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DOES THE FEDERAL INCOME TAX LAW FAVOR ENTREPRENEURS?

Eric Toder

This paper estimates the effective tax rate on entrepreneurial income, defined as the return to an individual who starts a successful new business and then sells their interest once it becomes an established enterprise. The rate depends on both the tax imposed on the appreciation of the firm's value during its growth phase and on the effects of the tax system on the value of equity in ongoing business enterprises. Under reasonable assumptions, this rate is lower than the rate the entrepreneur would pay on ordinary income. Preferential taxation of entrepreneurial income has consequences for both economic growth and income distribution.

Keywords: entrepreneurs, innovation, accrued gains, capital gains tax, corporate equity income

JEL Codes: H24, H25

I. INTRODUCTION: WHAT IS AN ENTREPRENEUR AND WHY ARE ENTREPRENEURS IMPORTANT?

The Merriman-Webster dictionary defines an entrepreneur as "a person who organizes, manages, and assumes the risk of a business organization." This definition would encompass anyone who starts or owns a business, from the founder of Apple to the owner of an independent corner grocery store. And many research papers (Gentry and Hubbard, 2004; Bruce and Deskins, 2012; Schuetze and Bruce, 2004) that have estimated the effects of tax policy on entrepreneurship have used measures of self-employment income or small business ownership as a metric.

This paper uses a more transformative concept of entrepreneurship favored by other writers. For example, the economic historian Joseph Schumpeter (1947, p. 151) defined entrepreneurship as "the doing of new things or the doing of things that are already being done in new way." Alternatively, Eisenmann (2013) defines entrepreneurship as "the pursuit of opportunity beyond resources controlled."

In this paper, I discuss how the federal income tax law taxes the income of successful entrepreneurs. I discuss the special characteristics of income of entrepreneurs and

Eric Toder: Urban-Brookings Tax Policy Center, Washington, DC, USA (etoder@urban.org)

explain how both the treatment of the income they accrue during the early growth phase of an enterprise and the taxes imposed on the incomes of the companies that they create compared with taxes on alternative assets affect their overall tax burdens. Finally, I briefly discuss the potential consequences of how the tax system treats entrepreneurial income compared with other activities.

A. Why Does It Matter?

Most economic analysis is concerned with marginal efficiency conditions, analyzing models that explain how best to rearrange existing resources to maximize social welfare. Even most growth models focus on how best to increase capital formation by increasing the reward to saving and investment at the expense of current consumption — another marginal effect. But giant leaps in productivity — from the development of mass production techniques for automobiles in the early 20th century through the invention of the personal computer in the 1970s and smart phones in the early 21st century — have transformed our economy and our living standards. There are countless other examples. In all of these examples, the transformation they brought about relied not only on the work of talented scientists and engineers but also on the contribution of entrepreneurs who took risks to establish businesses that brought these new products to scale and made them commercially viable.[1]

Studies of growth accounting dating back to Robert Solow (1957) have attributed a large share of economic growth to technical progress as opposed to changes in inputs of labor and capital. Recent data reported by the U.S. Bureau of Labor Statistics show that a significant share of recent economic growth continues to be attributable to a residual called "multifactor productivity," which reflects changes in technology, the quality of organizations, and other intangible factors (Table 1). Improvements in multifactor productivity contributed 0.9 percent per year to the average 2.0 percent annual growth rate in output per person-hour between 1990 and 2019. The slowdown in the growth

Table 1

Sources of Economic Growth, 1990–2019 (in Percent per Year)

	1990–2000	2000–2007	2007–2019	**1990–2019**
Output per hour	**2.2**	**2.8**	**1.4**	**2.0**
Capital intensity	0.9	1.1	0.7	**0.9**
Labor composition	0.3	0.3	0.2	**0.3**
Multifactor productivity	1.0	1.4	0.5	**0.9**

Source: U.S. Bureau of Labor Statistics (2020).

