, larger companies use pass-throughs because of the simplicity of the capital structure. I know I do every time we do a real estate deal.

So the comment was made about diversion of salary because of the 25 percent rate. Mr. Hodge, don't you think that it is possible that the extra jobs that would be created by that extra one-third after-tax income by the 25 percent rate, that would involve more salary workers rather than owners of business, would offset any kind of lost tax revenue, that an owner may take less salary?

Mr. Hodge. Well, I think they are kind of different issues. I see your point. But I think you have to be extremely careful about creating arbitrage opportunities. And pass-throughs already have the benefit of one layer of tax. And albeit, if you were to then reduce the rate even further, you do create arbitrage opportunities. And you have to be very mindful of that in writing the legislation so that——

Representative Rooney. Oh, sure. I understand.

Mr. Hodge. You don't want the doctor to be able to reclassify his income as pass-through.

Representative Rooney. And the IRS has some rules about that as well. But there has got to be a pretty strong impact of putting one-third more after-tax income in every pass through entity's pocket in terms of what they do with that money and the jobs they might create with it.

Mr. Hodge. Yes, there is, but—I will just leave it at that. It is going to be a thorny issue. I will just warn you about that. And I am all in favor of lower taxes on businesses, because I do think that that spurs more capital investment, and it spurs growth. But I do think you have to worry about these opportunities in the Tax Code for people to play games, and just, you have to be extremely careful about that.

Representative Rooney. That is for sure.

Let me ask you one more. This may be a little off the subject, hair-brain idea. A Fortune 100 CEO friend of mine proposed it. What if the repeal of the death tax were limited to bequests which go to blood relatives? If they don't give it to a blood relative, why don't they just pay the tax so we all share in it?

Mr. Hodge. Well, do you really want the government to dictate where people give their money? So——

Representative Rooney. Well, they do it now, a billion ways.

Mr. Hodge. That is the point. That is why we want to get rid of the estate tax, to get the government out of the death industry.

I love the sentiments. And I do think too many families have been disproportionately harmed because of the estate tax and families——

Representative Rooney. That is the point, yeah.

Mr. Hodge. But, at the same time, I think, again, you want to be careful about this body making determinations on where people believe that they should put their money. You know, if a guy has got a kid who is basically a ne'er-do-well——

Representative Rooney. This is the body that created renewable fuel standards.

Mr. Hodge. What?

Representative Rooney. This is the body that created the renewable fuel standards. Talk about where to incentivize your money.

Mr. Hodge. That is right. I rest my case.

Representative Rooney. Thank you very much.

Mr. Hodge. You bet.

Chairman Tiberi. Thank you.

Mr. Beyer, you are recognized for 5 minutes.

Representative Beyer. Thank you, Mr. Chairman, and thank you all for your testimony. I find it fascinating.

Mr. Arensmeyer, Mr. Dearie's testimony notes he has the chart about new entrants. And it starts to collapse in 2005, and I am not aware of any major change in tax policy around 2005 that had such a crippling impact on new business formation. As you pointed out, very few startups have heavy tax burdens. Only a very small percent pay the top corporate rate. Mr. Hodge pointed out that 55 percent of pass-through income is at that high rate. But as the principal in 12 different pass-throughs, let me tell you that is almost all from large, mature, established pass-throughs, some that have been around for decades, not the startups, not the entrepreneurs that this hearing addresses.

Wouldn't it make sense to conclude the decline in new business formation is primarily not a tax story, but that other factors and policies are more critical? For example, college debt, barriers to entry in so many different businesses, access to capital, which you have talked about?

Mr. Arensmeyer.

Mr. Arensmeyer. Yes, Congressman. I would actually agree. There are a myriad of reasons why the opportunity, you know, to startup goes up or goes down. I should point out that a period of greatest economic growth recently, and one where we actually temporarily closed the budget deficit, was in the 1990s when you-all had passed the tax cut—excuse me, a tax increase in 1993. And there really wasn't, you know, any relationship between that and the fact that the economy was really booming.

You are absolutely correct. It is access to capital, access to healthcare, access to a qualified workforce, which includes immigrants, who are, by the way, twice as likely to start new businesses as the national average. It is a whole host of factors that you cited. And I don't want to imply that taxes are irrelevant, but all the polling that we have done shows that the concern about a robust economy, access to healthcare, rank far higher than taxes as a major reason for making business decisions.

Representative Beyer. Mr. Arensmeyer, to continue, Ben Casselman, who wrote recently in the New York Times, quote, "The slump in entrepreneurship has coincided with a period of increased concentration in nearly every major industry." I was raised as an automobile dealer. There were 50,000 car dealers the year I was born. We are down to about 17,000 right now. Something like AutoNation, I think, sells 16 to 17 percent—one company—of the new cars sold in America. What is the impact of this concentration, in industry after industry, on the ability to start a new company?

Mr. Arensmeyer. I think it has made it more challenging. I mean, there is no question that some industries, you know, it is okay to grow and some industries or products are delivered much better by a larger entity. But we need a balance between excessive concentration and to make sure that we are not stifling the opportunity for small businesses to begin and grow.

Representative Beyer. One of the things I see is I have three millennial children who are all entrepreneurial, and when I visit the startups, the equivalent of VentureOhio in Virginia, I mean, they are the wonderful, they are great energy, but they are all looking for something brand new. They are not starting firms that have been around for a long time. And so it really creates maximum creativity to try to think of some place that has never existed before and starting there.

Mr. Arensmeyer, you also talked about the limited benefit of full expensing. I think, for Mr. Hodge, I, unfortunately look at these things through my own family business experience and think, boy, if we could full expense, I have all these buildings, boom, wonderful for 2017 taxes. But then after that I am paying taxes on my interest expense for years and years to come.

Have you looked hard at the tradeoff between taking away interest deductibility versus the full expensing?

Mr. Arensmeyer. Well, interest deductibility is something that is taken across the board on a percentage basis by large and small business entities, so we are not necessarily in favor of reducing that because in fact it is harder for smaller businesses to get access to equity capital and debt is a higher percentage of what is fueling them. So their ability to deduct interest on a percentage basis is actually often greater than a larger company.

As far as full expensing is concerned, I mean, obviously right now, under Section 179, small businesses can essentially do full expensing up to a half million dollars a year, and we don't see a huge benefit to smaller entities to change the law to allow for full expensing for much larger entities.

Representative Beyer. I am going to try to squeeze in 20 seconds.

Ms. Donohue, you did a valiant job trying to defend carried interests, and you are the first I have really seen that has differentiated between venture capitalist and private equity.

In fact, most of my experience in Virginia has been well-established, very wealthy individuals risking somebody else's money to get a capital gains rate on it. Is there a way to differentiate carried interest between venture capitalists and private equity?

Ms. Donohue. Well, most of the venture capitalists in Ohio, in fact, all that I can think of off the top of my head, also invest in those funds. You know, the average venture capital fund size in the U.S. is 22 million, which results in about $400,000 per year in management fees and $400,000 per year to pay the partners, to pay their CFO, to keep the lights on, to keep the rent. That is not how they are making their money.

The reason they do this is for the opportunity to earn carried interest once the fund is successfully deployed and they earn their returns back. And for us to keep these venture capitalists in Ohio, who are very talented individuals who could make a lot more money in New York or California, they could, but they are choosing to remain in Ohio, they are choosing to be pioneers, they are choosing to have the opportunity to make less money because they believe in the future of Ohio and they believe in supporting entrepreneurship.

Representative Beyer. Thank you, Mr. Chairman.

Chairman Tiberi. Thank you. Good question.

I would like to now recognize, breaking news, Congress' connoisseur of coffee from Arizona, Representative Schweikert.

Representative Schweikert. Look, I don't go around making fun of your problems. But we are thinking of starting a 12-step group for coffee. We are holding the meetings Tuesday at Starbucks.

Oh, come on. That is funny.

Thank you, Mr. Chairman. And a couple things I wanted to sort of run through, and I have been making some little side notes.

First off, just a couple things data-wise have been thrown out. A substantial number of LLCs, partnerships are actually held to hold assets and don't actually, if you actually look at the distributional curve of where they are on the IRS forms, they are producing actually very little income because they actually have tort liability shield.

So it is actually quite distorting to actually put those into your big numbers. And we all know better. So I was a little surprised to have someone actually distort the discussion that way.

Mr. Hodge, just because, I think, and please correct me, are you the only one on the panel that actually works with an organization that actually does large-scale data modeling with——

Mr. Hodge. Yes.

Representative Schweikert [continuing]. Shall we say, where you have a robust enough data set to actually model the model on the model each time with the velocity changes?

Mr. Hodge. Yes, we have a macroeconomic tax model—some might call it a dynamic model—that measures the effect of tax changes on the cost of capital and the supply of labor. And in doing so, we are able to then look at the effects of tax policy on the size of GDP, investment, wages, jobs, and, of course, Federal revenue.

Representative Schweikert. Now, why this is important, I think, to all of us sitting up here on the right and the left is if you actually look where we are in our demographic curve, I think there is a common understanding, in a decade, decade and-a-half, we are in real trouble, where our aging of our population, our entitlement promises, our ability to have enough economic expansion to actually cover those entitlement promises, almost every dynamic model hits a wall. And so having an honest conversation here that is a little less of, "this gets me reelected, this is best for economic expansion."

So if I came to you right now and said, let's be blind to my next election, what would the most growth-oriented tax model be that gives every American an opportunity to actually save and have employment and have wage growth, what would that model look like, because you are actually using real data instead of feelings?

Mr. Hodge. Well, the paradox of tax reform is that the tax changes that are most politically popular, such as lowering individual tax rates and child credits, and so forth, do the least for economic growth because they incentivize very little about people's work effort——

Representative Schweikert. I know we have the buzzers going off. Can you say that again? Because this is actually really uncomfortable for those of us who have got in front of audiences and talked about doubling the childcare credit or some of these other things, and the reaction we get when we actually show what happens to your future job prospects if you put the money here compared to expensing.

Mr. Hodge. Compared to expensing. And so, yes, again, the individual tax changes do the least for economic growth, whereas tax changes that affect the cost of capital, such as moving to full expensing, lowering the corporate tax rate, lowering business tax rates, actually have the greatest effect on not only economic growth, but ultimately productivity and wages and after-tax income.

And that really should be the goal of fundamental tax reform, is lifting living standards, not just putting money in people's pockets, but actually lifting their living standards for the long term.

A tax cut in my pocket is nice, but I would sure like a higher wage and higher living standards at the end of the day.

Representative Schweikert. Well, in continuing this sort of logic loop, for those of us who are absolutely fixated on how we are going to cover our social entitlement promises in a decade-plus, the size of our economy, the ability to have a tax base that has grown, which model gets us there?

Mr. Hodge. The policies that create the most growth, as I mentioned, lowering the corporate tax rate, lowering business tax rates, lowering the cost of investment, all of those things lead to a higher GDP and solve the problems that really are facing us that Mr. Dearie mentioned in terms of Social Security problems, entitlement problems, et cetera. Growth solves so many problems, that has to be the goal of tax reform.

Representative Schweikert. And here is where we will all, those of us who are policymakers, are going to have some soul-searching to do. Do we pander to our politics—which is what we do, it is how we get elected—or do we do actually quality math that grows our economic base and gives society a fighting chance to have that higher wage, that better job, and for us to have enough revenues to keep our promises?

With that, I yield back, Mr. Chairman.

Chairman Tiberi. Thank you.

Ms. Adams, you are recognized for 5 minutes.

Representative Adams. Thank you, Mr. Chairman.

And thank you all for your testimony.

Right now the vast majority of pass-through entities, 86 percent to be exact, are taxed below 25 percent. So ostensibly the tax break is for the remaining 14 percent of pass-through entities, most of which are individuals in the top 1 percent of economic distribution.

Mr. Dearie, would the remaining 14 percent of pass-through entities really provide enough economic growth to justify opening a potentially large tax loophole for law firms, hedge funds, and other profitable businesses to exploit and avoid contributing their fair share in taxes? Wouldn't the pass-through setup just shift the tax burden to the middle class?

Mr. Dearie. Well, I would answer the question by saying I think it is very, very important that however the tax-drafting committees handle tax rates pertaining to pass-throughs, that they do it in a way that does not open up the kind of loopholes to which you are referring.

I have heard the various figures today about exactly what portion of pass-throughs actually pay what taxes. I suppose that that is—you know, I have heard arguments and data on both sides.

I think it is important to get tax rates right, both because it is important for competitive purposes, also tax rates send a signal. And they contribute to the confidence of business people as to whether or not they are even going to go about the trouble of launching a business, their confidence as to their ability to survive.

So in my mind, regardless of which fraction of which pass-throughs pay which rate, I think getting the tax rates right and competitive is very important for both tax as well as psychological reasons.

Representative Adams. Thank you.

Mr. Arensmeyer, as you are aware, revenue neutrality is a key component of tax reform, but to do so major changes are needed to offset the cost of lowering tax rates. One such provision being considered is eliminating interest deductibility.

So does it make sense to eliminate this provision to help pay for reform or would you advocate keeping it?

Mr. Arensmeyer. As I said earlier, Congresswoman, small businesses use the interest deductibility on a percentage basis, at least as much as larger businesses, if not more.

I think if you are looking for other offsets in the Tax Code, for example, the offshore deferral, which costs a trillion dollars over 10 years, not only does that not benefit any small businesses, it actually doesn't benefit most large businesses. About 50 to 60 multinational corporations take most of that benefit.

So there are other provisions in the Tax Code you can look to other than interest deductibility to look for offsets. And we would agree that perhaps some reduction in the corporate rate makes sense, we would agree that some of what has been proposed by us and others here on the panel in terms of targeted incentives for venture capital and other types of investing. So you will need to be looking for offsets, but I am not sure the interest deductibility is the place to look.

Representative Adams. Thank you very much, Mr. Chairman. I am going to yield back.

Chairman Tiberi. Representative Comstock is recognized for 5 minutes.

Representative Comstock. Thank you, Mr. Chairman.

And I welcome my constituent, Mr. Dearie. Thank you for being here.

And, Mr. Hodge, I think this is the first hearing we have had since we worked back in the 1990s when I was staff. And you were very helpful on these issues, so I appreciate seeing you again.

I want to talk about growth again, because I know from my experience in the statehouse, we always had to look at who are we competing with, with States. To give you an example, we worked on data center taxation, because we have a large data center industry in Virginia but our taxation was not competitive with other States. And so as we went to look at it, of course, this was during a Republic administration, they were telling us it will cost this much if we changed the taxation model.

The problem was entire businesses were getting up and leaving, as they can in the tech industry. So when we realized the multiplier would be zero, then it doesn't matter what the rate is when you have the multiplier being zero.

So I really do think it is so important for us to focus on that rate, because actually when we did lower our rates the data center industry stayed here, grew here, got people from all over the country coming here. And obviously that helped with our tech industry.

So I was wondering, Mr. Dearie, you were talking about the pass-through rate, the corporate rate, and given that we are so much higher than the rest of the world and tech businesses can go anywhere and leave, could you address that in terms of the competition? Because if I am selling something for $20 and my competition is all at $12, if I am trying to pay for how I get down to $12, I am losing my business, aren't I?

Mr. Dearie. Yes. And as I mentioned earlier in response to another question, if you look around the world—and it is not just on taxes, it is on taxes, it is on immigration, it is on education, it is on training, et cetera, it is on access to capital—but certainly on taxes, the rest of the world gets it.

I mean, look at the steps that our competitors have taken. Countries like France and Great Britain now have tax rates substantially below the United States. They get it. We always tend to talk about them as being socialistic economies, et cetera, but they get that taxes matter for exactly the purpose that you are talking about. Corporations are more mobile today, given advances in technology and what have you. They can go anywhere. And it is very, very important for us to be on the playing field.

Representative Comstock. And when we are talking about competition, too, it is those high-end jobs, as you are talking about, in terms of immigration, in terms of visas and technology, that then will generate those new growth-disruptive industries.

So having that lower pass-through rate, the lower corporate rate is particularly important. And maybe, Mr. Hodge, you might want to address that, Ms. Donohue, in terms of getting the highest, being competitive in the growth areas all around the globe. That is essential, that we are not going to—if we are going to attract the talent, we also have to have those lower rates.

Mr. Hodge. Economists at the OECD studied the effects of different types of taxes on economic growth and found that the corporate income tax is the most harmful tax for economic growth. And it is particularly harmful for the most job-producing, growth-producing, energetic companies, and the ones that really, as Mr. Dearie said, have generated the most toward new advances and various things, whether it is technology or what have you.

And so that, as he said, the rest of the globe gets it. And corporate tax rates have fallen dramatically all over the globe, leaving us so far behind.

Representative Comstock. And something like the medical device tax industry, we are losing that because of that extra taxation here as well as——

Mr. Hodge. Yeah, more than 60 companies have left the United States and redomiciled in places like Ireland and Switzerland and the Netherlands because of lower corporate tax rates.

Representative Comstock. Can I ask for the record, if you could provide us all those companies that have left and any documentation that you might want to add to that I think would be helpful for the record.

Mr. Hodge. Sure, I would be delighted.

Representative Comstock. Ms. Donohue, if you want to address that.

