INNOVATOR Alliance

EMPOWERING INNOVATION THROUGH STRATEGIC TAX POLICY

April 7, 2025

The Honorable Roger Williams (R-TX)
Chairman
Committee on Small Business
2361 Rayburn House Office Building
Washington DC 20515

The Honorable Joni Ernst (R-IA)
Chair
Committee on Small Business and Entrepreneurship
428A Russell Senate Office Building
Washington, DC 20510

Dear Chairman Williams and Chair Ernst,

Thank you both for conducting tomorrow's joint House and Senate full Committee hearing "Prosperity on Main Street: Keeping Taxes Low for Small Businesses." In particular, we thank you for your ongoing efforts to restore the provisions of Section 174 of the Internal Revenue Code (IRC) relating to the first-year expensing of research and development (R&D) investment by American businesses. On behalf of millions of American entrepreneurs who work every day to launch and build the new businesses that drive economic growth, job creation, and opportunity expansion, we write today to express our strong support for your work to restore this critical policy support of American innovation – at a time when our nation's status as the global innovation leader is at stake.

For nearly 70 years, American businesses have been permitted to deduct from taxable income 100 percent of R&D expenses in the year those expenses were incurred. This favorable tax treatment promoted innovation by powerfully incentivizing critical investments in research and technological advancement. Those investments led to countless scientific breakthroughs, powered economic growth, and produced many significant commercial and military advantages for the United States.

But when Congress passed the Tax Cuts and Jobs Act (TCJA) in 2017, it changed the tax treatment of R&D in order to partially off-set the revenue impact of the tax cuts. Beginning in tax year 2022, businesses are now required to amortize R&D investments over five to fifteen years, dramatically increasing their annual tax liability and disincentivizing innovation-generating investments.

The nation's startups are hit disproportionately by the change, as they tend to invest heavily in developing, testing, and improving their new product or service. A tax liability that is substantial and unexpected can be devastating for innovative but fragile new companies earning little income in the crucial early years. Indeed, for many startups across the country, the required amortization of R&D investments can be fatal. This reality is of enormous economic consequence as research has repeatedly demonstrated that startups are disproportionately responsible for the innovations that drive productivity growth and economic growth, and account for virtually all net new job creation.

TCJA's change to Section 174 is especially damaging given the strategic imperative of preserving America's innovation leadership in the face of heightened global competition, particularly from China. For decades, China has worked relentlessly to wrest the mantle of global innovation leadership from the United States. The Belt and Road global infrastructure initiative, the Made in China 2025 plan to dominate global manufacturing, and the China Standards 2035 blueprint are critical aspects of China's ambition to be the 21st century's unrivaled economic superpower – all supported by research and development spending growing at double-digit rates year after year.

In March of 2021, China released its 14th Five-Year Plan, which accelerated development of advanced technologies in seven strategic areas – artificial intelligence, quantum computing, integrated circuits, genetic and biotechnology research, neuroscience, and aerospace. China also increased R&D spending by more than 7 percent annually through the end of 2025, began work on a network of national laboratories, revised regulations to facilitate the flow of venture capital into Chinese startups, and increased bank lending and extended tax incentives to encourage more research and development.

If there were any lingering doubt about China's ambitions, President Xi Jinping was crystal clear at China's 20th Communist Party Congress in October of 2022. In a two-hour speech to open the Congress, Xi declared that China will "accelerate efforts to achieve greater self-reliance and strength in science and technology...will be guided by national strategic needs...and resolutely win the battle of key and core technologies."

China intends to win the technological and innovation future. To meet that competitive threat, America must redouble its commitment to aggressively pro-innovation policies.

Unfortunately, TCJA's change to Section 174 severely undercuts America's innovation competitiveness. As Senator Todd Young (R-IN) explained in a May 10, 2023 Op/Ed:

> "China currently provides a 200 percent 'super deduction' for R&D expenses that amounts to 20 times the amount allowed in the U.S. tax code. A manufacturing company in China that spends $100 on R&D gets to deduct $200. Even before this provision expired, the U.S. ranked 27th out of 37 OECD countries with respect to R&D incentives. Our strategic competitors know this and are taking advantage."

