Tax

What is tax policy?
Congress is responsible for developing tax policy, while the Internal Revenue Service is responsible for the implementation of this policy. Federal tax policy includes several areas like personal taxes filed every year, various corporate taxes, and complex taxes on foreign profits of U.S. multinational corporations. States have their own tax systems which use credits and deductions to affect economic activity. The purpose of tax policy is not solely to raise revenue, but also to influence policy through the provision of tax credits and deductions.

Key Takeaways:
• Tax policy has a significant impact on startups and can represent a barrier to growth and formation.
• A simplified tax code is easiest for startups to navigate. Overly complicated and discriminatory tax frameworks could result in complex tax planning and passed-down costs for startups.
• Several states have enacted angel investor tax credits through which the state offers tax breaks for qualifying investments.

Why does it matter to startups?
Tax policy can be difficult for startups to navigate. Simple adjustments, like electronic filing of 83(b) elections, can ease this burden. While some tax benefits exist to assist startups and investors in offsetting their liabilities, many of these provisions can be improved. Benefits like the research and development (R&D) tax credit help startups fund critical and often costly research, while Section 1202 of the Internal Revenue Code excludes capital gains taxes for qualifying investments and encourages angel investment. Other considerations, like when stock-based compensation is taxed, can have a significant impact on the recruitment and retention of talent. Policymakers should consider new benefits to encourage startup formation and growth, particularly as the U.S. emerges from the pandemic. Many states encourage angel investment through tax credits, but comparable provisions do not exist at the federal level.

Where are we now?
R&D tax credit: Qualifying small businesses can currently take advantage of the R&D tax credit of up to $250,000 per year, offsetting the payroll tax. Companies also have the option of deducting their R&D expenses when they file their taxes. Policymakers should support efforts to continue allowing R&D expenses to be deducted each year, rather than spreading the deduction over five years beginning in 2022. Congress should consider expanding the cap on the refundable tax credit, expanding the credit itself, expanding eligibility for the credit, and even expanding the definition of what counts as R&D to include common software development activities.

First Employee Credit: Policymakers could also pursue a first employee tax credit that is equal to a percentage of W-2 wages filed. Because many startups are not yet profitable in their early stages, providing a tax credit against payroll tax liability would be particularly beneficial. And as the credit would be designed to help truly small businesses, the credit would be especially helpful to underrepresented founders.

Investor Tax Credits: While several states have enacted angel investor tax credits, there is no federal equivalent. Policymakers could consider enacting a federal counterpart that provides a credit of 25 percent to 50 percent of the amount invested in startups. Congress should also consider expanding the Opportunity Zone program, which provides tax benefits to individuals or corporations that invest in financially distressed regions.

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