Ms. Donohue. I will just add that a healthy corporate environment is essential for a healthy entrepreneurial ecosystem. To be successful, startups need access to talent and access to capital. And access to capital means access to customers, which are the corporations who are thriving in their region that can provide both of those.

Representative Comstock. And then having that healthy startup also keeps the bigger businesses more competitive because they have to compete with the startups. The ecosystem that is created with that kind of keeps everybody honest and on their toes and far more innovative. And when we lose that startup piece, we really sort of atrophy everywhere else, don't we?

Ms. Donohue. Yeah. It is healthy all the way around. We call it "innovate or die." You know, it is important for the corporations. It is important for the startups. They feed off of each other. They are primary economic drivers for our cities and to keep our college students within the State, because they want to work at cool tech companies, they want to work at cool corporations.

Representative Comstock. Thank you. I yield back, Mr. Chairman.

Chairman Tiberi. Thank you.

Mr. Delaney is recognized for 5 minutes.

Representative Delaney. Thank you, Mr. Chairman, for having this hearing.

I want to thank all the witnesses for being here and providing your insight.

So this is a topic that is near and dear to my heart. Before coming to Congress, I was an entrepreneur. I started my first company in the early 1990s. I took it public in 1996. I was the youngest CEO of the New York Stock Exchange at the time, sold it in 1999. Started my second business in 2000, took that public in 2003, and ran it until I decided to run for office. Ernst & Young gave me the Entrepreneur of the Year Award. So I have spent a lot of time around entrepreneurship.

And my second business was a commercial finance company, which meant we lent money to small to midsize businesses, and we lent $30 billion to 3,000 small to midsize businesses all over the country.

So when I think about being an entrepreneur, the thing that has struck me about this hearing is this notion that tax policy matters to entrepreneurs. Being an entrepreneur is about a dream. It is about thinking you can change the world. It is about thinking you have some innovation that can make a disproportionate difference in the lives of your community, your country, your people. It is about wanting to be independent, to chart your own path, to be a pioneer. Those are all the emotions of an entrepreneur.

I have never met an entrepreneur who was making a decision about whether to be an entrepreneur based on tax policy. Because, in fact, most startup companies don't make money for a while, and most entrepreneurs would say, "God, I hope to pay taxes one day because that means my business is working."

And to me, what allowed me to start up my businesses is I was married to a wonderful woman who had a job, that job gave us healthcare, and she was supportive of me doing this. So I could take the risk because we had that security in our own situation.

I started my business in a market here in the D.C. area in Chevy Chase, Maryland, where we had access to really terrific employees. And that allowed me to raise capital, because I had an idea, a plan. I was able to go do it. I was able to get a team. And I went around the country and pitched people to give me money, which in the early 1990s was hard.

Now it is relatively easy, not for venture capital, so Ms. Donohue, I think, is right, but for more professionally managed capital because that is just a better risk-return for most people than venture capital.

So this notion of, I guess, Mr. Dearie, you said something earlier about how tax policy matters to entrepreneurs and startups, but right now 80 percent of the professionally managed venture capital goes to northern California, New York, and Massachusetts, three of the highest taxed places in the country. How do you explain that if tax policy matters to these investors?

Mr. Dearie. You are absolutely right, Congressman, that very few entrepreneurs think about tax policy as they are thinking about becoming an entrepreneur. They are driven by passion, they are driven by an idea, exactly as you said. But——

Representative Delaney. So why does all the money go to the highest tax places?

Mr. Dearie. Well, because, I mean, in talking about the importance of tax policy, I certainly don't mean to say it is the silver bullet issue, the most important issue, that it is the dispositive issue.

Representative Delaney. Right.

Mr. Dearie. It is relevant. It is important. How I do know——

Representative Delaney. But the most important issue—taking back my time—the most important issue is creating that environment where people actually want to start a business.

Mr. Dearie. I agree.

Representative Delaney. So, I mean, if you had to make a choice, and you have to answer the question based on my choice, you could either cut the estate tax or increase investments in research and development, what would you choose to create more entrepreneurs?

Mr. Dearie. I would do the latter.

Representative Delaney. Invest in research and development?

Mr. Dearie. Yes.

Representative Delaney. Mr. Hodge, if you had a choice, which was to lower the tax rates on wealthy individuals—thank you for that honest answer, Mr. Dearie—lower the tax rates on wealthy individuals or do something like allow people with unrealized capital gains to sell those positions and defer paying their capital gains tax for 10 years if they invest that money in parts of the country that have very little economic growth, some of the regions that Ms. Donohue is advocating for, which would you choose, if those were your only two choices?

Mr. Hodge. I don't agree with using the Tax Code to try to micromanage people's investment decisions.

Representative Delaney. So you don't think it is important to create policies? Because really what has happened in this country is——

Mr. Hodge. No, I would——

Representative Delaney. Let me finish. My time.

You don't believe in policies that actually help put intellectual capital and real capital in parts of our country that have been hollowed out based on changes in our economy, to create more entrepreneurs like Mr. Arensmeyer—if I am pronouncing that right, because you sound like a great entrepreneur, sir—you don't think that is a role of tax policy?

Mr. Hodge. We have tried things like enterprise zones for decades, and they have had limited effect. And I think we ought to reconsider those policies.

Representative Delaney. Ms. Donohue, do you think it would be useful to have policies to get capital flowing to parts of, like, Ohio, where you are trying to actually get investment capital?

Ms. Donohue. I do. Brilliance is not concentrated in three States in the United States, but capital is.

Representative Delaney. Right. And we have got to do something about that problem.

Great. Thank you for your time everyone.

Chairman Tiberi. Last, but not least, Mr. LaHood is recognized for 5 minutes.

Representative LaHood. Thank you, Mr. Chairman.

And I want to thank the witnesses for your valuable testimony here today.

I wanted to see if I could focus just for a couple minutes on rural America. And there obviously seems to be a trend of people and resources and innovation moving to bigger cities and less so in what I call smaller non-urban areas. And I am wondering if we have examples of rural areas or non-urban areas that have succeeded in innovation and whether the Tax Code, as we look at reforming the Tax Code, whether we can help with that, incentivize that.

I also look at statistics. According to the Economic Innovation Group, from 2010 to 2014 half of the net growth in the number of businesses and 17 percent of the new unemployment took place in five metropolitan areas. And I guess, looking at does the Tax Code disadvantage rural areas, non-urban areas, burdening smaller enterprises as opposed to larger enterprises.

And I guess, Mr. Dearie, if you could comment on that?

Mr. Dearie. I don't think the Tax Code disadvantages those areas. I think those areas struggle with probably other issues. I mean, the two big needs of entrepreneurs, as my colleague pointed out a moment ago, are access to talent and access to capital.

In rural areas across the United States, I would say that those are the two biggest challenges. Tax policy can complicate that, but I would say that those are the real challenges for the rural areas to which you are referring.

Representative LaHood. And do you have any examples of rural areas that have succeeded and done well with innovation?

Mr. Dearie. I would need to think about that and get back to you. It is true, it is absolutely true that generally speaking—or more than generally speaking—when you think about innovation and entrepreneurship, you are typically talking about cities.

Representative LaHood. Ms. Donohue.

Ms. Donohue. I would agree. We have a long way to go. We are very proud of the innovation occurring in Ohio and having the first billion-dollar exit occurring this year. But even in a city like Columbus, which is the 14th largest in the United States, we are still nowhere access to talent and capital of our counterparts on the coasts.

Representative LaHood. And do you have any suggestions as we look at comprehensive tax reform where we can help in that area?

Ms. Donohue. A simplified Tax Code is, of course, beneficial to entrepreneurs, as is having access to more capital. So anything to simplify that and help entrepreneurs get that access to capital.

In Ohio, we have some statewide programs that have proven to be successful, such as the Ohio Third Frontier. This is capitalized venture capital funds and business development organizations that help provide access to capital and talent all over the State, including the more rural areas such as Mansfield, Ohio. But I think a program such as the Investing in Opportunity Act is a very smart way to get capital off of the sidelines and into the hands of innovative entrepreneurs who might not have access to capital, such as venture capitalists.

I mean, it is a very small and tight-knit community, whether you live in Silicon Valley or you live in Ohio. Access to venture capitalists is not something that everyone has. And it is the small groups of people that do have access to these individuals, that is great for them, but it is not so great for somebody in Mansfield, Ohio, who wouldn't even know where to look.

So ensuring that these different groups get to know each other, these innovative entrepreneurs in rural parts of the country and the investors with capital, putting them together, I think magic could happen.

Representative LaHood. Thank you.

Mr. Hodge, switching subjects, according to the Global Innovation Index, Switzerland, Sweden, and the Netherlands all rank above the United States in terms of innovation.

The arguments for the reasoning behind this can vary, but I am interested specifically in how the tax structures compare. What specifically about these countries' tax codes should the U.S. considering replicating so that U.S. businesses of all sizes can be more competitive globally?

Mr. Hodge. They all have, especially corporate taxes, much lower than the United States. And I think most people would be surprised that Sweden is actually a relatively low tax country compared to the United States.

Representative LaHood. What is their rate? Do you know?

Mr. Hodge. It is 22 percent, I believe. And Switzerland is even much lower than that. And, of course, it depends upon which canton you move to.

But all of those have structured their tax systems for business to be much more competitive. And especially for multinational businesses, they are extremely competitive places to do business.

Representative LaHood. Thank you. Those are all my questions. I yield back.

Chairman Tiberi. Thank you.

I would like to thank the witnesses again for being here today. It was a really good session, I believe. The record will be open for 5 business days for any member who would like to submit questions for the record or to our panelists.

With that, the hearing is adjourned. Thank you.

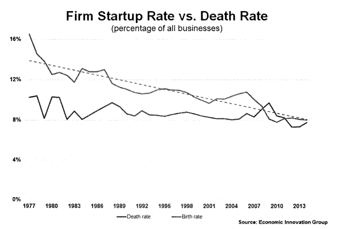
[Whereupon, at 11:29 a.m., the committee was adjourned.]

SUBMISSIONS FOR THE RECORD

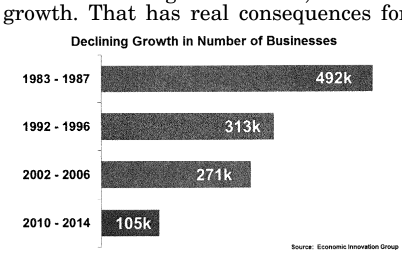
OPENING STATEMENT OF HON. PATRICK J. TIBERI, CHAIRMAN, JOINT ECONOMIC COMMITTEE

I call this hearing to order. The Joint Economic Committee is holding this hearing because entrepreneurship matters. It matters because startup businesses drive the innovation that fuels economic growth and opportunity—innovation that can improve or even save lives. In fact, anyone who uses a cell phone today should thank an entrepreneur. And very importantly, entrepreneurs matter because nearly all the gains in job creation come from businesses less than a year old—true startups.

The bad news is that the rate of business startups has been declining over the past few decades. That decline became an outright collapse during this recovery when—for three straight years—companies closed their doors more rapidly than they were opened.

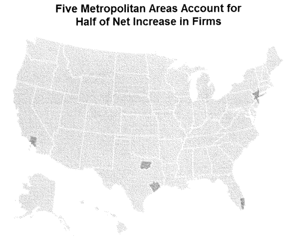


During similar periods in recent recoveries, the greatest gains in the number of American companies occurred during the Reagan Administration, perhaps not coincidentally when tax rates were falling. In contrast, this recovery saw only about a fifth of the business growth. That has real consequences for middle-class families.



According to analysis by the nonpartisan Economic Innovation Group, each startup creates an average of six jobs, meaning that if the number of startups had simply held steady at 2006 levels, America would have gained a total of 3.4 million additional jobs by 2014. Plentiful startups and plentiful jobs create a virtuous cycle where potential entrepreneurs are more willing to take a risk on a new venture because they'll have a job to fall back on. By the same token, weak levels of entrepreneurship and job creation create a downward spiral for both.

Another alarming trend is that the number of places where startup growth is actually happening is shrinking, which is a topic we investigated in a hearing in this committee earlier this year. In fact, from 2010 to 2014 half of all business growth and 17 percent of employment growth occurred in just five metropolitan areas. Unfortunately, much of the heartland was left behind. Blighted areas across the country are desperate for new businesses and the jobs and opportunities that would come with them. That is why I introduced the bipartisan Investing in Opportunity Act to attract capital and investment in distressed communities, and I hope it can become part of tax reform.



I didn't call this hearing because I believe tax reform is a silver bullet that will suddenly cure all of society's ills, including the startup slump. But it is a key tool in our policy arsenal that could remove artificial barriers to starting a business and foster an environment where entrepreneurship can thrive.

Truth be told, entrepreneurs probably don't think much about taxes when they launch a startup, and they shouldn't have to. But before long they are hit with mind-numbing complexity that drains precious resources from the business. They may spend every dime of profit buying expensive equipment to scale up production, but the tax code may not allow them to immediately deduct the cost. That means they'll owe taxes on profits they no longer have.

If they do manage to become profitable, startups that are corporate taxpayers will face the highest rate in the developed world. And successful startups that pay individual taxes because they're set up as pass-through businesses will face an even higher individual rate that has increased dramatically recently. The tax code also punishes success by forcing family business owners to do costly estate planning so the death tax doesn't steal their ability to pass the business to the next generation of entrepreneurs.

In this increasingly global economy, entrepreneurs can start or move a business anywhere in the world. Yet our tax system is out of step with our competitors, not only punishing our companies with the highest rate but imposing a large tax penalty when they invest profits earned overseas back in America.

Tax reform done right will grow jobs and grow paychecks, helping restore the virtuous cycle that gives entrepreneurs the confidence to take a risk and reach for the American dream. Tax reform done right will provide them with more capital, the lifeblood of entrepreneurs. And it will help make America the best place in the world to invest and start a business. Our future prosperity depends on it.

I look forward to hearing the thoughts of our excellent panel of witnesses today. I will introduce them in a moment, but first I recognize our Ranking Member Senator Heinrich for his opening statement.

PREPARED STATEMENT OF MARTIN HEINRICH, RANKING MEMBER, JOINT ECONOMIC COMMITTEE

Thank you Chairman Tiberi and thank you to our witnesses for being here today.

The tax reform debate is underway, and I'm happy our committee is taking this opportunity to examine the Nation's tax policy. I agree that our tax code must be simpler for families and small businesses.

Where we can promote policies that make sure that the tax code is working for working Americans, growing the economy, creating good paying jobs, and supporting families and communities across the country—I will be among the first to support it.

Unfortunately, the Republican starting point seems heavily focused on giving more tax-giveaways to large, multinational corporations and the wealthiest among us rather than on small businesses, rural entrepreneurs, and those communities still struggling to recover following the recession.

There's time to shift that focus and hearings like this one can help.

In New Mexico, small businesses make up more than 95 percent of all businesses and employ more than 55 percent of private-sector workers.

They are the heart and soul of our State's economy.

They are companies like RiskSense in Albuquerque that helps firms assess and manage cyber security risk.

Founded as a small business technology transfer from New Mexico Institute of Mining and Technology (NMT), the company now has 100 employees and earnings growing 50 percent annually.

It's a great story and we need more of them.

At the national level, start-up activity has picked up in the past three years, but the share of startups has declined by almost half since the late 1970s.

New firms are increasingly concentrated in a few big cities and states.

One report found that just 20 counties were responsible for half of the net increase in new businesses from 2010 to 2014.

And the share of startups created by veterans and in rural areas are both down in the past two decades.

There are a number of actions we should take to boost start-up activity, few of which have anything to do with the tax code.

It's vital that we strengthen the basic economic foundation—more jobs, higher wages, and improved access to education and health care.

And we must lay the groundwork for start-up activity in rural areas.

That means increasing access to capital, speeding the deployment of broadband in rural communities, and taking other steps to ensure that rural and tribal areas are able to compete when it comes to start-up activity.

We also should be clear about what will not help small firms.

Large tax cuts for large, established companies do nothing for startups—which have little to no taxable income in those critical early years while working to get their business off the ground.

And it does little for small businesses in need of capital to grow—capital that has been shrinking and drying up since the recession.

As we've seen time and again, tax giveaways for large corporations and our highest-earners do nothing to help small businesses, rural communities, and working people get ahead.

And it leaves fewer and fewer dollars to invest in roads, schools, entrepreneurs, and working families, compounding the challenges facing small cities and towns around the country.

The primary goal of reform should be to use the levers we have to level the playing field. One, because it's the right thing to do. And two, because every American should have the opportunity to turn their dream into a reality.

A zip code should not determine a child's success or her chances of starting a business.

The entrepreneurial spirit is alive and well from Las Cruces, New Mexico, to Boston, Massachusetts. It's our job to make sure we give every American the same chance to succeed, no matter their background.

Two things we could do right now to boost our economy and put more money in the pockets of working families are expanding the earned income tax credit and strengthening the child tax credit.

Our focus needs to be on creating better opportunities for the folks on Main Street, not delivering more tax breaks for bankers on Wall Street.

We have an opportunity this Congress to work together to craft a bipartisan tax reform package that promotes entrepreneurship, simplifies our tax code, and puts more money in the pockets of working people.

If we do that, we will give Main Street the boost it desperately needs. I'm ready to get to work.