[1] The use of these examples does not mean to imply that entrepreneurs are limited to founders of firms that introduce new technologies. The entrepreneurs who transformed a small chain of California hamburger stores (McDonald's) and a local Seattle coffee shop (Starbucks) into global enterprises are just as much entrepreneurs as Silicon Valley founders, even though their products are low-tech. And the same goes for founders of many less well-known businesses that satisfied some unmet demand.

rate after 2007 has been mostly due to a reduction in the growth rate of multifactor productivity, not the growth rate of capital per worker or labor quality.

Although entrepreneurial activity is often associated with the prevalence of small businesses, transformative entrepreneurs are those who start small, but often end up creating something very big. Today's giant corporations are the end result of the activity of entrepreneurs over the past generation. And today's new entrepreneurs, who we cannot yet identify, are creating the corporate giants of the future.

To illustrate this fact, note that most of the top companies in today's Fortune 500 list are new in many of our lifetimes. For example, among the 20 largest companies ranked by sales in 2019, only 5 were in the top 20 in 1999, although most were in the top 500 (Table 2). But going back another 20 years to 1979, only five of those firms were in the top 500.

Table 2

Ranking of Top Fortune 500 Companies, 1959–2019 (by Revenue)

Company	1959 Rank	1979 Rank	1999 Rank	2019 Rank
Walmart	*	*	3	1
Exxon Mobile	2	2	4	2
Apple	*	*	273	3
Berkshire Hathaway	499	*	112	4
Amazon	*	*	*	5
United Health Group	*	*	84	6
McKesson	*	*	59	7
CVS	*	*	99	8
AT&T	10	17	10	9
Amerisource Bergen	*	*	188	10
Chevron	19	6	38	11
Ford Motor	3	3	2	12
General Motors	1	1	1	13
Costco	*	*	49	14
Alphabet/Google	*	*	*	15
Cardinal Health	*	*	93	16
Walgreens	*	*	98	17
JP Morgan Chase	*	*	76	18
Verizon	*	*	25	19
Kroger	*	*	36	20

* = not in top 500

Source: Fortune 500, various issues.

B. A Recent Example

A recent example of a person who illustrates characteristics of a successful entrepreneur is Eric Yuan, the founder of Zoom, the business that the National Tax Association and many other organizations and firms are relying on for conferences and other virtual meetings during the pandemic. As a recent article in *Business Insider* (Rogers, 2020) explains, Yuan, as a college freshman in China, would take a 10-hour train ride to visit his girlfriend and used to imagine how he could see her without the train ride. In the 1990s, after earning bachelor's and masters' degrees in China, he decided to move to the United States because he recognized the internet as the wave of the future. Over a two-year period, he applied repeatedly for a visa to work in the United States and was rejected eight times before finally gaining admission on the ninth try.

After arriving in Silicon Valley, Yuan's career trajectory was rapid. He went to work for Web-Ex in 1997, which was later purchased by Cisco, which made him Vice President of Engineering. In 2011, he left Cisco to start a new company that would allow him to realize his college dream.

Yuan's story illustrates some of the important characteristics of successful entrepreneurs. He perceived an unmet need, displayed great tenacity and persistence, and was willing to take a risk by giving up secure and well-paid employment to start a new business. Being an outsider may also be a factor, as many of our most successful entrepreneurs have been immigrants or children of immigrants. And finally, a little bit of luck also helped, as without a doubt, he did not anticipate the current pandemic that accelerated the growth of his business.

II. WHAT DOES ENTREPRENEURIAL INCOME LOOK LIKE?

In this paper, I define entrepreneurial income as a type of compensation for work effort with special characteristics. First, business owners supply the work effort, not employees, and they receive compensation in the form of profits, not wages. Second, the business does not return operating profits until some years after its founding. Third, the source of entrepreneurs' income is a return to innovation, not a return to investment in physical assets. Innovation can take many forms, including introducing a new product or service, exploiting a new market, new methods that reduce production costs, or developing superior forms of business organization and management.

Entrepreneurial income includes both types of standard economic categories of income — labor income and capital income. Labor income is a return to the effort, skills, and ideas of the entrepreneur. Capital income is the component of the income that reflects the return for waiting to receive cash returns until the firm matures and becomes profitable, and the reward for assuming risk.

