April 8, 2025

The Honorable Roger Williams
Chairman
House Committee on Small Business
Washington, D.C. 20515

The Honorable Joni Ernst
Chairman
Senate Committee on Small Business & Entrepreneurship
Washington, D.C. 20510

The Honorable Nydia M. Velázquez
Ranking Member
House Committee on Small Business
Washington, D.C. 20515

The Honorable Ed Markey
Ranking Member
Senate Committee on Small Business & Entrepreneurship
Washington, D.C. 20510

Dear Chairmen Williams and Ernst, Ranking Members Velázquez and Markey, and members of the House and Senate Committees on Small Business,

Engine is a non-profit technology policy, research, and advocacy organization that bridges the gap between policymakers and startups. Engine works with government and a community of thousands of high-technology, growth-oriented startups across the nation to support the development of technology entrepreneurship through economic research, policy analysis, and advocacy on local and national issues. We appreciate the opportunity to provide input on the implications of tax reform for small businesses and startups.

Tax policy touches on all areas of the startup ecosystem. Startup friendly tax policy can help founders stretch their limited funds, help to de-risk entrepreneurship as a career pathway, enable hiring, and incentivize investment. Conversely, unfavorable tax policy can significantly inhibit startup formation and growth.

<u>Policies that enable startups to make their funds go further</u>

For decades, U.S. businesses have been able to immediately expense their R&D costs—much like other countries.[1] This tax treatment was critical in driving innovation by incentivizing and enabling startups to conduct R&D, which in turn helped founders build their companies and their teams. The 2022 shift to amortization and capitalization has been disastrous for U.S. startups. Companies have been hit with significant tax bills, forcing founders to make tough decisions including laying off employees, slowing growth, and ceasing R&D activities. One San Francisco-based founder explained, "if I spend money on R&D, I will go from breakeven to showing a large profit. I cannot afford the tax bill, so I am not investing in additional R&D hires at the moment."[2]

[1] Innovator Alliance, *Section 174: Full Expensing of Research and Development*, https://tecnatechnologycouncilsofnorthamericaca.growthzoneapp.com/ap/CloudFile/Download/P1Jwg24L.
[2] See feedback from startups at: https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/65aab57ad2e95b5842460f10/1705686396146/Startup+spotlight+R%26D+%281%29.pdf

While many companies were affected, this shift had an outsized impact on the innovation community, where novel ideas necessitate intensive R&D efforts. The resulting impact is slowed job growth, overall decline in R&D investment, and falling behind on innovation.[3] When the shift went into place, one founder told us the rule change "is a major disincentive to startup R&D. If it stays in place, it is going to materially impact startups as they invest in product development which they cannot deduct as they go, and could even cause a cash crunch for many startups at a critical time." Another founder explained that immediate expensing of R&D "allows small, early-stage technology companies to immediately re-invest those dollars in building more innovative solutions."

It is imperative that Congress immediately revert to immediate expensing for R&D costs, ideally retroactively—if not for all companies conducting R&D, for a carve out of tartups.[4]

Other policies that help startups build their businesses and stretch their funds do so by incentivizing companies, including startups, to invest in capital equipment, either through deduction or Section 168k depreciation. For startups that cannot take advantage of the Section 179 deduction, enhanced bonus depreciation helps enable new purchases of capital equipment by allowing businesses to more quickly recover the cost of those purchases. This is extremely helpful for cash strapped startups, but the provision is facing a full phase out in 2027.

Congress should restore 100 percent bonus depreciation in support of startup growth.

Policies that lower a startup's overall tax burden

As we've said in the past, lower tax liabilities mean that founders have more capital available to reinvest in and grow their companies. And, "[b]ecause corporations are taxed twice, at the business level and again at the shareholder level, a higher tax rate disincentivizes investment in businesses, including startups."[5]

But many startups are structured as pass throughs and can't avail themselves of the corporate rate. Currently, the 20 percent deduction for pass-through business income helps to equalize treatment between corporations and pass-throughs. The deduction, which, when coupled with the lower individual tax rates also implemented by TCJA, significantly lowers the top marginal rate for many startups and small businesses. If allowed to phase out at the end of the year, pass throughs will be at a significant disadvantage when compared with C corporations.