I look forward to the panel's testimony.

CENTER *for* AMERICAN ENTREPRENEURSHIP

"The Start-up Slump: Can Tax Reform Help Revive Entrepreneurship"

Testimony before
The Joint Economic Committee
House of Representatives
October 3, 2017

John R. Dearie
Founder and President
Center for American Entrepreneurship

Chairman Tiberi, Ranking Member Heinrich, and members of the Committee, thank you for the invitation to testify today.

My name is John Dearie and I'm the founder and president of the Center for American Entrepreneurship (CAE), a nonpartisan research, policy, and advocacy organization whose mission is to engage policymakers in Washington and across the nation regarding the critical importance of entrepreneurs and start-ups to innovation, economic growth, and job creation – and to pursue a comprehensive policy agenda intended to significantly enhance circumstances for new business formation, survival, and growth.

Introduction

The Committee's focus today on tax reform and entrepreneurship is not only timely and important, it is, in my view, the intersection of two of the most urgent policy areas demanding the attention of our nation's policymakers. I say that because of the critical importance of both sound tax policy and thriving entrepreneurship – and the mutually reinforcing relationship between the two – to the nation's foremost economic challenge, accelerating economic growth.

As members of the Committee are no doubt aware, the U.S. economy has been mired in a rut of sub-par performance for more than a decade. After expanding at an average annual rate of about 3.4 percent for most of the post-World War II era, the economy has not grown at 3 percent or better since 2005 – that is, for nearly 13 years now – and has averaged only 2.2 percent since the end of the Great Recession, more than eight years ago.

The current Administration has rightly made economic growth of 3 percent or better its top economic objective, and has also correctly identified comprehensive tax reform as one of the principal pathways for achieving that goal. As members of this Committee understand all too well, our nation's current tax code is a mess – overly complex and burdensome, illogical, uncompetitive, outdated, riddled with inefficiencies – all of which amounts to a significant obstacle to investment, work, production and, ultimately, economic growth.

Tax policy is one of the most powerful tools of economic policymaking available to Congress, and tax reform that achieves a simpler code, a broader base, and lower tax rates would be a tremendous boon to economic growth, job creation, and greater economic opportunity.

But even the most successful tax reform will not be enough for the United States to achieve its full economic potential. A simple, efficient, fair, and properly focused tax code is a powerful facilitator of economic growth – but it's not where economic growth comes from.

Economic growth comes principally from gains in productivity, driven by innovation – which comes disproportionately from new businesses, or "start-ups." And, as the title of this hearing references, American entrepreneurship is in trouble, with start-up rates falling for nearly three decades. Re-achieving America's full economic potential – and the growth, jobs, and opportunity the American people deserve – requires turning that decline around, which in turn requires changes in public policy. Tax reform is one of the essential changes in public policy that thriving entrepreneurship requires.

And – importantly – thriving entrepreneurship will compound the positive impact of an effective and efficient tax code. Start-ups, and the entrepreneurs who launch them, take incredible risks against very long odds to become the next generation of successful American companies. More start-ups mean more profitable businesses paying more taxes. And faster economic growth – driven by thriving entrepreneurship and facilitated by a world-class tax code – means more Americans employed, consuming, investing, and paying taxes.

Tax reform promotes stronger entrepreneurship, which, in turn, expands and extends the benefits of a competitive tax code. This hearing, therefore, hits the bull's eye of America's economic growth challenge.

The first part of my testimony will address the importance of entrepreneurship to economic growth. The second part will address the importance of tax reform to thriving entrepreneurship.

America's Economic Growth Crisis

For more than a decade now the U.S. economy has been mired in a pattern of below-historical trend economic growth. Since emerging from the Great Recession more than eight years ago, the U.S. economy has grown at an average annual rate of just 2.2 percent – more than a percentage point slower than the post-WWII average of 3.4 percent. Indeed, as mentioned above, the U.S. economy has not grown at 3 percent or better on an annual basis since 2005, thirteen years ago.

Alarmingly, the Congressional Budget Office (CBO) recently announced that economic growth "is projected to remain modest, averaging slightly above 2.0 percent through 2018 and averaging somewhat below that rate for the rest of the period through 2027."[1]

Many private sector economists agree. A survey earlier this year by the National Association for Business Economics found that respondents had lowered their growth outlook to just 2.2 percent this year and 2.4 percent next year.[2] Former Treasury Secretary Larry Summers has referred to the U.S. economy's sub-par post-recession performance as "secular stagnation."[3]

An economy that grows at a healthy pace of 3 percent or better on a sustained basis provides the opportunity necessary for the American people to pursue their dreams and achieve their potential. Slower growth – particularly over an extended period – means less economic opportunity, slower job creation, lower wages, and greater economic anxiety.

Indeed, weak economic growth experienced since 2005 is the principal cause of America's most serious, politically difficult, and, in some ways, mutually reinforcing challenges, including:

- persistent underemployment;[4]
- high and rising long-term debt;
- stagnant middle-class wages;
- wide and worsening income, wealth, and opportunity inequality;
- the highest poverty rates since the late-1960s; and,
- record numbers of Americans reliant on government programs like food stamps and disability insurance.

To meaningfully address these challenges – and the anger, cynicism, and populism they inspire – we must accelerate economic growth back to the historical average *on a sustained basis.*

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[1] "An Update to the Budget and Economic Outlook: 2017 to 2027," Congressional Budget Office, June 2017.

[2] "Survey: Economists Expect Slower U.S. Growth," *Associated Press*, June 5, 2017.

[3] "U.S. Economy May Be Stuck in Slow Lane for Long Run," Josh, Boak, *Associated Press*, February 9, 2014.

[4] "The Idle Army: America's Unworking Men," Nicholas Eberstadt, *The Wall Street Journal*, September 1, 2016.

The difference between growth of 2.2 percent and 3.4 percent may not seem significant, but in an economy the size of the U.S. economy percentage points matter. Had the economy grown at 3.4 percent since emerging from recession in 2009, GDP last year would have been more than $1 trillion greater. Over a twenty-five year period, the difference between a U.S. economy growing at 2.2 percent annually versus 3.4 percent is more than $100 trillion in *additional* economic output.

While complete solutions to the challenges listed above require progress on a number of fronts, there is little doubt that our ability to address these and other problems would be greatly enhanced by faster economic growth. Growth at or above the post-WWII rate of 3.4 percent on a sustained basis would produce the jobs necessary to end underemployment, the opportunity necessary to accelerate socio-economic mobility, the rising real wages needed to narrow the income gap and reduce poverty, and the additional tax revenue necessary to narrow budget deficits and substantially reduce the nation's long-term debt.

Where Does Economic Growth Come From?

Over most of economic history, it had been widely assumed that economic growth stems from enhancements to one or both of the two principal components of an economy – labor and capital. For an economy to grow, it was thought, either the supply of labor had to expand or capital intensity had to somehow increase.

But in 1957, American economist Robert Solow demonstrated that most of economic growth cannot be attributed to increases in labor or capital, but only to gains in productivity – more output per unit of input – driven by innovation. As businesses and workers become more efficient, costs fall, profits and incomes rise, demand expands, and economic growth and job creation accelerate.[5]

Solow's identification of innovation-driven productivity gains as the driver of economic growth has been echoed by economists ever since. As Nobel Laureate economist Paul Krugman has observed: "Productivity isn't everything, but in the long run it's almost everything."

> A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker...Compared with the problem of slow productivity growth, all our other long-term economic concerns – foreign competition, the industrial base, lagging technology, deteriorating infrastructure, and so on – are minor issues.[6]

Solow's growth model is one of the great economic insights of all time – the economic equivalent of $E=MC^2$. Solow was awarded the Nobel Prize in economics in 1987, the National Medal of Science in 1999, and the Presidential Medal of Freedom in 2014.

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[5] Robert M. Solow, "Technical Change and the Aggregate Production Function," *Review of Economics and Statistics* (The MIT Press) 39, no. 3, 1957: 312–320.

[6] Paul Krugman, *The Age of Diminished Expectations*, The Washington Post Company, 1990, pp. 9–13.

New Businesses as the Engine of Innovation, Productivity Gains, and Growth

The great significance of Solow's work is that it not only defined the *nature* of economic growth, it also identified its principal *source*. That's because economists have long understood that innovation – particularly major or "disruptive" innovation – comes disproportionately from new businesses, or "start-ups."

Economists Robert Litan and Carl Schramm emphasized this reality in their 2012 book *Better Capitalism*:

> [E]ntrepreneurs throughout modern economic history, in this country and others, have been disproportionately responsible for truly radical innovations — the airplane, the railroad, the automobile, electric service, the telegraph and telephone, the computer, air conditioning, and so on— that not only fundamentally transformed consumers' lives, but also became platforms for many other industries that, in combination, have fundamentally changed entire economies...
>
> Large companies, with their large fixed costs of plant, equipment, and to some extent personnel, have perfected the economic arts of economies of scale production and incremental innovation. But...most large companies are less eager to pursue radical innovations — those that disrupt current business models in which the firms are heavily invested.[7]

In addition to innovation, research conducted in 2009 by John Haltiwanger, Ron Jarmin, and Javier Miranda, followed by further analysis by scholars at the Kauffman Foundation, has shown that start-ups also account for virtually all net new job creation.[8]

From the standpoint of innovation, economic growth, and job creation – arguably the three most important metrics of economic health and vitality – thriving entrepreneurship is the beating heart, the very soul, of any economy.

The Engine of Innovation and Growth is Breaking Down

Unfortunately, as scholars at the Kauffman Foundation, the Brookings Institution, and elsewhere have documented, entrepreneurship in America is in trouble. Not everywhere, of course; in places like Silicon Valley, Austin, TX, Boulder, CO, and Cambridge, MA entrepreneurship is thriving. But in broad terms, entrepreneurship in America is struggling.

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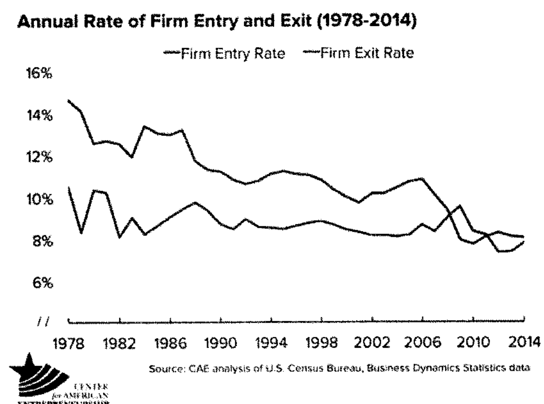
[7] Robert E. Litan and Carl J. Schramm, *Better Capitalism: Renewing the Entrepreneurial Strength of the American Economy*, Yale University Press, 2012.

[8] John Haltiwanger, Ron Jarmin, and Javier Miranda, "Business Dynamics Statistics Briefing: Jobs Created from Business Start-Ups in the United States," Ewing Marion Kauffman Foundation, 2009; Dane Stangler and Robert Litan, "Where Will the Jobs Come From?" Ewing Marion Kauffman Foundation, November 2009; Tim Kane, "The Importance of Start-Ups in Job Creation and Job Destruction," Ewing Marion Kauffman Foundation, July 2010.

After remaining remarkably consistent for decades, the number of new businesses launched in the United States peaked in 2006 and then began a precipitous decline – a decline accelerated by the Great Recession. New data released by the Census Bureau on September 20th show that new business formation continues to languish near a record low. From 2000 to 2006, the economy produced an average of 511,000 new employer firms each year. Since 2009, however, the number of new business launched annually has dropped to about 400,000 – meaning the United States currently faces a start-up deficit of 100,000 missing new firms *every year*.[9]

Research by the Kauffman Foundation indicates a rebound in 2015 and 2016, but the recovery is from a very low level and the number of start-ups remains well below pre-recession rates.[10]

Even more alarming, economists Robert Litan and Ian Hathaway have shown that entrepreneurship rates have fallen near a 30-year low – and that this decline is occurring in all 50 states, in all but a handful of the 360 metro areas examined, and across a broad range of industry sectors, including high-technology.[11] The chart below, taken from Litan and Hathaway's May 2014 paper, shows that the number of new firms as a percentage of all firms has been in steady decline for more than three decades – and, from 2008 to 2012, actually fell below the rate of business failure. In other words, over that brief period, more businesses were failing in America than launching.



[9] Business Dynamic Statistics, Census Bureau, https://www.census.gov/ces/dataproducts/bds/data.html.

[10] Index of Start-Up Activity, Ewing Marion Kauffman Foundation, August 2016. Also see testimony by Dane Stangler, Vice President for Research & Policy, Ewing Marion Kauffman Foundation, before the Committee on Small Business and Entrepreneurship, U.S. Senate, June 29, 2016.

[11] "Declining Business Dynamism in the United States: A Look at States and Metros," Robert Litan and Ian Hathaway, The Brooking Institution, May 5, 2014. Also see John Haltiwanger, Ian Hathaway, and Javier Miranda, "Declining Business Dynamism in the U.S. High-Technology Sector," the Ewing Marion Kauffman Foundation, 2014.

As Solow's growth model would predict, U.S. productivity has fallen along with the decline in rates of new business formation. Annual productivity gains averaged about 2.5 percent from 1948 to 2006, but have fallen to about 1.1 percent since 2011– less than half the historical rate. Growth in output per hour slowed to just 0.5 percent in 2014, 0.3 percent in 2015, and just 0.2 percent last year.[12]

Nobel Prize recipient Edward Prescott and his colleague Lee Ohanian from Stanford University have argued that the economy's anemic performance in recent years is due largely to the plunge in productivity growth – caused by the dramatic decline in start-ups:

> The remarkable productivity growth that has enabled the U.S. to become the wealthiest country on earth has slowed considerably in recent years.
>
> The most recent period of rapid productivity growth in the U.S. — and rapid economic growth — was in the 1980s and '90s and reflected the remarkable success of new businesses in information and communications technologies, including Microsoft, Apple, Amazon, Intel, and Google. These new companies not only created millions of jobs but transformed modern society, changing how much of the world produces, distributes and markets goods and services.
>
> Sadly, the annual rate of new business creation is about 28 percent lower today than it was in the 1980s, according to our analysis of the U.S. Census Bureau's Business Dynamics Statistics annual data series. Getting the U.S. economy back on track will require a much higher annual rate of new business start-ups. [13]

Circumstances in rural areas of America are particularly acute. A recent report by the Economic Innovation Group shows that most of the new business formation that has occurred since the Great Recession has been highly concentrated, clustered mostly in high-density urban or suburban areas. Fully half of the net increase in U.S. business establishments between 2010 and 2014 occurred in just 20 counties, and 17 of those 20 counties are in just four states – California, Florida, New York, and Texas. This pattern of concentration stands in stark contrast to previous recoveries. From 1992 to 1996, for example, 125 counties generated the same 50 percent of new businesses.[14]

Given the critical role start-ups play as the principal source of disruptive innovation, productivity growth, economic growth, and job creation, such circumstances amount to nothing short of a national emergency.

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[12] Eric Morath, "U.S. Productivity Advanced for Second Straight Quarter, *The Wall Street Journal*, February 2, 2017.

[13] Edward C. Prescott and Lee E. Ohanian, "U.S. Productivity Growth Has Taken a Dive," *The Wall Street Journal*, February 3, 2014.

[14] "A New Map of Economic Growth and Recovery," Economic Innovation Group, May 2016.

Why are Start-up Rates Declining?

Rates of new business formation have fallen near multi-decade lows, both in terms of the number of new businesses being launched and the share of all U.S. businesses that are new.

But why?

To find out, a colleague and I decided to put the question directly to America's entrepreneurs. Over the summer of 2011, we conducted roundtables with entrepreneurs in 12 cities across the United States, asking them, quite simply: "What's in your way?"

More than 200 entrepreneurs participated – from a web-based software company in Seattle to an industrial construction firm in Orlando, from a developer of bioscience technologies in Boston to a distributor of glow-in-the-dark fluorescent fish in Austin – all explaining in specific and vividly personal terms the issues, frustrations, and obstacles that are undermining their efforts to launch new businesses, expand existing young firms, and create jobs.[15]

An astonishing take-away from our roundtables – and enormously significant from the standpoint of potential policy solutions – is that the problems and obstacles encountered by entrepreneurs across the country are remarkably consistent. Entrepreneurs from Austin to Boston and from Seattle to Orlando reported the same burdens, frustrations, and difficulties:

- "We have the jobs, and we need to fill them to survive, but we can't find enough people with the skills we need."
- "Our immigration policies don't effectively attract and retain the world's best and most innovative talent."
- "Access to start-up capital is even more difficult in the wake of the financial crisis."
- "Over-regulation is killing us."
- "Taxes take scarce capital from us, and tax complexity and uncertainty divert too much of our time and attention away from our new businesses."
- "There's too much economic uncertainty – and it's Washington's fault. Whether it's the fiscal cliff, the debt ceiling, government shut-downs, the inability to achieve tax reform, immigration reform, or effectively deal with the national debt, Washington is a generator of problems not solutions, a source of anxiety and uncertainty for businesses – and it's killing the economy."

[15] For more on the roundtables and what we learned from American entrepreneurs, see *Where the Jobs Are: Entrepreneurship and the Soul of the American Economy*, John Dearie and Courtney Geduldig, John Wiley & Sons, 2013.