In the stylized examples of entrepreneurial returns in this paper, the entrepreneur founds a company, supplies "sweat equity" in the form of work effort and ideas in creating the firm, and in exchange, acquires an ownership share of future profits. The entrepreneur sells the company when it reaches maturity and begins to earn operating

profits. Other people supply work effort along the way (employees), provide financial capital (investors), and own and manage the ongoing enterprise after it reaches maturity.

This is, of course, a very simplified description of the creation of new firms and their ongoing operations. In practice, the same person often performs multiple functions, and there is no sharp division between the growth period before operating profits begin and a level stream of profits that starts after a fixed number of years. The entrepreneur may supply work effort throughout the initial growth period and may continue to manage the ongoing enterprise instead of selling it once it becomes profitable. They may supply their own financial capital to the enterprise in addition to raising external funds. The stylized examples, however, intend to isolate the portion of the activity, which is an entrepreneurial activity, as opposed to standard investment and management services. Entrepreneurial income consists of the components of an individual's income from creating a business and waiting, often for many years, for it to generate operating profits. It does not, by this definition, include the returns the same individual may receive from contributing financial wealth to the business or from managing it after it becomes a successful ongoing business.

III. HOW DOES THE TAX BURDEN ON ENTREPRENEURS COMPARE WITH TAXATION OF OTHER ACTIVITIES?

The income entrepreneurs earn comes in the form of an increase in the value of the business enterprises they found between the time it is established and the time it reaches maturity and starts earning operating profits. The income tax law can affect the after-tax income of entrepreneurs in two ways — first, by taxing the income accrued during the growth phase and, second, by affecting the value of the business the entrepreneur creates through the taxation of business income and the income of alternative investments. These components of the tax burden can be called the "accrual tax rate" and the "asset value tax rate."

A. Taxation of Accrued Gains

Entrepreneurial income is treated preferentially in the accrual phase because entrepreneurs receive their income in the form of an increase in the value of the enterprise they own instead of net current receipts. This form of income benefits both from the deferral of tax on accrued gain until the enterprise or shares in the enterprise are sold, and from the preferential rates the tax law applies to realized capital gains compared with ordinary income.

For purposes of this discussion, I divide the life cycle of a firm into two phases — a growth phase in which the firm has no receipts, and an operating phase in which the firm earns a constant annual net operating profit. I assume the entrepreneur creates the business at time 0 and sells their shares in the business in year n when it begins earning net profits. Other people supply labor and physical assets during the growth phase of the business and own and manage the firm after it begins earning net receipts. The

expected value of this firm at the time of start-up (V_0) is the return to the labor services of the entrepreneur. It can be expressed as:

$$E(V_0) = E(V_n)/((1 + d)^n),$$

where V_n = the value of the firm at maturity (year n) and d = the risk-adjusted discount rate.

The value of the firm increases as it approaches the date at which it will start generating income. In the first year, the accrued gain is simply $E(V_0)$, the contribution of the founder's sweat equity. In any subsequent year t, the increase in value, or accrued capital gain income, is equal to:

$$G_t = d \times E(V_t - 1),$$

where G_t = the accrued gain in year t and $E(V_t - 1)$ is the expected value at the end of year $t - 1$.

Adding up over all years from start-up to maturity, the present value of income accrued within the firm can be expressed as:

$$PV(G) = (1/(1 + d)^n) + (d \times (n - 1)/(1 + d)(^{n+1}) \times E(V_n))$$

The present value of the capital gains tax paid when the asset is sold is equal to:

$$T_g = g \times E(V_n)/(1 + d)^n,$$

where g = the tax rate on realized gains.

Therefore, the effective tax rate on gains in the accrual period is equal to:

$$ETR_A = (g \times (1 + d))/((1 + d) \times (1 + d \times (n - 1)))$$

When $n = 1$, the accrual tax rate simply becomes $T_g = g$. For $n > 1$, the accrual tax rate declines the longer the time between start-up and maturity (n) and the higher the discount rate (d). The accrual tax rate also declines with reduced tax rates on realized capital gains.

For example, if $g = 23.8$ percent and $d = 20$ percent, the effective accrual tax rate varies from 15.9 percent with $n = 4$ to 8.4 percent with $n = 12$ (Table 3). If $g = 23.8$ percent and $n = 8$, the effective accrual tax rate varies from 14.5 percent with $d = 10$ percent to 9.1 percent with $d = 30$ percent.