In addition to restoring the first-year expensing provisions of Section 174, the innovation community is also focused on three other important tax policy priorities. Founding, investing in, and working for a startup is risky by nature. In a new business' early years, tax policies can affect critical decisions that can lead to more opportunities for new companies to grow, attract capital and skilled talent, and boost productivity. Our other tax policy priorities include:

Expand favorable tax treatment of QSBS: Congress enacted the qualified small business stock (QSBS) exclusion from taxation (section 1202 of the IRC) decades ago to spur job creation and incentivize long-term investment in startups and small businesses. This important bipartisan provision exempts most startup investors, employees, and founders from capital gains taxes when selling their equity if certain conditions are met, including a five-year holding commitment. The QSBS incentive attracts capital from early-stage investors that helps entrepreneurs pursue innovative ideas and companies that fuel continued economic growth. Importantly, the favorable tax treatment of QSBS also helps promising startups attract and retain the skilled talent they need to survive and grow – while most young startups can't offer the higher salaries of more established companies, they can compensate employees with equity in the growing company. We urge policymakers to expand eligibility to more businesses, making it easier and cheaper for entrepreneurs to raise capital and provide more flexibility in financing options.

Modernize net operating loss treatment to support startups: Launching and building a new business requires investment – investment to research and develop a new technology or innovation, to prototype and perfect a new product or service, to fund the salaries for critical initial employees, and to pay other essential early expenses. Because such costs are incurred long before the first dollar of revenue, most new businesses lose money in their initial years. Such losses are referred to as net operating losses, or NOLs. Tax law permits all businesses to deduct NOLs from taxable income. But because most startups have little or no income in their early years against which to apply losses, NOLs are carried forward to apply to income the startup, if it survives, will hopefully earn in the future.

But two aspects of the IRC complicate the tax treatment of NOLs and other tax credits for startups. Section 382 pertains to net operating losses and Section 383 pertains to other tax credits. Sections 382 and 383 were written in the mid-1980s to prevent a practice known as "loss trafficking" – companies acquiring failing young firms with large losses solely to use the acquired company's tax losses to offset other unrelated income. As currently written, the sections restrict startups from carrying forward NOLs and other tax credits, and can have the effect of virtually eliminating any value associated with carry-forwards for startups, especially following transactions perceived to be a change in ownership. And perceived changes in ownership can include investments from venture capital firms or other sources – investments that startups often depend on for many years. With these important realities in mind, we respectfully urge Congress to modernize the tax treatment of NOLs in Sections 382 and 383 to reflect the unique nature and importance of startups. Specifically, we urge Congress to establish a safe harbor for startups that will enable new businesses to maintain the value of NOLs and other tax credits as they continue to need and accept outside investment.

Preserve favorable tax treatment of carried interest: Current tax policy offers favorable tax treatment on capital gains to investors that provide longer term capital (greater than one year).

Longer term "patient" capital fuels new business growth, job creation, economic growth. Managers of private funds that invest in startups are generally compensated in two ways: management fees and "carried interest." Management fees are charged as a percentage of assets under management (generally 2 percent), while carried interest is a percentage of the fund's investment profits that fund managers receive as compensation (generally 20 percent). Because these profits are a return on investment, they are taxed at a long-term capital gains rate.
The prospect of sharing in any investment gains incentivizes fund managers to invest wisely and responsibly, and aligns fund managers' interests with that of their investors. Importantly, carried interest is especially critical for emerging fund managers, who typically raise and manage smaller funds with fewer assets under management and, therefore, rely principally on carried interest for the majority of their compensation, enabling them to continue investing in emerging founders. To maintain robust investment in the startup ecosystem to fund critical new companies and innovations, we respectfully urge Congress to maintain the current tax treatment of carried interest.

Your work to restore first-year expensing of R&D investments, expand QSBS, modernize tax treatment of startups NOLs, and preserve carried interest is about much more than tax rates and federal tax receipts – it is central to our nation's long-term economic competitiveness and ability to win the future in a world in which power is defined in terms of technology and innovation.

Thank you again for your continued leadership on behalf of America's new and small businesses, and for your ongoing work to preserve America's global innovation leadership.

Sincerely,

AdvaMed
Angel Capital Association
Carta
Center for American Entrepreneurship
Engine
National Venture Capital Association
Technology Councils of North America (TECNA)