Our summer on the road revealed a number of critical insights central to any discussion about accelerating economic growth.

First, new businesses are extremely fragile – a third fail by their second year, half by their fifth. And yet, those new businesses that survive tend to grow, innovate, and create jobs at very rapid rates.

Second, the policy needs and priorities of new businesses are unique. Start-ups are different from existing businesses. The challenges they confront are different and their ability to successfully navigate those challenges is more limited.

Third, many policymakers in Washington and around the country do not sufficiently understand or appreciate the unique nature, importance, vulnerabilities, and needs of start-ups. Focused on the priorities of either large corporations or the small business community, policymakers too often overlook the economy's true engine of growth and job creation.

Finally, policy help for America's entrepreneurs is urgently needed. Given the critical role they play in our nation's economy as the principal source of innovation, growth, and job creation, America's young businesses need and deserve a comprehensive policy framework designed to cultivate and nurture start-ups.

Tax Reform and Entrepreneurship

As mentioned in the Introduction, tax policy is one of the most powerful levers of economic policymaking that Congress has at its disposal, and tax reform is one of the essential changes in public policy that thriving entrepreneurship requires. Many often assume that tax policy isn't relevant to start-ups since new businesses typically lose money in their early years and, therefore, don't pay income tax. This generalization overlooks the reality that the U.S. tax code presents a number of challenges for start-ups – challenges that can amount to the difference between survival and failure. Specifically, the current tax code penalizes businesses with substantial, early-years losses, discourages investors from backing risky new businesses, and impedes successful new companies from expanding.

CAE's tax reform proposals for revitalizing American entrepreneurship are:

Reduce Tax Rates

While many start-ups lose money in their early years and, therefore, don't pay income tax, some do achieve profitability shortly after launch. For those fortunate new businesses, tax rates are important because capital is the lifeblood of any new business. As one entrepreneur explained to us: "People talk about access to capital in the context of investors. But it's also about holding onto the money you generate internally through sales. Young businesses barely scrape by in the early years, and yet the government takes a third of any profit in taxes – money that could have been invested back into the business."

Nearly 95 percent of U.S. businesses, 85 percent of small businesses, and virtually all new businesses are organized as S corporations, partnerships, limited liability companies (LLCs), or sole proprietorships. Such businesses are referred to as "pass-through" businesses because their profits are passed through to owners and investors who pay taxes on those distributions by way of their individual returns.

Entrepreneurs who choose to organize their new business as a pass-through currently face a higher federal tax rate – 44.6 percent – than at any point since 1986, and 10 percentage points higher than C corporations. A recent Tax Foundation report showed that the all-in tax rate on pass-through business income can exceed 50 percent when state and local taxes are included. New businesses that organize as C corporations are taxed at 35 percent – the highest statutory business tax rate in the industrialized world. Meanwhile, the top tax rate on capital gains – 25 percent – is the highest since 1997, and the top tax rate on dividends – also 25 percent – is the highest since 2002.

Simplify the Tax Code

Tax complexity and uncertainty exacerbate the burden of high tax rates. Unlike larger or more established firms, start-ups typically don't have the resources to hire a chief financial or tax officer to navigate a complex and ever-changing tax code – they do it themselves. And uncertainty regarding future tax obligations can discourage or even punish calculated risk-taking. Entrepreneurs distracted with tax compliance rather than focused on their product, service, and the marketplace are much more likely to make mistakes, miss opportunities, or even fail.

CAE supports comprehensive tax reform that would significantly reduce tax rates by simplifying the tax code and broadening the tax base through major reductions in existing expenditures, exemptions, preferences, and other loopholes. According to the Joint Committee on Taxation, revenue lost due to tax expenditures hit a record high in 2017 of $1.6 trillion, or nearly 80 percent of combined corporate and individual tax revenue. If counted as part of the annual budget, expenditures would amount to over a quarter of total government spending. Reducing the number and/or size of expenditures, exemptions, and other loopholes would enable policymakers to lower statutory rates without a significant loss of net revenue.

More favorable and predictable tax treatment would help cultivate new business formation, survival, and growth by allowing new businesses to retain and reinvest more of what they earn, preserving critical cash flow, and minimizing the distraction and burden of tax complexity and uncertainty.

Allow Start-ups to Use the Cash Method of Accounting

Current law generally permits businesses with gross receipts of $5 million or less to use the cash method of accounting. The cash method is simpler, less costly, and easier for new businesses to understand than accrual accounting or other more complex accounting methods, and simplifies tax accounting. CAE recommends that start-ups be permitted to use the cash method of accounting, if they choose to, for the first five years of operation.

Move to a Territorial Tax System

A particularly counterproductive and anti-innovation aspect of the current U.S. tax code is that the United States is the only major industrial nation that applies income tax to the worldwide earnings of U.S.-based businesses. Most other nations maintain a "territorial" framework whereby taxes are paid only to the governments of the countries in which foreign profits are earned. The Germany-generated earnings of France-headquartered companies, for example, are taxed by Germany but not also by France.

Though the U.S. code applies to worldwide earnings, business income earned overseas is taxed only if it is transferred home. As long as foreign-earned profits remain abroad, U.S. taxes are indefinitely deferred. The system of assessing taxes on income earned anywhere in the world, together with the deferral of taxation until earnings are repatriated, creates a powerful incentive for U.S.-based businesses to keep their foreign earnings overseas – and to reinvest those funds anywhere but back in the United States.

U.S. corporations currently hold as much as $3 trillion overseas, with hundreds of billions added every year. Moody's has noted that the practice is particularly common among technology companies, which depend on high rates of innovation and continuous research and development and are, therefore, particularly sensitive to repatriation taxes. According to a recent analysis by Bloomberg, the top eight technology companies alone account for a fifth of all U.S. corporate earnings held overseas – nearly $500 billion.

CAE urges policymakers to shift to a territorial tax system. To be sure, overseas investment by U.S. corporations should not be discouraged or penalized. U.S. companies earn a large and growing share of their total earnings overseas, and foreign operations create additional value for shareholders and promote economic growth and job creation back home. But the global allocation of companies' resources should not be artificially driven by powerful and illogical tax-related incentives. A shift to a territorial system of taxation would result in the repatriation of hundreds of billions or even trillions of dollars, a significant portion of which would fund research and innovation that would likely spawn thousands of new American start-ups over time.

Allow Start-ups to Defer Income Tax Liability

Because capital is the lifeblood of any new business – and because holding onto as much capital as possible can be the difference between success or failure – CAE also recommends that start-ups be permitted to defer any tax liability incurred during the critical first five years, and to apply that tax liability at any time over the ensuing 20 years. Because money has a time value – future tax payments are worth less than immediate payments – deferred tax payments should be assessed a reasonable rate of interest, perhaps a real (inflation-adjusted) rate of 2 percent. The interest adjustment would also provide an incentive for start-ups to discharge of any deferred tax liability as quickly as possible once profitable.

Allow Start-ups to Carry Forward Losses and R&D Credits by Exempting from 382 and 383 Restrictions

The current tax code entails a fundamental asymmetry between the tax treatment of operating profits and losses – an asymmetry that significantly disadvantages new businesses. If an existing business sustains a net operating loss in a given year, it is often eligible to "carry back" and deduct the loss from income earned in previous years, or to "carry forward" the loss to be deducted from future income. Current law permits businesses to carry forward operating losses for a period of 20 years.

Most new businesses lose money in their initial years – sometimes for many years – before hopefully becoming profitable. Such losses are often due to substantial research and development (R&D) investments, salaries, and other expenses that exceed earnings. For many start-ups, R&D and salaries can be the primary expenses of the new company in its early years. Whatever the cause, start-ups, because they are new, have no previous income against which to apply current operating losses. Moreover, income against which losses can eventually be deducted might not materialize for years. Such circumstances are not only problematic from the standpoint of minimizing start-ups' tax liability, but can also discourage investment in new ideas, since the cost of new investment is not recoverable in a tax context.

Even more problematic, two aspects of the current tax code that restrict loss and credit carry-forwards – Sections 382 and 383 – can have the effect of virtually eliminating any carry-forward tax benefit for start-ups. Sections 382 and 383 were written in the mid-1980s to prevent "loss trafficking" – companies acquiring failing firms with large losses solely to use the acquired company's tax losses to offset other unrelated income. Section 383 pertains to tax credits, while Section 382 pertains to net operating losses. The rules can virtually eliminate the use of net operating losses and credits following transactions perceived as a change in ownership.

Start-ups often depend on outside investments, from venture capital firms or other sources, to finance R&D and other expenses, sometimes for many years. Such investments are critical for the survival and growth of new firms – but often trigger 382 and 383 change-of-ownership restrictions, potentially nullifying net operating loss carry-forward tax benefits, including for R&D investments. In other words, Section 382 and 383 carry-forward restrictions actually punish start-ups for incurring the very kinds of investments that federal tax policy explicitly encourages for older established firms.

With this policy inconsistency in mind, CAE recommends that net operating losses and R&D credit carry-forwards for start-ups be exempt from the limitation rules of Sections 382 and 383.

Allow Start-ups to Expense 100 Percent of Business Investment

Once a new business has been successfully launched and has established the viability of its product or service in the marketplace, entrepreneurs seek to grow, or "scale," their new business as rapidly as possible. Scaling is important to solidifying the long-term viability of a new business and to job, wealth, and opportunity creation. Successful scaling of a new business often requires significant capital investment in equipment, additional office space, and machinery.

Rapidly growing start-ups are disadvantaged by the current tax code, which requires businesses to deduct the cost of capital investment over long periods of time according to more than two dozen complex depreciation schedules. Because immediate deductions are more valuable than future deductions, the longer that businesses have to wait to write off the full cost of capital investment, the less likely they are to make critical investments necessary to expand.

The Small Business Tax Revision Act of 1958 created for the first time a special first-year depreciation allowance, whereby small businesses could deduct or "expense" from taxable earnings a portion of their total cost of capital and equipment investment, pursuant to section 179 of the Internal Revenue Code. Expensing is the most accelerated form of depreciation, allowing businesses to write off the cost of business investment immediately rather than over time. The purpose of the provision was to reduce the tax burden on small businesses, stimulate small business investment, and simplify tax accounting for smaller firms. The original deduction was limited to $2,000 of the cost of new and used business machines and equipment.

Since 1958, the limits and details of the special expensing allowance have changed many times – most typically to raise the expensing limit as a means of stimulating economic growth by incentivizing business investment. In the midst of the accelerating economic downturn in 2008, Congress raised the allowance to $250,000 as part of the Economic Stimulus Act of 2008, and then to $500,000 as part of the Small Business Jobs Act of 2010. The American Taxpayer Relief Act of 2012, signed by President Obama to avoid the "fiscal cliff," preserved the $500,000 allowance for 2013.

CAE recommends that start-ups be allowed 100 percent first-year expensing of all business-related capital, equipment, and real estate. According to an analysis by the Treasury Department, 100 percent expensing lowers the average cost of capital on new investments by more than 75 percent.[16] Such savings are enormously significant, especially for new businesses for whom access to sufficient capital at reasonable terms remains a principal challenge.

Together with the ability to carry forward losses, explained immediately above, 100 percent expensing of all business-related investment – which would contribute to losses – would dramatically improve start-ups' financial and tax-related circumstances.

<u>Expand PATH Act Payroll Tax Offset of R&D Credits</u>

The Research and Experimentation Tax Credit – commonly known as the research and development (R&D) tax credit – was created as part of the Economic Recovery and Tax Act of 1981 to incentivize technological progress and innovation by allowing businesses to deduct a portion of the cost of research and product development from their taxable earnings. The United States was one of the first countries to incentivize R&D by way of the tax code and claimed the world's most generous tax treatment of R&D into the early 1990s.

[16] "The Case for Temporary 100 Percent Expensing: Encouraging Businesses to Expand Now by Lowering the Cost of Investment," Department of the Treasury, Office of Tax Policy, October 29, 2010.

Since its introduction, the R&D tax credit has been shown to be a powerful driver of innovation and economic growth. A large and growing body of research indicates that R&D investment is associated with future gains in profitability and market value at the firm level, and with increased productivity at the firm, industry, and broader economy levels. R&D also has significant "spill-over" benefits, as research conducted by one firm can lead to progress that increases the productivity, profitability, and market value of other firms in related fields.

The credit is particularly relevant for start-ups, which often incur substantial losses in their early years due to research and development of new products and services, methodologies, and techniques – and for whom preservation of cash flow and operating capital is crucial to survival. And yet, until recently, start-ups were largely shut out of any benefit associated with the credit because it could only be applied against taxable earnings.

The Protecting Americans from Tax Hikes ("PATH") Act of 2015 made a number of improvements to the application of the R&D tax credit, perhaps most notably by finally making the credit permanent after numerous extensions and expirations since its creation in 1981. Now certain of the credit's availability, businesses can make investment decisions more effectively and efficiently. In addition, the PATH Act addressed the disconnect between the policy intention of the R&D credit and start-ups by allowing new businesses to apply the credit against payroll taxes, rather than income taxes, up to $250,000 annually. To qualify, companies must have had gross receipts for five years or less and gross receipts of less than $5 million for the tax year the credit is applied.

CAE recommends enhancing the PATH Act's payroll tax provision by expanding the eligibility definition to be consistent with the current definition of "qualified small businesses" (i.e., young companies with under $50 million in gross assets), and to raise the payroll tax deduction limit to $1 million annually.

Exempt Gains on Early-Stage Investments from Capital Gains Tax

Early-stage or "seed" financing is critical to the formation, survival, and growth of new businesses. "Angel" investors – wealthy individuals who invest in new companies – have emerged as the principal source of such funding, providing 90 percent of outside seed capital, once entrepreneurs have exhausted their own resources and those of family and friends. Each year, angels invest about $25 billion in more than 70,000 new companies. For every new company that receives venture capital, 15 others receive angel capital. Amazon, Home Depot, and Uber are just a few examples of the many companies launched with angel capital.

According to the Center for Venture Research (CVR), which has analyzed the angel market since 1980, there are about 300,000 active angel investors in the United States. Angel investing has also become more organized in recent years, with more angels participating in groups, which facilitate more rigorous analysis of potential ventures, and, occasionally, help spread risk by syndicating investments. They also help entrepreneurs identify and connect with active angel investors. According to the Angel Capital Association, the number of angel groups across the country has tripled since 1999 to more than 400.

Angel investors are similar to venture capitalists in a number of ways. Like VCs, angels invest in new, high potential companies in exchange for an equity stake in the business. Many angel investors – particularly those who are current or former entrepreneurs – also provide advice, mentoring, and other support to the management teams of the new businesses they invest in. As with venture capital, angel capital is recovered and any returns realized when financed firms either go public or are bought by another company.

And, like venture investing, angel investing is very risky. According to the Angel Capital Association, half of all angel investments fail and just 7 percent of investments generate 75 percent of total returns.

Angel investors also differ from venture capitalists in significant ways. Unlike VCs, who invest institutionally-raised capital in amounts of $1 million or more, angels invest their own money, typically in amounts between $25,000 and $500,000. Despite smaller individual investments, aggregate angel capital invested rivals that of venture capital.

Given the critical importance of early-stage seed capital to start-ups, the formation and commitment of angel capital should be incentivized. Section 1202 of the tax code was enacted in 1993 to incentivize investment in "qualified small businesses" by excluding a portion of any capital gains on investments held for at least five years from federal income tax. Section 1202 originally excluded 50 percent of capital gains from gross income.

The PATH Act of 2015 made permanent a 100 percent exclusion from capital gains tax for any gains on long-term investments in qualified small businesses, up to $10 million or ten times the original investment, whichever is greater. Previously, the American Recovery and Reinvestment or "Stimulus" Act of 2009 raised the excluded portion from 50 percent to 75 percent, and exempted any gains from the Alternative Minimum Tax (AMT). Subsequent legislation raised the exclusion to 100 percent and extended the AMT exclusion temporarily. CAE recommends that this full exclusion from federal income tax of any gains on angel investments in start-ups held for at least five years be retained in order to maximize the pay-off on any successful investments.

At present, the Section 1202 exclusion only applies to companies organized as C corporations. Because most new businesses are launched as S corporations, partnerships, or limited liability companies (LLCs) – "pass-throughs" (see first recommendation above) – CAE also recommends that the 1202 exclusion be applied to any start-up that converts to a C corporation within five years – and that the period of time spent as a pass-through count toward the five-year holding period required by Section 1202. In other words, angel investors would not have to hold the investment for five years beyond conversion to a C corporation, but only five years beyond the original investment in the company.

Total capital gains tax revenues have historically represented less than 5 percent of federal tax revenues, so exempting gains on angel investments would have almost no impact on federal tax revenue. And since most angel investors reinvest most or all of their returns into the next generation of innovative new companies, exempting such gains from federal taxes would have the further benefit of increasing the amount of seed capital available to start-ups.