B. Effects of Taxation on Enterprise Value

The second way the tax system affects entrepreneurial income is through its effects on the value of the firms they create. I assume that when an entrepreneur takes their company public, it becomes a C corporation that faces the double tax on corporate

Table 3

Effective Income Tax Rates on Buildup of Entrepreneurial Income: Current Law

Years to Maturity	Discount Rate (in Percent)	Effective Tax Rate (in Percent)
4	20	15.9
6	20	13.0
8	20	11.0
10	20	9.5
12	20	8.4
8	10	14.5
8	15	12.4
8	20	11.0
8	25	9.9
8	30	9.1

income, but also benefits from the reduced rates on dividends and capital gains and by opportunities for corporations, especially global enterprises, to reduce their U.S. tax liability by shifting profits to low-tax foreign countries. The value of the corporation thus created is also affected by the taxes that investors must pay on alternative investments.

As discussed in Toder (2017), I express the required pretax return on corporate investments as:

$$R = (1/(1 - w)) \times ((iD \times (1 - u) + e \times (1 - D)),$$

where w = the effective tax rate on corporate profits, i = the corporate bond rate, D = the share of corporate capital financed by debt, u = the statutory corporate tax rate, $(1 - D)$ = the share of corporate capital financed by equity, and e = the net of corporate tax but gross of individual tax return on equity income.

Assume the interest rate (i) is determined on global markets. The required return to equity investors is then:

$$e = (i \times (1 - t_i)) + p)/(1 - t_e),$$

where t_i = the marginal tax rate on interest income, t_e = the marginal tax rate on equity income, and p = the equity premium required by investors to adjust for the higher risk of equity relative to debt investments. The marginal tax rate on equity income, t_e, is computed as a weighted average of the marginal tax rates on dividends, realized capital gains and unrealized capital gains (zero).

Under the assumption that the firm's life is perpetual, its value $V = 1/R$. If R^* is the required return on corporate capital in the absence of all individual and corporate income taxes, then $V^* = 1/R^*$. The effective tax rate on the asset value created by the entrepreneur is then:

$$ETR_V = (V^* - V)/V^*,$$

where ETR_V = the asset value tax rate, V = the sale price received by the entrepreneur, and V^* = the price the entrepreneur would receive in the absence of taxes. This tax rate could be positive or negative depending on how the tax system affects the relationship between the after-tax return on corporate equity investments and the after-tax return on interest-bearing assets. The value of the firm declines, the higher the tax rate on corporate equity income and increases the higher the tax rate on interest-bearing assets.

The equations noted earlier show that the asset value tax rate varies positively with the net of tax equity premium, the effective corporate tax rate, and the marginal tax rate on equity income on the "marginal" investor who is equilibrating returns on stocks and bonds. The asset value tax rate varies inversely with the ratio of corporate interest costs to the cost of equity capital. This means that the asset value tax rate increases, all other things equal, with lower interest rates, a higher effective corporate rate (relative to the statutory rate), and a higher tax rate on the equity income of the "marginal" investor.

For example, at a corporate statutory tax rate of 21 percent, a corporate bond rate of 4 percent, a debt to capital ratio of 40 percent, an equity premium of 6 percent, a tax rate on equity income of the marginal investor of 4.5 percent,[2] and a corporate effective rate of 15 percent, the asset tax rate is equal to 0.9 percent (Table 4). This rate can vary substantially as the assumed parameters change. With all other parameters held fixed, the asset tax rate falls to –7.8 percent at a corporate effective tax rate of 7.5 percent and increases to 7.9 percent at a corporate effective rate of 21 percent. It falls to –2.8 percent if the equilibrating investor is a tax-exempt organization and increases to 12.4 percent if the equilibrating investor faces a marginal rate on equity income of 17.9 percent (which could result from an individual with a 23.8 percent marginal rate receiving 25 percent of income in the form of unrealized capital gains.) It rises to 2.1 percent if the debt to capital ratio is 20 percent and falls to –0.7 percent with a debt to capital ratio of 60 percent. It falls to –10.3 percent if the equity premium is 2 percent and rises to 5.9 percent if the equity premium is 10 percent. It increases to 7.5 percent at a 2 percent interest rate and falls to –3.3 percent at a 6 percent interest rate.