Making the 20% pass-through deduction permanent would ensure this disadvantage does not come to pass and would allow startups to better reinvest in their companies, increase employee wages, and expand their businesses.

Policies that incentivize employees to join early stage startups

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[3] Innovator Alliance, *supra* note 1.
[4] See feedback from startups at: https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/65aab57ad2e95b5842460f10/1705686396146/Startup+spotlight+R%26D+%281%29.pdf
[5] Engine, *What's on the table—and chopping block—for tax reform in 2025*, https://static1.squarespace.com/static/571681753c44d835a440c8b5/t/66f58b203278a83768edad64/1727367968434/Engine+2025+tax+reform+two-pager+%284%29.pdf.

Launching a startup is a risky endeavor, as is joining an early stage company. Section 1202, or the Qualified Small Business (QSBS) exemption, incentivizes early employees to join startups, as well as startup investment, by permitting investors to exclude part or all of the capital gains earned when selling QSBS, if the stock is held for a minimum of five years. It is a crucial tool in a founder's toolbox when hiring, allowing startups to grow their teams at a time when they may be unable to compete with the salary packages of established companies. Without QSBS treatment, startups will struggle to hire needed talent, stifling innovation.

It is imperative that policymakers maintain the current 100% exclusion on QSBS. Policymakers should also consider expanding the tax treatment, including by expanding it to benefit more companies and through a lower, phased in holding period.[6]

Policies that incentivize entrepreneurship

As we've previously stated, launching and growing a startup is a risky endeavor that is often unaccompanied by benefits enjoyed by employees of established companies. Provisions like the child tax credit, help to provide a cushion for entrepreneurs raising families. We know tax benefits like the CTC work—during the pandemic the child tax credit was expanded, helping to enable more parents to work, including through entrepreneurship. The TCJA levels of the CTC are set to expire at the end of this year, dropping the credit to a maximum credit of $1,000 per child.

Policymakers should implement an expansion to the CTC, so that more Americans can undertake the risk associated with entrepreneurship while raising their families.

Policies that incentivize startup investment

Investment is critical to the success of the startup ecosystem. A number of policies drive investors to direct funds to innovators. The tax treatment of carried interest, for example, helps to support emerging fund managers who are more likely to issue smaller dollar checks critical to very early stage startups across the country. And favorable tax treatment for long term investments incentivizes investment in the innovation ecosystem.

Other policies, like qualified opportunity zones (OZs), which are set to expire in 2026, allow investors to temporarily defer capital gains when those gains are placed in qualifying Opportunity Funds and a permanent exclusion on capital gains when investments in qualifying Opportunity Funds are held for a minimum of 10 years. This incentive is crucial for many startups. As Omaha, NE-based founder Andrew Prystai explains, because of the benefits provided by the OZ program, his company is an example of OZs succeeding, through which they've "hired over 10 employees throughout our history, raised over $1 million in venture capital, went through a Techstars program, won the 2021 Omaha Tech Startup of the Year, and have expanded to promote events in more than 200 cities across the U.S."[7]

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[6] See resources from the Innovator Alliance, at: https://innovatoralliance.org/policies

[7] Engine, *Opportunity Zones are expiring and startups need Congress to act* (Dec. 6, 2024), https://engineadvocacyfoundation.medium.com/opportunity-zones-are-expiring-and-startups-need-congress-to-act-dabbd9e509b6.

But while the OZ program is helpful, it is currently most beneficial in real estate. Reforms could be implemented to incentivize more startups to launch or relocate to OZs. Mr. Prystai explains:[8]

> [P]olicymakers could provide the same opportunity zone capital gains benefit that applies to selling our company to other equity holders like founders and employees with common stock, as currently the capital gains benefits upon sale of an OZ business are only applicable to OZ investors. They could also explore introducing other tax credits, especially refundable tax credits, that provide working capital to the businesses in the OZs as they continue growing jobs and investing in those areas.

At minimum, policymakers should reauthorize the opportunity zone program—but to truly strengthen the program, consider reform as well.

Thank you for the opportunity to provide feedback on 2025 tax reform and the potential impact on startups. We look forward to serving as a continued resource for the committee on the needs of the startup ecosystem.

Sincerely,

Engine Advocacy
700 Pennsylvania Ave NE
Washington, D.C. 20003
policy@engine.is

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[8] *Id.*