Allow Losses on Angel Investments to Be Deducted from Ordinary Income

As a counterpart to the Section 1202 tax treatment of angel investment *gains*, Section 1244 of the tax code allows investors in qualified small businesses to deduct *losses* on such investments as an ordinary loss (deducted from ordinary income) rather than as a capital loss. Normally, the tax code treats equity investments as capital assets and, therefore, losses are deducted as capital losses to offset capital gains. If capital losses exceed gains in a particular year, remaining losses are deductible up to a limit of $3,000 annually, with any additional remaining losses carried forward to subsequent years. By contrast, a loss on a Section 1244 investment is deductible from ordinary income up to $50,000 for individuals and $100,000 for couples filing jointly.

To qualify for Section 1244 treatment, the issuing company's aggregate equity capital must not exceed $1 million at the time of issuance, the company must have derived more than 50 percent of its income from business operations rather than passive investments for the previous five years, and the shareholder must have purchased the stock directly from the company and not received it as compensation. Start-ups generally don't issue stock for years after launch, if ever – nor have they been in existence for five years – and, therefore, currently don't meet the requirements of qualifying small businesses.

To further incentivize seed-stage investments in start-ups, CAE recommends expanding Section 1244 to permit losses sustained by angel investors on investments in new companies held for at least 5 years to be deductible from ordinary income up to $100,000 annually.

Conclusion

Economic growth is driven by productivity gains, which are driven by innovation – which comes disproportionately from new businesses. Revitalizing American entrepreneurship, therefore, is the *essential pathway* to faster economic growth and the nation's ability to meaningfully address its most serious socio-economic challenges.

But that necessary revitalization requires changes in public policy. Fortunately, we have a good sense of what needs to be done. Research conducted in recent years, together with input from entrepreneurs by way of the roundtables mentioned above and other forums, has produced a uniquely credible pro-entrepreneurship growth agenda that, if enacted, would dramatically enhance the circumstances for new business formation, survival, and growth – and, in doing so, accelerate economic growth, in aggregate and across America's many communities, to the rate necessary to generate the opportunity, jobs, and wage growth the American people deserve.

Tax reform that includes a special focus on the unique tax-related vulnerabilities of start-ups is a critical part of America's pro-entrepreneurship, pro-growth policy agenda.

Thank you for organizing this important hearing and for inviting me to participate.

TAX FOUNDATION

Written Testimony of
Scott Hodge
President of the Tax Foundation

Before the Joint Economic Committee

TESTIMONY
October 2017

"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.

Written Testimony to the Joint Economic Committee of the U.S. Congress by Falon Donohue, CEO, VentureOhio October 3, 2017

1. Introduction

Chairman Tiberi, Ranking Member Heinrich, members of the Joint Economic Committee, thank you for the invitation to provide testimony for this important hearing. My name is Falon Donohue, I am the CEO of VentureOhio - a non-profit organization dedicated to the growth and diversification of Ohio's statewide startup community.

I am speaking to you today on behalf of VentureOhio's membership - the entrepreneurs, innovators and investors who are creating high-paying jobs in the Midwest and changing the world we live in. And the topic of reviving entrepreneurship through tax reform is very important to the hearts and minds of the members of VentureOhio.

I am also speaking today on behalf of the larger group of Midwesterners who are most affected by the growth and development of our new tech-based economy. These are my fellow veterans seeking to transfer the technical skills acquired while serving their country into high paying jobs in their hometown. These are my young friends who want to build applications that will change the world at cool tech companies but don't want to leave their families for New York or California. Finally, these are the good people of Mansfield, Ohio, my hometown, and small towns across the Midwest who are seeking access to new technical jobs as they watch their current jobs become obsolete due to the rapid changing pace of technology.

2. Innovation Through Investment

The Midwest is in the midst of a renaissance. Abandoned warehouses in long-forgotten parts of town are being repurposed as tech incubators. Startup company successes are dominating the headlines of local newspapers while the community surrounds them and cheers for their success. Ohio's best and brightest are choosing to remain in the state and work at high-tech companies in lieu of leaving for the coasts.

These startup founders are choosing this path to create some of the most innovative and disruptive companies of our generation. In the coming decade, startups will create whole new industries that will impact millions of jobs across our country. From autonomous vehicles to artificial intelligence, the impact of these companies will be swift and complete.

3. Ohio Innovation and Investment

In Ohio, we have seen massive growth in our startup ecosystem and venture capital activity, reaching the highest point in our state's history in 2016. From our latest research released in *VentureOhio's 2017 VentureReport*, venture capital investments have increased 46% in Ohio since 2014. In 2016 alone, investors deployed $470 million into 210 Ohio startups and Ohio-based funds raised an additional $631 million in new funds, giving them the ability to deploy additional funds in the near future.

We have also seen the results of innovation and entrepreneurship through the acquisition of Ohio companies like CoverMyMeds, which was acquired last year by California-based McKesson for over $1 billion. As the largest technology acquisition in Ohio's history, this sale was a major milestone for the Ohio entrepreneurial community, setting the tone for what is to come.

Success stories like CoverMyMeds in Columbus or AssurexHealth in Mason, which was acquired in 2016, and many others each year demonstrate that it is an exciting time to create a startup in Ohio.

Startups are creating millions of new jobs, fueling research and development in the technologies of the future and continuing America's innovation dominance. Without them, we might have to imagine a world without social networks, streaming TV, or the on-demand delivery of nearly everything. But we might also have to imagine a world without life-saving drugs or the ability to more easily take drunk drivers off our roads. A future without startups would not likely include world-changing innovations like autonomous cars and artificial intelligence.

I speak with investors and entrepreneurs everyday who are taking massive risks to create jobs and grow our economy, and are very aware of the need to revamp our tax system. Our very complex system is forcing them to take their attention off of growing awesome businesses and instead worry about the tax environment in which they operate. Meanwhile, when the tax code targets high income people, it does so at the risk of funding venture backed companies, most of which operate at large losses during their most critical early years.

We believe the companies being created in Ohio today will be the next crop of the Apples, Googles, Airbnbs, and Facebooks. They will create millions of jobs and change a generation of families. This is the most exciting time Ohio entrepreneurship has seen in decades and I'm very pleased to be with you today to speak about the ways the tax code can help encourage future startups.

4. Regulatory and Tax Changes

In 1979, regulatory changes allowed pension funds to invest in VC, creating the modern venture capital industry as we know it today. According to a recent Stanford University study, 43% of the public companies founded between 1974 and 2015 were venture-backed. These companies represent 38% of the employees and 57% of the market cap of the "new" public companies.

While lower tax rates can have a great impact on small businesses, high-growth venture-backed companies, which often operate with negative income while they use investment capital to build new products and expand their workforces, do not benefit from these changes. Venture-backed companies and the investors that support them are in need of different types of regulatory and tax changes.

Among the proposals supported by VentureOhio are allowing startups to utilize the Research and Development Tax Credit, simplifying Qualified Small Business Stock Rules, passing the Empowering Employees Through Stock Ownership Act, maintaining Carried Interest Capital Gains, and maintaining the Capital Gains Rate Differential.

Specifically, VentureOhio agrees with the following recommendations[1] from the National Venture Capital Association (NVCA) which we believe will encourage new company formation:

Expanded Research and Development Tax Credit
While current law allows very early stage startups, less than five years old and with less than $5 million in annual sales, to use R&D credits to offset up to $250,000 in payroll tax obligations, we believe Congress should expand this credit to startups with less than $100 million in assets to be able to offset up to $1 million worth of payroll taxes with R&D credits.

While the creation of this provision as part of the PATH Act was a great start to encouraging the growth of innovative American companies, the size/age limit restrictions leave many startups unable to access the benefits of their R&D tax credits at a time when they are pouring considerable resources into R&D to build the enterprise. Increasing these limits will ensure startup companies can access the benefits of the R&D credit when they need it most.

Qualified Small Business Stock Rules Changes
The Qualified Small Business Stock (QSBS) rules contained in Section 1202 are an effective motivation for investments in early stage startups, especially in non-coastal ecosystems like Ohio that are home to funds with a higher percentage of taxable investors. Unfortunately, the significant complexity of the eligibility rules and a size limit that hasn't increased with inflation or economic realities have limited the ability of Section 1202 to bolster the entrepreneurial ecosystem as well as the policy goals envisioned by those who passed the law.

VentureOhio supports the ten reforms suggested by the National Venture Capital Association (NVCA) to Section 1202 to make the eligibility rules easier to understand and increase the gross asset limit (indexed for inflation).

[1] https://nvca.org/wp-content/uploads/2017/07/NVCA-Tax-Reform-Finance-Submission-07172017.pdf

VentureOhio believes that, if Congress makes the recommended reforms, Section 1202 could become one of the most powerful incentives for venture capital fund and entrepreneurial capital formation in non-coastal regions.

Passing the Empowering Employees Through Stock Ownership Act
VentureOhio supports the passage of the Empowering Employees Through Stock Ownership Act, which would allow startup employees to defer tax liability on income arising from exercised but illiquid stock options.

Stock options are a critical tool for attracting talented individuals to work at startups across the nation, including in Ohio. Employees are often compensated with stock options as a promise that if the startup succeeds, everybody shares in the gain.

In a state like Ohio, which has experienced a 46% increase in venture capital investments into our startups in the past 2 years alone, the importance of stock option incentives is reaching a critical state. As many startups opt to stay private longer rather than pursue an initial public offering (IPO), startup employees face significant burdens when their stock options vest without a liquid market to sell their shares in order to pay the taxes that are due.

Allowing an additional period of time for employees to defer taxes on exercised stock options is a common sense solution to this challenge that will encourage more talented Americans to help build today's startups into tomorrow's Fortune 500 success stories.

Allowing additional time for employees to defer taxes on exercised stock options is a common sense solution to this challenge that will encourage more talented Americans to help build today's startups into tomorrow's Fortune 500 success stories.

Maintaining Carried Interest Capital Gains
While many different factors have converged over time to create America's leadership in innovation, significant credit is due to our long-standing tax policy that supports the spirit of entrepreneurship. One such policy is the capital gains treatment of carried interest received by venture capitalists.

Carried interest is the *primary* economic incentive for participation in venture capital. Venture capitalists create partnerships with institutional investors (e.g. pension funds, endowments, foundations) and individual investors. This partnership marries the talent, expertise, and personal capital of the venture capitalist with the capital of the institutional or individual investor to make risky, long-term equity investments into innovative startups. These are generally partnerships that last ten to fifteen years. Carried interest is the VC's share of gains (if there are any) from the partnership in accordance with the partnership agreement. Capital gains treatment of carried interest is an important feature of the tax code that properly aligns the long-term interests of investors and entrepreneurs to build great companies together since the creation of the modern venture capital industry. Venture capital activity is entirely consistent with the core concepts of a long-term capital gains tax rate. As such, partnership gains attributable to the general partners of a venture capital partnership should continue to be afforded capital gains treatment.

If one were 'white boarding' the best public policy solutions to encourage new company creation, they would be hard pressed to find a more perfect alignment of interests than the carried interest capital gains a venture capitalist receives from a successful startup investment. When a startup fails, the carried interest on a deal is zero. In fact, carried interest is only realized if one or more startups in a venture capital fund are so successful as to offset the inevitable failures in the fund. Carried interest tax policy is defined by a simple equation, which holds that no benefit is extended unless and until our country receives the benefit of greater economic activity through company and job creation. This policy has been critical to our country's economic success.

A tax increase on carried interest capital gains would have the most severe impact on the venture capital business model for several reasons, which include:

- Venture capital is the smallest asset class of investment partnerships and because management fees are a far less significant source of compensation for VCs, the potential for carried interest is far more critical, and in fact is the primary economic incentive for participation in venture capital.

- Venture capitalists hold assets for the longest, and therefore wait the longest to realize carried interest if their fund is successful. The *typical* VC partnership agreement runs a decade, with options for extensions for further years that are commonly exercised. The net result of a tax increase on carried interest capital gains would be a shift away from riskier investments with greater promise for breakthrough innovation and towards safer investment strategies that favor incremental progress. This is not what policymakers should be encouraging because our country needs bold investments by VCs into areas like new drug discovery, quantum computing, and energy solutions.

- A tax increase on carried interest earned by venture capitalists would have its most severe impact on new fund formation, particularly in underserved regions of the country. Setting aside California, Massachusetts, and New York, the median size venture capital fund in the remaining 47 states is about $15 million. The 2 percent management fee on a fund of that size means that, after fund expenses, there might be little or nothing remaining for general partner salaries. In these cases, carried interest capital gains can be the *sole* economic incentive for participation in venture capital.

In a state like Ohio, which saw more than $600 million in new funds raised last year, a tax increase on carried interest could be devastating for our recently burgeoning venture capital community. Rather than harm capital formation in places like Ohio, we encourage policymakers to embrace and support the entrepreneurial ecosystem that has developed in Ohio.

Maintaining the Capital Gains Rate Differential
U.S. capital gains tax policy has been critical to the success of the U.S. entrepreneurial ecosystem. Primarily, the policy has facilitated patient capital formation for high-risk enterprises and encouraged entrepreneurship.

A competitive capital gains tax rate with a meaningful differential from the top ordinary income tax rate is fundamental to fostering a climate where entrepreneurship and risk investment can continue to flourish. The business model of venture capital is to invest for longer periods (5-10 years on average) in risky companies with little track record but strong growth potential. The long-term and high-risk nature of venture capital make it particularly sensitive to tax policy.

Angel and venture capital are the only significant sources of patient capital available to startups and entrepreneurs. America is the global leader in innovation—a critical component in a globally competitive economy—in large part because of our entrepreneurial capital formation climate.

If venture capital isn't around to support an entrepreneurial ecosystem, no other investment class, nor government spending, can fill this gap.

6. Conclusion
Our society and the future of innovation in America depends on startups and entrepreneurs who take significant risks to start their companies. When startups succeed, they produce the most significant and generation-changing innovations that impact not just our nation but the world. I hope Congress continues to create and strengthen the policy environment to allow America's entrepreneurial ecosystem to thrive and have the greatest chances for success.

SMALL BUSINESS MAJORITY

WRITTEN STATEMENT

BEFORE THE UNITED STATES CONGRESS JOINT ECONOMIC COMMITTEE

HEARING ON

"THE STARTUP SLUMP: CAN TAX REFORM HELP REVIVE ENTREPRENEURSHIP?"

October 3, 2017

John Arensmeyer

Small Business Majority

Chairman Tiberi, Ranking Member Heinrich, Vice-Chair Lee and fellow Members of the Committee,

Thank you for inviting me to speak with you today about policies that can help promote entrepreneurship, and to offer testimony about the major issues facing America's small businesses.

I was a long-time small business owner prior to founding Small Business Majority 12 years ago. For 13 years, I was the founder and CEO of ACI Interactive, an award-winning interactive communications company, and earlier I was the chief operating officer of a pioneering multimedia business. Following my years of experience running small businesses, I founded Small Business Majority to create a national organization to serve as a leading advocate for America's entrepreneurs.

Small Business Majority's mission is to empower America's entrepreneurs to build a thriving and inclusive economy. We actively engage small business owners and policymakers in support of public policy solutions, and deliver information and resources to entrepreneurs that promote small business growth and drive a strong, sustainable job-creating economy. Our extensive scientific opinion polling, focus groups and economic research help us educate and inform policymakers, the media and other stakeholders about key issues impacting small businesses and freelancers, including access to capital, taxes, healthcare, retirement and critical workforce issues.

Small Business Majority has a network of more than 55,000 small business owners across the country, with 10 offices in Washington, D.C. and eight states. We work closely with our network and with more than 1,000 local business groups to create a strong small business voice in Washington and state capitals, and deliver critical education and resources to America's job-creating entrepreneurs.

Through our daily interaction with small business owners and self-employed entrepreneurs we know that small businesses are not just the backbone of the American economy; they are its foundation. America's 28 million small businesses represent 99% of all employer firms and account for half of our nation's jobs and economic output, and their creativity spurs innovation in all sectors of the economy. According to the U.S. Small Business Administration, small businesses have created two out of three new private-sector jobs since the Great Recession.[i] Private-sector job creation at small- and medium-sized businesses has outpaced the rate of large-size companies for every month of 2017, per ADP's National Employment Report.[ii]

In order to ensure our nation's job creators can thrive and help grow our economy, it's crucial that Congress focus on policy solutions that will truly help our nation's entrepreneurs succeed. Those solutions include the need for access to responsible credit and capital, affordable and quality health coverage and tax reform that directly benefits Main Street small businesses rather than Wall Street, large corporations and a select group of wealthy individuals.

Leveling the Playing Field for Small Business through Meaningful Tax Reform

We need a tax system that benefits America's entrepreneurs who are focused on growing their enterprises and making payroll at the end of each month. Small business owners feel that our tax system primarily benefits wealthy corporate interests at their expense. They don't want special treatment; they simply want to compete on a level playing field.

Small Business Majority's polling has shown that 90% of small business owners believe big corporations are using loopholes to avoid taxes that small businesses have to pay, and 92% believe corporations' use of those loopholes is a problem.[iii] Similarly, 9 in 10 small business owners believe that U.S. multinational corporations' use of these loopholes to shift U.S. profits overseas is a problem. What's more, three-quarters believe their small business is harmed when loopholes allow big corporations to avoid taxes.