[2] The 4.5 percent rate reflects the average effective shareholder-level tax rate that results from assuming the marginal tax rate on realized capital gains and dividends is 23.8 percent, the dividend-payout ratio and the ratio of realized to accrued gains are both 50 percent, and only 25 percent of shares are held by taxable investors (Rosenthal and Austin, 2016), with the remainder held by qualified retirement saving plans and foreign investors.

Table 4

Asset Tax Rates under Alternative Assumptions (in Percent)

Interest Rate	Equity Premium	Debt to Capital Ratio	Marginal Tax Rate on Equity Income	Corporate Effective Tax Rate	Asset Tax Rate
4	6	40	4.5	**7.5**	–7.8
4	6	40	4.5	15.0	0.9
4	6	40	4.5	**21.0**	7.9
4	6	40	**0**	15.0	–2.8
4	6	40	**17.9**	15.0	12.4
4	6	**20**	4.5	15.0	2.1
4	6	**60**	4.5	15.0	–0.7
4	**2**	40	4.5	15.0	–10.3
4	**10**	40	4.5	15.0	5.9
2	6	40	4.5	15.0	7.5
6	6	40	4.5	15.0	–3.3

C. Combined Effective Tax Rate on Entrepreneurial Income

The combined effective tax rate on entrepreneurial income (ETR_Y) depends on both the effective tax rate in the accrual phase and the effective tax rate on the value of the firm the entrepreneur creates:

$$ETR_Y = ETR_V + (1 - ETR_V) \times ETR_A$$

For example, if an entrepreneur creates a firm that would be worth $100 million in the absence of the federal individual and corporate income taxes and the asset tax rate is 0.9 percent, then the tax system lowers the value of the firm to $99.1 million. If the accrual tax rate is an additional 11.0 percent, the entrepreneur receives a net amount of $88.2 million from the sale of the firm, making the total effective tax rate on the entrepreneur's income from starting the firm equal to 11.8 percent.

The combined tax rate can vary widely, depending on the values of the accrual tax rate and the asset value tax (Table 5). For values of the accrual tax rate that ranges from 6.7 to 18.7 percent and values of the asset value tax rate that ranges from –11.9 percent to 15.0 percent, the combined tax rate can range from –4.4 to 30.9 percent. In spite of this wide range of possible values, it appears that for most reasonable assumptions about parameter values, the combined effective tax rate on entrepreneurial income is significantly lower than the top individual income tax rate (currently 37 percent).

Table 5
Combined Effective Tax Rate with Alternative Values of Accrual Tax Rate and Asset Value Tax Rate

	Accrual Tax Rate (in Percent)	Asset Value Tax Rate (in Percent)	Combined Tax Rate (in Percent)
Low	6.7	–11.9	–4.4
Medium	11.0	0.9	11.8
High	18.7	15.0	30.9

IV. HOW DO TAXES ON ENTREPRENEURS MATTER?

Lower effective tax rates on entrepreneurial income may affect both the supply of entrepreneurs and the distribution of income. Depending on how one views them, they could be supported as an appropriate incentive to promote economic growth or opposed as a major contribution to unfairness in the tax system (between the taxation of different forms of income) and income inequality.

A. Effects on Supply of Entrepreneurs

Tax benefits for entrepreneurial activity may affect the supply of entrepreneurial activity in several ways. By raising the reward of starting a company compared with remaining in a secure, well-paid job, they may encourage talented and ambitious individuals to assume the risks involved in starting a new business. By increasing the ability of an entrepreneur to accumulate a huge fortune, they may encourage talented individuals to migrate to the United States instead of remaining in their home country or migrating elsewhere. Finally, by rewarding capital gains relative to ordinary income, they may increase the supply of external financial capital to new ventures, thereby facilitating the efforts of entrepreneurs.