That's why we're concerned by the current proposal for tax reform. While some are touting the plan as a boon for small businesses, the reality is that it will not actually benefit most Main Street businesses and would greatly add to the deficit. Indeed, the proposal would add at least $2.4 trillion to the deficit over 10 years according to the Tax Policy Center, and would continue to put small businesses at a disadvantage by not addressing corporate loopholes.[iv]

Some claim the current proposal to cap the tax rate for pass-through entities at 25% would be a boon for small business. In fact, this would impact only a handful of small firms according to the Tax Policy Center analysis. More than 87% of pass-through entities already pay a marginal tax rate of 25% or less, and less than 2% pay the current top marginal rate of 39.6%. Moreover, if individual tax brackets are streamlined to 12%, 25% and 35%, pass-through entities that would benefit from the pass-through cap rate would include only the 1.8% earning $425,000 or more.

A startling 88% of the savings generated by cutting the pass-through rate to 25% would go to the top 1% of earners. In short, this proposal would primarily benefit hedge fund managers, lobbyists and investment bankers—not Main Street small businesses.

And, last but not least, a tax code with a large gap between top individual rates and top pass-through rates can potentially encourage wealthy individuals to game the system by simply declaring themselves pass-through business entities.

If Congress wants to offer a responsible tax cut for most Main Street small businesses, and offset that cut with a reduction in existing loopholes, allowing all businesses to deduct a modest amount of their profits would have a much greater impact.

As for corporate taxes, cutting the top rate would help some small businesses that are organized as C-corporations, especially considering small businesses are unable to take advantage of the same accounting loopholes as large corporations. But doing so without getting rid of corporate tax loopholes would greatly increase the deficit. Economists from the Tax Policy Center estimate that reducing the corporate rate to less than 26% would be impossible to offset with just a reduction in loopholes; a reduction to 20% would reduce federal tax revenue by $1.6 trillion over 10 years.[v]

This is why it's crucial to implement policies that will help all entrepreneurs rather than giving tax breaks to those who need it least. Any substantive changes to the tax code must promote economic development from the bottom-up, enacting policies that benefit small businesses, rather than the top-down. Our specific proposals include the following:

- Ensure any changes to the corporate and personal tax codes have a significant, direct benefit to small businesses and self-employed individuals, as opposed to large businesses, hedge funds and the very wealthy.
- When considering a targeted, responsible reduction in business tax rates, ensure that it is accompanied by the elimination of costly loopholes that primarily benefit the wealthy and large corporations, such that the result is revenue-positive, or at least revenue-neutral.
- Instead of reducing pass-through business income tax rates from the top down in a manner that benefits only a sliver of small businesses, we urge the committee to examine a proposal as part of regular order discussions about tax reform that would benefit small businesses from the bottom up, rather than the current top-down proposals that will only benefit wealthy individuals. For example, we propose allowing small businesses to deduct their first $25,000 in business income whether or not they file their tax-returns as a pass-through entity or as a C-Corporation. This deduction should be paid for by eliminating loopholes and be accompanied by a phase-out for businesses with $150,000-200,000 in income to ensure it is targeted to the majority of Main Street small businesses.
- Consider a modest reduction of the nominal corporate tax rate, thus reducing the actual tax rate for most C-Corp small businesses, while eliminating unfair, inefficient tax loopholes in a manner that ensures a net revenue increase to bring down our deficit and fund key programs. Loopholes that can be eliminated include offshore tax deferral and the carried interest deduction.
- Reject the current proposal for "full expensing" of all capital purchases. Small businesses can now expense their first $500,000 of capital expenditures under Section 179. Allowing for full expensing above that level would have little benefit to them.
- Oppose any efforts to reduce top individual tax rates. It is a myth that top individual tax rates adversely harm Main Street small businesses. Only 1.7% of pass-through businesses pay income tax at the top rate.[vi]
- Oppose the enactment of a "territorial" corporate tax system that would allow a select few large multinational corporations to game the system by funneling their profits to the lowest-taxation foreign jurisdictions.
- Crack down on the ability of large corporations to reduce their tax burden simply by parking their profits offshore or moving their headquarters outside the country.
- Uphold the estate tax in its current form, understanding that it currently protects virtually all small businesses and family farms.[vii]
- Ensure parity between online and bricks-and-mortar businesses with a reasonable and fair Internet sales tax solution.
- Simplify and expand the small business tax credit created by the Affordable Care Act—helping more small businesses qualify for and utilize it.
- Pass healthcare tax equity for the self-employed so that freelancers can deduct their healthcare expenses from their FICA tax obligations—just like other business entities.
- Enact the bipartisan Investing in Opportunity Act that will help revitalize economically distressed communities by, among other things, allowing investors to temporarily defer capital gains recognition if they invest in an "opportunity zone."
- Increase limits for deducting start-up and organizational expenses from the current $5,000 levels to $10,000 each.

- Allow very small firms to use a simplified method of cash accounting.

These changes will provide critical benefits to the entrepreneurs and small business owners who need it most, allowing them to grow and expand their business on a level playing field with large corporations.

Promote Policies that Increase Access to Capital

While meaningful tax reform can play a role in spurring small business innovation and job creation, a more critical issue for entrepreneurs is access to capital. Access to capital is at the core of what entrepreneurs need to thrive and grow their business. Unfortunately, too many small businesses, especially women and minority-owned firms and entrepreneurs in distressed and rural communities, are struggling to gain the capital they need to launch or grow their businesses. According to our scientific opinion polling, 90% of small business owners agree that access to capital is a problem, particularly since the Great Recession.

The Federal Reserve Bank of Cleveland found that while lending for big businesses reached record levels in 2014, small business lending hasn't caught up with pre-recession levels. There are several reasons that small business lending has lagged since the recession. The recession seriously damaged the credit of many entrepreneurs while also causing a devaluation of collateral, lowering the credit worthiness of many borrowers.

Additionally, most traditional banks of all sizes, even those offering Small Business Administration-guaranteed loans, have significantly reduced or eliminated loans below a certain threshold, typically $250,000. For traditional banks, it costs them roughly the same to underwrite a $5 million loan as it does a $200,000 loan, and these costs decrease banks' willingness to offer smaller loans.[viii] Others simply won't lend to small businesses with revenue of less than $2 million. This hits small businesses particularly hard, particularly those in minority and distressed communities, as 68% of small businesses seek loans of less than $250,000, and, 55% of employer firms sought less than $100,000 in financing in 2016.[ix]

While there are some signs that access to capital is improving in some parts of the small business community, there are significant gaps that remain in critical areas, including minority and rural communities and for women and veterans. For example, while women-owned firms are the fastest-growing segment of businesses, studies find that women do not get sufficient access to loans and venture investment. Women account for only 16% of conventional small business loans and 17% of SBA loans even though they represent 30% of all small companies. Similarly, minority business development is on the rise—the rate of minority business ownership was 14.6% in 2012 compared with 11.5% in 2007. Yet, according to the National Community Reinvestment Coalition, African-American businesses received 2.3% of SBA loans in 2013, down from 11% in 2008.

The struggle female and minority business owners face in accessing capital is illustrated by the story of an African-American entrepreneur in our network from Chicago who left a job at a multinational accounting firm to start a bake shop. As a startup, she struggled to get traditional financing from a big bank, so she turned to Accion, a nonprofit microlender, for a microloan. While she had been seeking a $50,000 loan from big banks, this microloan provided just $10,000 in funding. Still, thanks to these funds and Accion's personalized approach, this business owner was able to grow her business and sign contracts with retailers like Whole Foods, Starbucks and Amazon Fresh.

We're glad community financial development institutions (CDFIs) like Accion are filling the gap for small businesses, but there is not nearly enough capital available to entrepreneurs from CDFIs alone. New online lending opportunities offer promising new sources of capital, with alternative lending already reaching more than $3 billion a year. Yet, these new online lenders also present a risk to small business owners, with new forms of lending such as peer-to-peer lenders, merchant cash advance companies and others, operating in an almost entirely unregulated market. We must open new avenues of lending, but we can't leave small business vulnerable to unscrupulous lenders who offer loans with exorbitant interest rates or unclear terms.

There are several steps that policymakers can take to increase access to capital for entrepreneurs and unleash their potential as job creators. These proposals include:

- Maintain and expand Small Business Administration lending, counseling and procurement programs, such as 7(a), microlending and Community Advantage, while also making permanent the fee waiver on SBA-backed loans under $150,000.
- Maintain and expand funding for the CDFI Fund, an important source of small business lending. The CDFI fund is slated to be cut by $58 million in the current proposed budget; this would be disastrous for small businesses, particularly those in distressed and rural areas.
- Promote responsible lending practices by new and alternative lenders and brokers. To this end, Small Business Majority has worked with a coalition of lenders, brokers, think tanks and small business advocates to launch the Small Business Borrowers' Bill of Rights, the first-ever consensus on responsible lending practices. The Small Business Borrowers' Bill of Rights outlines a set of fundamental principles for lending and puts the rights of borrowers at the center of the lending process.
- Support the efforts of the Consumer Financial Protection Bureau (CFPB) to collect small business lending data as required by current law.
- Ensure fair and clear regulations on crowdfunding and other non-bank, non-VC sources of capital while providing safeguards for business owners and investors.
- Provide small businesses, particularly minority businesses, with increased opportunities to participate in SBA loan programs and small business development center programs.
- Support and expand all other government efforts (e.g., SBA, Commerce Department, Agriculture Department) to educate and provide resources to small business owners.

Increasing responsible lending opportunities and protections for small business owners will provide a powerful benefit to disadvantaged areas and the American economy as a whole, as entrepreneurs—especially the growing ranks of women and minorities—safely access the loans they need to build a business that generates household wealth and stability for themselves and the members of their communities they employ.

Access to Healthcare

In addition to more options to access capital, small business owners need reliable and affordable healthcare so that they can invest their time and resources into growing and expanding their businesses. Prior to the implementation of the Patient Protection and Affordable Care Act (ACA), entrepreneurs and their employees comprised a disproportionate share of the working uninsured. Indeed, in 2011 more than 6 in 10 of the nation's uninsured workers were self-employed or working at a company with fewer than 100 employees.[x] Post-ACA, the uninsured rate for self-employed individuals has fallen drastically from 31% in 2012 to 19.5% in 2015.

A recent analysis by the U.S. Treasury Department found that 1.4 million marketplace consumers were self-employed, small business owners, or both, meaning that 1 in 5 marketplace users was a small business owner or self-employed in 2014. Additionally, small businesses and self-employed entrepreneurs were nearly three times more likely to purchase marketplace coverage than other workers. The Center on Budget and Policy Priorities found that 3.1 million small business employees gained coverage through the individual marketplace after the ACA was implemented.

The strong reliance of self-employed individuals and small business employees on marketplace coverage is clear evidence that the ACA greatly reduced "job lock." Prior to the law, many individuals, particularly those with pre-existing conditions, felt tied to their jobs because they could only access affordable health insurance through employer-sponsored coverage. The ACA bans insurers from denying coverage based on pre-existing conditions or charging more based on health status, making obtaining affordable insurance through the individual marketplace a reality for millions. This has enabled a significant number of entrepreneurs to leave their jobs and start businesses, since they are no longer afraid to leave a job with health benefits now that a pre-existing condition will not prevent them from accessing comprehensive and affordable coverage.

Entrepreneurs and small business owners have also benefitted from the expansion of Medicaid. Small Business Majority's scientific opinion polling found 21% of small business owners or their employees are enrolled in Medicaid.[xi] According to the U.S. Census Bureau's 2016 Current Population Survey, there was roughly a 44% increase in the number of small business employees enrolled in Medicaid between 2013 and 2016.

For many entrepreneurs, the ability to access healthcare through the individual marketplace or Medicaid was the push they needed to start or expand their business. For example, a young business owner from Columbus relied on his previous employer's health insurance while he was getting his urban planning business off the ground due to a preexisting condition. However, in 2016, he purchased insurance through the individual marketplace and was able to pursue his dream of entrepreneurship full-time. He fears that without the ACA's pre-existing conditions protections that he would no longer be able to purchase his own health insurance and would have to leave his business, potentially putting his business partner out of business as well. Another small business owner from Ohio was unsure how much income her fledgling photography business would generate, and relied on the state's expansion of Medicaid to get health insurance while she was getting her business off the ground.

In addition to the decreases in the unemployed rates and reduced job lock, small business owners have also seen their costs stabilize. We're now seeing much smaller increases in the small group market compared to pre-ACA, where double-digit increases were often the norm. A report from the Centers for Medicare and Medicaid Services found that from 2008-2010, the average annual increase in the small group market was 10.4%; from 2011-2015, the rate dropped by half to 5.2%.

While there are some aspects of the ACA that could be improved upon, repealing the ACA would hurt entrepreneurs and small business employers and stunt job growth. Our recommendations to stabilize insurance markets include protecting robust enrollment and marketing efforts to ensure stable and healthy marketplaces with a mix of age and health risks, ensuring healthcare tax equity for the self-employed and addressing the rising cost of prescription drugs.

Healthcare is a critical issue for our nation's entrepreneurs, and they need the peace of mind that they can start and invest in their businesses without worrying about affording coverage for themselves or their employees. Ensuring access to a variety of healthcare options through Medicaid, the individual marketplaces and the small group market is critical to making sure that individuals can make the leap to seek out their own entrepreneurial path or join thriving small businesses.

Conclusion

Congress should enact policies that will encourage more entrepreneurs to start a business and support small business growth. While tax reform can and should be a key component of such policies, small business owners also need reliable access to capital and affordable health care.

Thank you again for inviting me to appear today. I look forward to your questions.

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QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR MIKE LEE AND RESPONSES FROM MR. JOHN R. DEARIE

In contrast with the scope of the corporate tax debate, one of the lesser-known debates in overall tax reform has to do with two different methods of accounting: cash accounting and accrual accounting. Under our current code, small businesses that make less than $5 million in annual gross receipts have the option of using a cash-based system, as opposed to the more complex accrual accounting system, which records revenue and expenses as they are booked, even if the actual money has not changed hands. Mr. Dearie, can you comment on the impact these two accounting methods have on firms hoping to grow their annual revenue above the $5 million threshold, and the implications either raising or lowering this threshold may have on the ability of new and growing businesses to flourish in our economy?

New businesses are enormously important to the vitality and productive capacity of the economy. New businesses are disproportionately responsible for the innovations that drive gains in productivity and, therefore, economic growth. Recent research has also shown that start-ups account for virtually all net new job creation.

And, yet, new businesses are also extremely fragile—a third fail by their second year, half by their fifth. Given the importance of new businesses, the aim of public policy should be to create circumstances favorable to new business formation, survival, and growth.

Unlike larger or more established firms, start-ups typically don't have the resources to hire a chief financial or compliance officer to navigate complex and ever-changing tax and regulatory codes—they do it themselves. Entrepreneurs distracted with tax and regulatory compliance, or complex accounting requirements, rather than focused on their product, service, and the marketplace are much more likely to make mistakes, miss opportunities, or even fail.

The cash method of accounting is simpler, less costly, and easier for new businesses to understand than accrual accounting or other more complex accounting methods, and, therefore, simplifies financial reporting and tax compliance—which improves operating circumstances for fragile, resource-strapped start-ups.

One policy option would be to allow start-ups to use the cash method of accounting, if they choose to, for the critical first five years of operation, regardless of revenue or total assets. Another option would be to apply the definition for Qualified Small Business (QSB) under Section 1202 of the tax code, which pertains to the tax treatment of any gains on investments in QSBs. QSBs are currently defined as C corps with total gross assets under $50 million. The National Venture Capital Association has recently advocated that the QSB asset threshold be raised to $100 million.

QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR AMY KLOBUCHAR AND RESPONSES FROM MR. JOHN R. DEARIE

THE DEFERRED ACTION FOR CHILDHOOD ARRIVALS (DACA) PROGRAM

Mr. Dearie, on October 3, I attended a Judiciary hearing on the Deferred Action for Childhood Arrivals (DACA) program. DACA has provided protection to nearly 800,000 DREAMers—including more than 6,000 in Minnesota—who were brought here as children and only know the United States as their home. They serve in our military, pay taxes, and contribute to communities across the country. The vast majority of these young people—more than 97 percent—are in school or the workforce. And one recent study found that 72 percent of all DACA recipients currently in school are pursuing a bachelor's degree or higher.

Immigrants have been part of our Nation's greatest achievements. In 2010, Fortune magazine found that more than 40 percent of the Fortune 500 were founded by immigrants or their children—including 3M and Hormel Foods in Minnesota. I joined a letter, along with 41 of my Senate colleagues, urging the President to keep DACA in place. I also support the bipartisan Graham-Durbin Dream Act.

How would immigration reform boost entrepreneurship?

Economic growth comes from growth in the labor force and/or gains in productivity. In recent years productivity growth has been half the historical average, making population growth especially important to economic growth. And given demographic realities like the retirement of the baby-boom generation and historically low birth rates, immigration has accounted for half of labor force growth in recent years. Were it not for immigration, the United States would be Japan—shrinking in population, economically stagnant, waning in global importance.

But the benefits of robust immigration reach far beyond the impact of simply more people working and consuming. Research shows immigrants to be highly entrepreneurial. To immigrate requires a willingness to pick up one's life and move, often at great personal and financial risk, to a different country, with a different culture, and often a different language—a profoundly entrepreneurial act.