There is an issue, however, of how much these incentives make a difference, given the extremely high rewards that successful entrepreneurs earn. While preferential treatment may make some marginal investments earn enough to be worth making, they do not necessarily affect the decision to start a business of someone with a taste for risk-taking who is motivated by the prospect of earning a very high rate of return.

The analysis here has focused on successful entrepreneurs, although most new business start-ups fail. According to the normal risk-return types of calculations, risk-averse potential entrepreneurs would be motivated both by the potential gains and loss offset provisions.

If entrepreneurs were sensitive to potential losses, their probability of starting a new venture would decrease to the extent losses were less than fully deductible. To the extent the cost of starting a new venture is the loss of income from high-paid employment,

losses are effectively fully deductible at the marginal tax rate on employee compensation. To the extent the loss is in the form of a negative return on a financial contribution, the loss may be deductible if the firm is organized as a pass-through business, and the entrepreneur has positive income from other sources. But if the new firm is organized as a C corporation or the entrepreneur does not have enough other income against which to deduct losses from a pass-through business, loss offsets would be incomplete. In that case, the effective tax rate on the expected return from the activity (considering the subjective probability of both gains and losses) would be higher than the accrual tax rate, as calculated in this paper.

B. Effects on Income Distribution

Successful entrepreneurs accumulate large amounts of wealth. For example, *Forbes* magazine lists 267 members of the Forbes 400 as self-made (Collins and Hoxie, 2018). Some of these are entertainers and athletes, but most became wealthy by starting businesses. (Many of the others inherited their fortunes from earlier generations of entrepreneurs.) And wealthy individuals have substantial amounts of unrealized (and therefore, untaxed) capital gains, much of it coming from ownership of privately held businesses. For example, Batchelder and Kamin (2019) find that nearly 40 percent of the wealth of the top 1 percent is in the form of unrealized capital gains and that the top 1 percent hold about half of all such gains.

To the extent the firms they create become multinational corporations, entrepreneurs also benefit from a low "asset value tax rate" resulting from the low corporate tax rate (compared with the individual rate), preferential treatment of dividends and capital gains, and corporate tax preferences, including the ability of U.S. multinational corporations to avoid corporate income tax by shifting profits to low-tax jurisdictions (Kleinbard, 2011).

V. CONCLUSION

This paper defines entrepreneurial income as the return from starting a successful firm and growing it to maturity. The returns of successful entrepreneurs are characterized by a long lag between the establishment of a firm and when it begins to generate net operating income and come in the form of an increase in the value of the enterprises they found. These returns are tax favored for two reasons: 1) the deferral of tax on the accrual of asset value during the firm's growth phase and 2) the taxation of this gain, when realized, at preferential capital gains rates. But the benefit of the low tax rate on accrued gains may be offset because rules for taxing income of the businesses entrepreneurs create may reduce the gain from creating them. This paper shows how the size of the effective tax rate on entrepreneurial income depends on both the taxation of income accrued during a new firm's growth phase (the accrual tax rate) and the impact on the firm's market value of tax rules applied to equity income of established companies, compared with alternative investments (the asset value tax rate).

Both the accrual and asset value tax rates depend on a variety of parameters. The accrual tax rate varies with the discount rate, the years to maturity, and the tax rate on realized capital gains. The asset value tax rate depends on the statutory and effective corporate tax rates, the tax rates on individual income from interest, dividends, and capital gains, the share of the mature firm that is debt financed, the interest rate, and the equity premium. Overall, making reasonable assumptions about the values of these parameters, I estimate that the effective tax rate on entrepreneurial income is lower than the marginal tax rate that entrepreneurs would pay if their income was taxed as earnings. The 2017 Tax Cuts and Jobs Act increased the favorable treatment of entrepreneurial income, mainly by reducing the corporate income tax rate substantially, while reducing the top marginal individual income tax rate only modestly.

I have not attempted to evaluate whether this preferential treatment is on balance desirable policy. Entrepreneurial activity is a critical driver of economic growth, but it is unclear how much additional entrepreneurial activity is attributable to its preferential tax treatment. And the tax policies that generate this favorable treatment, in particular the long-standing preferential treatment of capital gains and the recent-reduced taxation of corporate income, contribute to income inequality.

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