It should be no surprise, then, that immigrants are twice as likely as native-born Americans to start a business. Though just 15 percent of the population, immigrants account for a quarter of all small businesses. And, as you point out, 40 percent of Fortune 500 companies were founded by foreign-born entrepreneurs or a child of immigrants. Iconic American companies founded by foreign-born entrepreneurs—and employing millions of Americans—include Intel, Google, Yahoo, eBay, Tesla, YouTube, PayPal, Nvidia, Pfizer, LinkedIn, Levi Strauss, Sun Microsystems, Dow, AT&T, DuPont, and Anheuser-Busch. We want the next generation of these companies launched here in the United States, creating jobs, opportunity, and careers for Americans.

Immigrants are also highly innovative—again, a reality that should not surprise. A 2012 study found that foreign-born researchers were involved in more than 75 percent of the nearly 1,500 patents awarded at the Nation's top 10 research universities. Last year, all six of America's Nobel Prize recipients were immigrants.

The net result of immigrants' propensity for innovation and entrepreneurship is job creation. This effect is most pronounced for immigrants with advanced degrees from U.S. universities working in science and technology fields. According to a study by the American Enterprise Institute, between 2000 and 2007 each group of 100 foreign-born workers with such backgrounds was associated with 262 additional American jobs.

With these realities in mind, immigration reform to enhance American entrepreneurship and ensure America's economic competitiveness reform should include:

- A new green card category should be created to attract foreign-born graduates in science and technology based on a points system focused on skills, level of education and training, and other key metrics.

- Green cards should be granted to foreign-born students who complete a degree from an American college or university who wish to remain in the United States and who meet national security requirements. Under current policy, foreign-born graduates are required to return home, taking their U.S.-acquired human capital with them.

- A start-up visa should be created for foreign-born entrepreneurs who want to launch new businesses in America—the United States is the only industrialized nation that does not have such a visa category. A 2013 study by the Ewing Marion Kauffman Foundation concluded that a start-up visa would create between 500,000 and 1.6 million new American jobs over 10 years.

THE STARTUP ACT

Mr. Dearie, one of the most important things we can do to support entrepreneurs and our innovation economy is to increase the pace of commercialization—bringing research out of labs and into the marketplace. I am an original cosponsor of the Startup Act, which includes provisions to support entrepreneurs in getting Federally funded research off the shelf and into the market. Supporting this kind of activity creates new companies and jobs, along with a payoff on the Federal dollars invested in the initial research.

From your experience supporting entrepreneurs and in venture capital, how will increasing the commercialization of new technologies support these entrepreneurs and our innovation economy?

Federal funding of research and development (R&D), most of which is conducted at colleges and universities, is a critical aspect of America's innovation and entrepreneurial ecosystem. Accelerating the process by which new innovation is commercialized—by reducing obstacles and bottlenecks, and streamlining the commercialization process—will greatly enhance entrepreneurship and help accelerate economic growth.

The Federal Government accounts for about 30 percent of all R&D investment. Most critically, whereas businesses fund and conduct the vast majority of applied R&D, about 70 percent of basic research is funded by the government and conducted primarily at U.S. colleges and universities.

Basic or pure research is conducted to gather general information and to build on existing knowledge and understanding. Applied research is conducted for more targeted purposes—to resolve a particular question or to achieve a specific commercial objective. For example, a neurologist who studies the human brain to understand its structure and general workings is conducting basic research. A neurologist who studies the brain to determine the causes of Alzheimer's disease is conducting applied research.

While businesses conduct some basic research, they are generally not well suited for such research. First, individual businesses are generally unable to take on the scale and risk that basic research entails. Moreover, firms are highly unlikely to invest in research that has an unknown outcome or that is unlikely to produce an immediate practical application. Basic research results are also not patentable. Finally, because businesses naturally hope to capture the full economic payoff of any R&D expenditure, they are less inclined to share any spillover benefits, limiting the broader societal value of such research.

And yet basic research—in addition to expanding human understanding of science and technology—is also the basis for applied research, establishing the context of knowledge and understanding within which additional progress can be made regarding specific inquiries.

In this sense, applied research by businesses depends on basic research funded principally by government. Indeed, government funding of basic research has played a critical role in driving many technological breakthroughs that have helped U.S. industry become a global technology leader. Sun Microsystems, Pfizer, Google, Genentech, and Cisco are examples of companies whose origins can be traced back to basic research funded by the government.

Unfortunately, the U.S. government's commitment to R&D has waned dramatically in recent years. The Federal share of total R&D peaked at 67 percent in 1964, before slowly declining to 30 percent by 2009. After growing at an inflation-adjusted average annual rate of 7 percent between 1950 and 1990, growth in government outlays for R&D fell to an annual average of just 1.4 percent between 1990 and 2012.

Meanwhile, other nations have dramatically expanded government support of R&D. Over the period 1992 to 2009, Australia increased government R&D spending at an average annual rate of 9 percent, South Korea by 11 percent, Singapore by 14 percent, and China by nearly 20 percent.

Circumstances are even more alarming when government R&D expenditures are considered as a percentage of GDP. U.S. government R&D fell steadily from a high of 2.2 percent of GDP in 1964 to a low of 0.7 percent of GDP in 2000, and has remained at or below 1 percent of GDP ever since.

If America is to retain its status as the world's innovation leader, the multi-decade decline in the commitment of Federal dollars to scientific research must be reversed.

Questions for the Record Submitted by Senator Mike Lee and Responses from Mr. Scott A. Hodge

In our current tax reform debate, there is a stark contrast of opinions about some of the major concepts being considered. For example, take the corporate tax. One side of the aisle consistently argues that a cut to our 35% corporate tax would be a simple handout to the wealthiest executives. However, a real look at exactly how the corporate tax works reveals that this regressive tax actually taxes a combination of capital and labor—both the investor's dividends and the wages of the workers. Although economists debate what this ratio truly is, it is commonly understood that lost worker wages make up between one-quarter and one-half of corporate tax revenue—and possibly even more. This is why in January I proposed eliminating the corporate tax altogether, and shifting the tax burden on investors instead of workers, by taxing capital gains and dividends at ordinary individual income rates. Under this strategy, workers would be liberated from their share of the corporate tax burden, and America would, without a doubt, become the most popular place to invest and do business. Mr. Hodge, can you comment on this proposal, and possibly elaborate on the effects that such a strategy would have on the entrepreneurial community and overall investment in new and growing firms?

The approach of reducing entity-level taxes and raising shareholder-level tax on income earned by C corporations is a fundamentally sound one.

Generally speaking, a tax system is more efficient when it applies taxes to immobile activities, rather than mobile ones. Corporations are highly mobile: in an era of open global capital flows, corporations can easily move operations into more competitive jurisdictions if U.S. marginal tax rates are high. On the other hand, U.S. shareholders are less mobile: when taxed on their investment income, they will not generally decide to expatriate (although they may decide to save less and consume more).

Furthermore, there is reason to believe that current entity-level taxes on C corporations are more harmful to investment than shareholder-level taxes on the same income. This is because the current corporate income tax contains a significant bias against physical business investment: businesses are not allowed to deduct the full cost of their investments in equipment, machinery, and structures. Meanwhile, shareholder-level taxes are levied on distributed business cash flow—a tax base that does not include a bias against physical investment.

All in all, lowering entity-level taxes and raising shareholder-level taxes is a policy trade that could encourage investment in the United States and increase growth.

There are at least two concerns to which lawmakers should be attentive when designing a plan to lower entity-level taxes with shareholder-level taxes.

First, a significant amount of U.S. corporate equity is held by foreign shareholders. These parties would benefit from a lower U.S. corporate rate, but would not necessarily remit higher shareholder-level taxes to the U.S. Federal Government; this could lead to significant revenue loss. This problem could be ameliorated by creating a withholding tax on corporate dividend payments, which would be refundable to taxable shareholders, but non-refundable to foreign and other tax-exempt shareholders.

Second, raising tax rates on capital gains may create a lock-in effect, where shareholders become more reluctant to sell their equity holdings in the presence of high rates that occur upon realization. This problem could be ameliorated by creating a partial deduction for realized capital gains that are reinvested.

Mr. Hodge, you have testified about your skepticism regarding a special rate for pass-throughs, but given the current tax reform framework's proposal to have a separate pass-through rate and to have rules to minimize tax avoidance—what, in your opinion, should those rules look like?

Many lawmakers have proposed enacting a maximum tax rate on pass-through business income which is lower than the top ordinary income tax rate. For instance, the recently released Unified Framework from Republican leadership calls for a maximum tax rate of 25 percent on pass-through business income, while proposing a top tax rate of at least 35 percent on ordinary income (such as wages and salaries).

This proposal would mean that, for the first time since the creation of the Federal income tax in 1913, income from pass-through businesses would be taxed on a separate rate schedule from income from wages and salaries.

A number of economists, accountants, tax lawyers, and policy experts have raised concerns that this approach could lead to tax avoidance. Specifically, the proposal would create an incentive for sophisticated taxpayers to try to re-categorize their wage income as pass-through business income for tax purposes, in order to take advantage of the lower rate.

One particularly concerning avenue for abuse is the case of individuals who are both owners and employees of a business—such as a lawyer or accountant. In these cases, a business would have an incentive to lower its wages for owner-employees, which would lead to higher business profits. As a result, the owner-employees would report lower wages and higher pass-through business income on their personal returns, which would lead to tax savings.

In my view, there are three basic families of approaches for combating the potential tax avoidance that could arise under a preferential rate schedule for pass-through business income. The first two would attempt to define the portion of a business' payment to an individual that represents bona fide business income, as well as what portion represents a compensation for labor provided (i.e., disguised wage income). The third would simply exclude certain pass-through businesses or owners from the benefits of a lower rate.

The first family of approaches could be termed "formulary" approaches. These would attempt to define the portion of a business' income that is eligible for a lower pass-through rate by a mathematical formula. Formulary approaches are likely more effective at combating potential abuse of a lower pass-through rate, because they leave less room for creative accounting. However, they run the risk of mischaracterizing arrangements between businesses and owners, as formulas may not always reflect economic realities.

One formulary approach would be to deem 70 percent of a business' payments to an owner-employee as "wages" and 30 percent of the business' payments as "profits." The benefit of this approach would be to remove ambiguity about what counts as business income, making abuse more difficult. However, business arrangements with owner-employees vary widely, so this approach might not perfectly match the reality of each arrangement.

A more promising formulary approach would focus on the amount that each owner has invested in a pass-through business (this is known as an "asset-based approach”). After all, if the rationale for a lower rate on pass-through businesses is to encourage investment in the United States, it may make sense to limit the benefits of the lower rate to owners who have invested the most in the business. Under this approach, owners would track their basis in each pass-through business and calculate a “normal return” to their investment. The amount of normal investment return would be eligible for a lower rate, while income that exceeds a normal return would be deemed ineligible for the lower rate. After all, business profits that exceed a normal return are likely to represent investments that are so profitable that they would have been made even without a rate cut (or, alternatively, disguised wage income).

A second family of anti-abuse approaches are those based on “facts and circumstances.” These would attempt to describe, in qualitative terms, which payments from businesses to individuals should be categorized as compensation for labor services provided and which ones should be categorized as business profits.

Current law already contains at least one “facts and circumstances” anti-abuse rule: the requirement that S corporations provide “reasonable compensation” to owner-employees for the labor they provide to the business. This rule is intended to discourage taxpayers from recategorizing wages as business profits for the purpose of reducing self-employment taxes.

However, there is reason to believe that the current reasonable compensation standard is relatively weak. In 2009, the Government Accountability Office found that there is significant use of S corporations to recategorize wages as business profits.

Some have proposed trying to strengthen the reasonable compensation standard, or creating a new “facts and circumstances”-based standard for preventing abuse. One proposal would require businesses to compensate owner-employees in line with industry norms. Another would create a new third-party verification system, relying on large accounting firms to independently ensure that pass-through businesses are not disguising wages as business profits.

The strength of the “facts and circumstances” approach is that these standards may more accurately reflect the arrangements between businesses and owners. However, because these tests are ultimately subjective, they run a much larger risk of abuse and manipulation.

Finally, a third approach to combating abuse of a lower pass-through rate would be to exclude certain pass-through businesses or owners from the benefits of a lower rate. For instance, some lawmakers have proposed excluding “personal service companies,” such as law firms and accounting firms, from the benefits of a lower rate. The rationale for this idea is that such businesses typically earn a large share of their gross revenue from labor, rather than from investment; as such, these businesses might be especially likely to recategorize labor income as business profits.

This third approach could greatly limit the available opportunities for abuse of a lower pass-through rate. However, it could also make the tax code less neutral between different sectors of the economy.

Ultimately, none of these approaches would be perfect at preventing abuse. Indeed, whenever lawmakers create different tax rates on different categories of income, there will always be some potential for creative accounting to maximize the amount of income subject to the lower rate.

Questions for the Record Submitted by Representative Barbara Comstock and Responses from Mr. Scott A. Hodge

Below is the citation for my comment to Representative Comstock about the number of companies that have moved offshore.

More than 50 companies have moved their headquarters abroad since 1981. Zachary Mider, “Tax Inversion,” Bloomberg, March 2, 2017. *https://www.bloomberg.com/quicktake/tax-inversion*

Questions for the Record Submitted by Senator Amy Klobuchar and Responses from Ms. Falon Donohue

Crowdfunding

Ms. Donohue, both of you have helped raise the capital needed by a startup. I supported the JOBS Act, which will help entrepreneurs to use crowdfunding as another source of capital.

How is crowdfunding different from traditional bank financing and how can crowdfunding help start-ups gain access to capital?

Crowdfunding can be a very useful source of capital for many startups. In Ohio, my friends at OROS Apparel used the crowdfunding site Kickstarter to raise more than $350,000 and gain early users of their NASA inspired outdoor apparel. In this case, crowdfunding allowed the OROS founders, undergraduate students at Miami University in Oxford, Ohio, to start a highly capital intensive apparel product company before they even graduated. Since that time, OROS has raised more than $1,000,000 in traditional venture capital from NCT Ventures and continues to create innovative products.

A clear benefit of crowdfunding is the ability to validate your product and acquire early customers before committing large sums of capital to build out your company or product. In addition, because crowdfunding takes place on the internet, geographic boundaries do not limit the companies to a particular set of investors.

Generally, crowdfunding is best for companies with mass public appeal. While crowdfunding does not work for every company and many will have to continue seeking traditional financing to help build their companies, crowdfunding can be a very useful way to access capital for companies with mass appeal.

THE STARTUP ACT

Ms. Donohue, one of the most important things we can do to support entrepreneurs and our innovation economy is to increase the pace of commercialization—bringing research out of labs and into the marketplace. I am an original cosponsor of the Startup Act, which includes provisions to support entrepreneurs in getting Federally funded research off the shelf and into the market. Supporting this kind of activity creates new companies and jobs, along with a payoff on the Federal dollars invested in the initial research.

From your experience supporting entrepreneurs and in venture capital, how will increasing the commercialization of new technologies support these entrepreneurs and our innovation economy?

Tech commercialization and tech transfer is an important way for many people to begin their entrepreneurial journey.

Employing technology, which is born from validated research and experimentation at a university or research institution, may increase the chance of success for a company, in turn creating good-paying jobs. It also ensures new products and companies are created from the taxpayer-funded research and development process of our public universities.

Many of the research institutions and universities in Ohio have seen increasing success commercializing their technology and intellectual property. In many cases, the institutions and venture capital partners have combined resources to enable capital deployment for companies which have successfully commercialized technologies.

In Ohio, companies like Nikola Labs, which was born from research in The Ohio State University's ElectroScience Lab, and Assurex Health, which licensed technology from Mayo Clinic and Cincinnati Children's Hospital Medical Center, are both examples of companies demonstrating why strong tech commercialization is increasingly useful to our innovation economy.

QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR AMY KLOBUCHAR AND ANSWERS FROM MR. JOHN ARENSMEYER

CROWDFUNDING

How is crowdfunding different from traditional bank financing and how can crowdfunding help start-ups gain access to capital?

Crowdfunding is an alternative method for startups to raise capital. Equity Crowdfunding (targeted by the JOBS Act) differs from traditional financial institutional lending, in that a large group of small-contribution shareholders provide the necessary startup capital. This is primarily based in online social media, a form of social lending.

Crowdfunding helps provide entrepreneurs with limited access to financial lending with a chance to get their businesses off the ground with community support. It is believed that crowdfunding has raised over $34 billion since 2003.

While many entrepreneurs have been afforded great success with crowdfunding, a large majority do not. On their own, most entrepreneurs can expect to raise an average of $10,000 or less through online crowdfunding. Several cities, like Philadelphia, have made attempts to correct this by facilitating crowdfunding through the Kiva platform.

Small Business Majority was also a strong supporter of the 2012 JOBS Act. This legislation allowed rules to be put in place to allow companies broader access to startup capital through crowdfunding.

THE DEFERRED ACTION FOR CHILDHOOD ARRIVALS (DACA) PROGRAM

How would immigration reform boost entrepreneurship?

DACA recipients make up a vast number of our Nation's youngest and brightest students, entrepreneurs and small business owners. From the Center for American Progress, based on a scientific survey of 3,063 DACA recipients: 5% of all DACA enrollees and 8% of those older than 25 years old have started their own businesses in the United States, compared to a rate of 3.1% for the U.S. population as a whole.

All immigrants start businesses at twice the national average. It is crucial to ensure proper immigration reform allows for these young men and women—who have grown up and lived their lives in the United States—to stay and continue contributing to a robust and innovative economy. It is not in the best interest of the small business community for the DACA program to remain unresolved.

Small Business Majority's polling shows a vast majority—74%—of our Nation's small business owners agree that the most appropriate immigration solution is to create a path toward citizenship accompanied by effective enforcement. Three-quarters believe we would be better off if people who are in the country now illegally became legal taxpayers, so they can pay their fair share. We must implement responsible immigration reform and combat policies that inhibit the economic benefits our immigrant population brings to our country. This includes:

- Passing a comprehensive immigration law guaranteeing eventual citizenship for those who play by the rules and contribute to our economic success, coupled with appropriate and reasonable employment verification provisions.
- Supporting expansion of the existing H–1B visa program to allow more visas for low-skilled workers.
- Opposing efforts to needlessly inhibit the success of immigrants in the country when there is no countervailing security reason to do so.

START-UP AND SMALL BUSINESS TAX INCENTIVES

What other commonsense tax policies can we put in place that target businesses as they are starting out?

We need a tax system that benefits America's entrepreneurs who are focused on growing their enterprises and making payroll at the end of each month. Small business owners feel that our tax system primarily benefits wealthy corporate interests at their expense. They don't want special treatment; they simply want to compete on a level playing field.

Small Business Majority's polling has shown that 90% of small business owners believe big corporations are using loopholes to avoid taxes that small businesses have to pay, and 92% believe corporations' use of those loopholes is a problem.[1] Similarly, 9 in 10 small business owners believe that U.S. multinational corporations' use of these loopholes to shift U.S. profits overseas is a problem. What's more, three-quarters believe their small business is harmed when loopholes allow big corporations to avoid taxes.

That's why we're concerned by the current proposal for tax reform. While some are touting the plan as a boon for small businesses, the reality is that it will not actually benefit most Main Street businesses and would greatly add to the deficit. Indeed, the proposal would add at least $2.4 trillion to the deficit over 10 years according to the Tax Policy Center, and would continue to put small businesses at a disadvantage by not addressing corporate loopholes.[2]

Some claim the current proposal to cap the tax rate for pass-through entities at 25% would be a boon for small business. In fact, this would impact only a handful of small firms according to the Tax Policy Center analysis. More than 87% of pass-through entities already pay a marginal tax rate of 25% or less, and less than 2% pay the current top marginal rate of 39.6%. Moreover, if individual tax brackets are streamlined to 12%, 25% and 35%, pass-through entities that would benefit from the pass-through cap rate would include only the 1.8% earning $425,000 or more.

A startling 88% of the savings generated by cutting the pass-through rate to 25% would go to the top 1% of earners. In short, this proposal would primarily benefit

[1] Small Business Majority, October 2012, *http://smallbusinessmajority.org/our-research/government-accountability/opinion-poll-small-business-views-taxes-and-role-government*

[2] Tax Policy Center, September 2017, *http://www.taxpolicycenter.org/publications/preliminary-analysis-unified-framework*

hedge fund managers, lobbyists and investment bankers—not Main Street small businesses.

And, last but not least, a tax code with a large gap between top individual rates and top pass-through rates can potentially encourage wealthy individuals to game the system by simply declaring themselves pass-through business entities.

If Congress wants to offer a responsible tax cut for most Main Street small businesses, and offset that cut with a reduction in existing loopholes, allowing all businesses to deduct a modest amount of their profits would have a much greater impact.

As for corporate taxes, cutting the top rate would help some small businesses that are organized as C corporations, especially considering small businesses are unable to take advantage of the same accounting loopholes as large corporations. But doing so without getting rid of corporate tax loopholes would greatly increase the deficit. Economists from the Tax Policy Center estimate that reducing the corporate rate to less than 26% would be impossible to offset with just a reduction in loopholes; a reduction to 20% would reduce Federal tax revenue by $1.6 trillion over 10 years.[3]

This is why it's crucial to implement policies that will help all entrepreneurs rather than giving tax breaks to those who need it least. Any substantive changes to the tax code must promote economic development from the bottom-up, enacting policies that benefit small businesses, rather than the top-down. Our specific proposals include the following:

- Ensure any changes to the corporate and personal tax codes have a significant, direct benefit to small businesses and self-employed individuals, as opposed to large businesses, hedge funds and the very wealthy.
- When considering a targeted, responsible reduction in business tax rates, ensure that it is accompanied by the elimination of costly loopholes that primarily benefit the wealthy and large corporations, such that the result is revenue-positive, or at least revenue-neutral.
- Instead of reducing pass-through business income tax rates from the top down in a manner that benefits only a sliver of small businesses, we urge the committee to examine a proposal as part of regular order discussions about tax reform that would benefit small businesses from the bottom up, rather than the current top-down proposals that will only benefit wealthy individuals. For example, we propose allowing small businesses to deduct their first $25,000 in business income whether or not they file their tax returns as a pass-through entity or as a C corporation. This deduction should be paid for by eliminating loopholes and be accompanied by a phase-out for businesses with $150,000–200,000 in income to ensure it is targeted to the majority of Main Street small businesses.
- Consider a modest reduction of the nominal corporate tax rate, thus reducing the actual tax rate for most C corp small businesses, while eliminating unfair, inefficient tax loopholes in a manner that ensures a net revenue increase to bring down our deficit and fund key programs. Loopholes that can be eliminated include offshore tax deferral and the carried interest deduction.
- Reject the current proposal for "full expensing" of all capital purchases. Small businesses can now expense their first $500,000 of capital expenditures under Section 179. Allowing for full expensing above that level would have little benefit to them.
- Oppose any efforts to reduce top individual tax rates. It is a myth that top individual tax rates adversely harm Main Street small businesses. Only 1.7% of pass-through businesses pay income tax at the top rate.[4]
- Oppose the enactment of a "territorial" corporate tax system that would allow a select few large multinational corporations to game the system by funneling their profits to the lowest-taxation foreign jurisdictions.
- Crack down on the ability of large corporations to reduce their tax burden simply by parking their profits offshore or moving their headquarters outside the country.
- Uphold the estate tax in its current form, understanding that it currently protects virtually all small businesses and family farms.[5]
- Ensure parity between online and bricks-and-mortar businesses with a reasonable and fair internet sales tax solution.

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[3] Tax Foundation, May 2016, *https://taxfoundation.org/costs-20-corporate-tax-rate-are-temporary-while-benefits-are-permanent/*

[4] Tax Policy Center, August 2016, *http://www.taxpolicycenter.org/model-estimates/distribution-business-income-august-2016/t16–0185-sources-flow-through-business*

[5] Tax Policy Center, 2017, *http://www.taxpolicycenter.org/briefing-book/who-pays-estate-tax*

- Simplify and expand the small business tax credit created by the Affordable Care Act—helping more small businesses qualify for and utilize it.
- Pass healthcare tax equity for the self-employed so that freelancers can deduct their healthcare expenses from their FICA tax obligations—just like other business entities.
- Enact the bipartisan Investing in Opportunity Act that will help revitalize economically distressed communities by, among other things, allowing investors to temporarily defer capital gains recognition if they invest in an "opportunity zone."
- Increase limits for deducting start-up and organizational expenses from the current $5,000 levels to $10,000 each.
- Allow very small firms to use a simplified method of cash accounting.

These changes will provide critical benefits to the entrepreneurs and small business owners who need it most, allowing them to grow and expand their business on a level playing field with large corporations.

THE STARTUP ACT

From your experience supporting entrepreneurs and in venture capital, how will increasing the commercialization of new technologies support these entrepreneurs and our innovation economy?

The Startup Act has facilitated the commercialization of technology through critical Federal funding to higher education institutions and developmental laboratories. Taxpayer supported research gives the United States economy a competitive edge over our global competitors by fast tracking technological developments to commercial production phase. This is key to stimulating our innovative economy. Not only did the Startup Act provide research provisions, but sought to attract immigration by STEM graduates by offering permanent residency. Increasing the number of STEM innovators in our economy provides us with the human capital to remain the world's leading technological innovator.

QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR MARGARET WOOD HASSAN AND RESPONSES FROM MR. JOHN ARENSMEYER

WOMAN-OWNED BUSINESSES

What are some ways that we can include these types of service-based firms and thus make it easier for women-owned businesses to start-up and grow?

There are over 8 million women owned firms in the United States today, and of those, 90% are small businesses.

Since our inception, Small Business Majority has been active in redressing business-related inequities across the board, including by advancing entrepreneurship opportunities for women and pressing for workplace policies like family medical leave, secure healthcare and paid sick days that ease work-life complexities for women.

In 2015, we launched our Entrepreneurship Program, targeted to underserved communities. The program delivers information that small business owners need to launch and run a successful business, including resources and education specifically geared toward women business owners. The program builds on our 12 years of work organizing small business owners and establishing partnerships with business organizations such as regional Women's Business Centers. The program is focused initially in nine cities across the country where we have staff on the ground—Baltimore, Columbus, Chicago, Denver, Los Angeles, San Francisco Bay Area, Springfield (MO), St. Louis and Washington, D.C.—with companion national webinars and educational websites.

Women's Entrepreneurship Program

As part of our expanded Women's Entrepreneurship Program, we will deliver targeted education and resources specifically geared for women business owners. We will launch this program nationally, with an initial focus on 2–3 metropolitan areas. Here is our plan:

Access to capital

Increasing women's access to and options for obtaining capital is a top priority of our Entrepreneurship Program. Although women-owned firms are the fastest-growing segment of businesses, studies find that women do not get sufficient access to loans and venture investment. According to the Small Business Administration, women account for a paltry 17% of SBA loans, even though they represent 30% of all small companies. In their report, "Empowering Equality: 5 Challenges Facing Women Entrepreneurs," Third Way researchers found that women entrepreneurs are more likely to finance their business startup with personal debt.

Our access to capital program was designed to address these issues. It offers unbiased, business-based education and information about access to responsible sources of capital. Topics range from how to find and secure financing, to navigating the growing number of lending and repayment options, to raising awareness about predatory lending. Our unique role in this growing ecosystem is to reflect and deliver on the needs of entrepreneurs in a comprehensive, unbiased fashion. We do not provide the actual loans or technical assistance services. We do, however, make sure that after we educate entrepreneurs that we direct them to the appropriate doors to address their needs.

The umbrella program offers the following activities and resources:

1. Education and outreach: We educate women entrepreneurs about lending options, how to protect themselves from predatory loans and funding opportunities specifically for women entrepreneurs, such as Federal grants, microloan programs geared toward women such as Kiva, and venture capital opportunities such as SheEO. We will expand our partnerships and form new partnerships with business organizations that serve women entrepreneurs, including the Association of Women's Business Councils, to cosponsor online and in-person for women entrepreneurs.
2. Resource and community portal: We will expand our online resource portal that helps entrepreneurs make sense of the financing environment. The portal currently includes our educational resources, a locator to find local CDFIs and technical assistance providers, blog posts, industry news, and additional resources such as online calculators, tips on creating a business plan, and other advice such as information on how personal credit scores can affect small business owners' loan eligibility.

To expand the portal, we will develop a community portal within our existing website that will facilitate peer-to-peer connections. The first version of this portal will be targeted to women. Members will be encouraged to leave comments, ask questions, create profile pages and reach out to other members. The goal of this community portal will be to build networking opportunities for women entrepreneurs. The portal will also include information on mentorship and procurement opportunities and resources (see below). We will launch this portal as a pilot in a few designated cities and expand it over time.

3. Online lending portal: We will design our SimpleGrowth online lending portal and outreach efforts to target women entrepreneurs, by including CDFIs and other lenders that have loan program specifically geared for women and marketing the platform to our women business owner networks.

Procurement

Women entrepreneurs also lag in procuring State and Federal contracts. While the Federal Government has had a stated goal since 2000 of ensuring women-owned businesses receive at least 5% of Federal contracts, this goal was only just met in 2015. To help women in this critical area of entrepreneurship, we will offer targeted assistance to national, State and commercial efforts to improve procurement opportunities for women through the following activities:

1. Outreach and education: We are adding a procurement component in our Entrepreneurship Program designed to educate women business owners about their procurement options, particularly Federal procurement, and how to obtain certification as a woman-owned business. It will include an overview of the SBA's WOSB Federal Procurement program, strategies for pursuing corporate procurement, and local resources and networks that can help.
2. Partnerships and resource connections: We will form partnerships with groups that specialize in procurement opportunities, provide them with audiences from our small business network, invite them to speak at our events, cohost events with them and distribute information through our networks, portal and events. We also will build out a section of our portal dedicated to procurement opportunities for women entrepreneurs.

Mentorships and networking

It is widely known, through anecdote and analysis, that women have a more difficult time finding mentors than men. Indeed, according to a survey of more than 1,000 working women conducted by networking site LinkedIn, 1 out of 5 women say they've never had a mentor. The Third Way report also found that women lack the networks and "social capital" entrepreneurs need to start and grow their firms. Our own informal focus groups of women small business owners have shown us that women seek and need more mentorship and networking opportunities. We will address this issue through the following activities:

1. Education and resources: We will include a mentorship component to our Entrepreneurship Program, educating women entrepreneurs on mentorship opportunities and programs such as those offered by Small Business Development Centers, SCORE offices and our other partners. At our events, we will encourage women business owners to sign up for and use our community portal, with the goal of building a network of entrepreneurs who can both offer and seek out mentorship and networking opportunities through our portal.
2. Partnerships and resources connections: We will add to the networking and knowledge bank on the issue by compiling these resources, listing them on our website and forming partnerships with mentors whom we can connect to small business owners. Over the years, we have developed strong relationships with local Small Business Development Centers and other mentorship groups such as Pacific Community Venture's BusinessAdvising.org program, which offers free mentorship to entrepreneurs across the country.

Childcare

For women with children, the cost and difficulty of finding high quality childcare remain an obstacle to their entrepreneurship. A 2010 Census paper on married stay-at-home mothers noted that "especially for mothers who have more than one child under 5, the cost of day care might be higher than she could support unless she has fairly high earnings." A recent study by the Ms. Foundation found that full-time child care costs for an infant eat up 41% of the average income of a single mother. This puts the mother in the position of working just for childcare. Our childcare work will include the following activities:

1. Outreach and education: We will launch an outreach program designed to educate women business owners about childcare policies that they can set up at their businesses as well as policies and tax changes being studied at the national level. We will set up and hold a series of roundtable discussions to examine the issue of affordable, high quality childcare and its consequences for the success of a woman-owned business and effects on her bottom line.
2. Partnerships and resource connection: We will form partnerships with groups that specialize in childcare issues, provide them with audiences from our small business network, invite them to speak at our events, cohost events with them and distribute information through our networks, portal and events. We will build out a section of our portal dedicated to childcare issues, resources on tax credits and other policies that provide benefits to small business owners for providing childcare, and policy updates for women entrepreneurs.

Policy support

On the Federal, State, and commercial levels, Small Business Majority will track the following issues and engage our small business network and alliances. This engagement will be designed to bring the small business voice to the table. We start with research and polling to determine small business owners' needs and concerns. We then use our outreach and educational events to locate these spokespeople and then deploy our outreach and communications staff to vet and train them to speak out in a variety of settings and audiences: op-eds, letters to the editor, legislative hearings and meetings with policymakers. We also work to create opportunities for them to get their voices onto the public stage and coordinate with advocacy partners to provide spokespeople on a given issue.

- Supporting the Women's Small Business Ownership Act: Introduced in October 2015, the act would address the gender gap in lending by expanding or improving SBA programs to reach more women seeking business loans.
- Making permanent the fee waiver on SBA loans under $150,000: This has been extended through 2016, but a permanent waiver would be helpful because these smaller loans often help finance women, minorities, veterans and other underserved individuals interested in creating new startups and entrepreneurship. According to the Urban Institute, SBA loans are three to five times more likely to go to women and minority-owned businesses than conventional loans.
- Support the current movement within Federal procurement to increase Federal Women Owned Small Business (WOSB) total dollar procurement targets to 10% of all contracting dollars

- Support the development and expansion of training programs that teach women entrepreneurs how to leverage SBA certifications for Federal, State, and commercial work (such as WOSB, Women Business Enterprise and Economically Disadvantaged WOSBs)
- Support State efforts to remove the need for certifications from State-level procurement programs
- Support HR 4524, the Child CARE Act. Introduced in Congress this year, the Act would expand access to high-quality child care for infants and toddlers from low-income families who do not receive child care funded through the Child Care and Development (CCD) Fund
- Support State earned income tax credit and child care credits. Research has shown that both credits offer numerous benefits for working mothers and their children alike
- Support Federal and State efforts to implement paid family leave and paid sick days for small businesses, such as the FAMILY Act

Additional Women-Owned Business Research Material

Small Business Majority partner and Director of American University's Kogod Tax Policy Research Center, Professor Caroline Bruckner, testified before the House Committee on Small Business earlier this month on tax reform for entrepreneurs. Specifically, her research has a focus on women-owned businesses. We have separately sent her testimony and findings to supplement these answers for the record.

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