

Middle Class Proposal #8

Launching New Entrepreneurs

Small businesses are the engine of American job growth and the seedbed of innovation. Many of the world's greatest companies began as one person with one idea, tinkering in the garage. But getting a new venture off the ground is not as easy it should be. New small business tax breaks—a standard home office deduction and a double deduction for start-up costs—can help entrepreneurs get a foot up the ladder and closer to realizing their dreams.

THE PROBLEM

Starting a business is too complicated and unnecessarily costly

Many Americans aspire to the dream of working for themselves—at any given time, as many as 7% of American workers are actively in the process of starting a business, and one in ten Americans is self-employed.¹ Government should be doing more to help more small businesses and entrepreneurs get off the ground.

Small businesses are the engine of American job growth.

Small businesses employ slightly more than half of the American workforce and create half of the nation's gross domestic product.² In 2004, small businesses accounted for all of the new jobs created in America—they generated nearly 1.9 million net new jobs while bigger companies actually shed workers.³ On average, small businesses account for as much as two-thirds of all net new job growth.⁴ Small businesses are also the lifeblood of the rural economy—nine out of ten businesses in rural America are small businesses.⁵

But business start-up costs can be steep.

Fledgling entrepreneurs face a host of expenses even before they open their doors—everything from legal and accounting fees to advertising and signs, supplies and equipment, tools, licensing, permits and other costs of regulatory compliance, rent and utility deposits. For solo entrepreneurs, the median start-up costs for starting a business is \$6,000, while for team-based ventures, it's as much as \$20,000.⁶ The vast majority of small business owners—between 80% and 90%—also invest significant amounts of their own money into their businesses.⁷

Some tax provisions are outdated and hostile to small businesses.

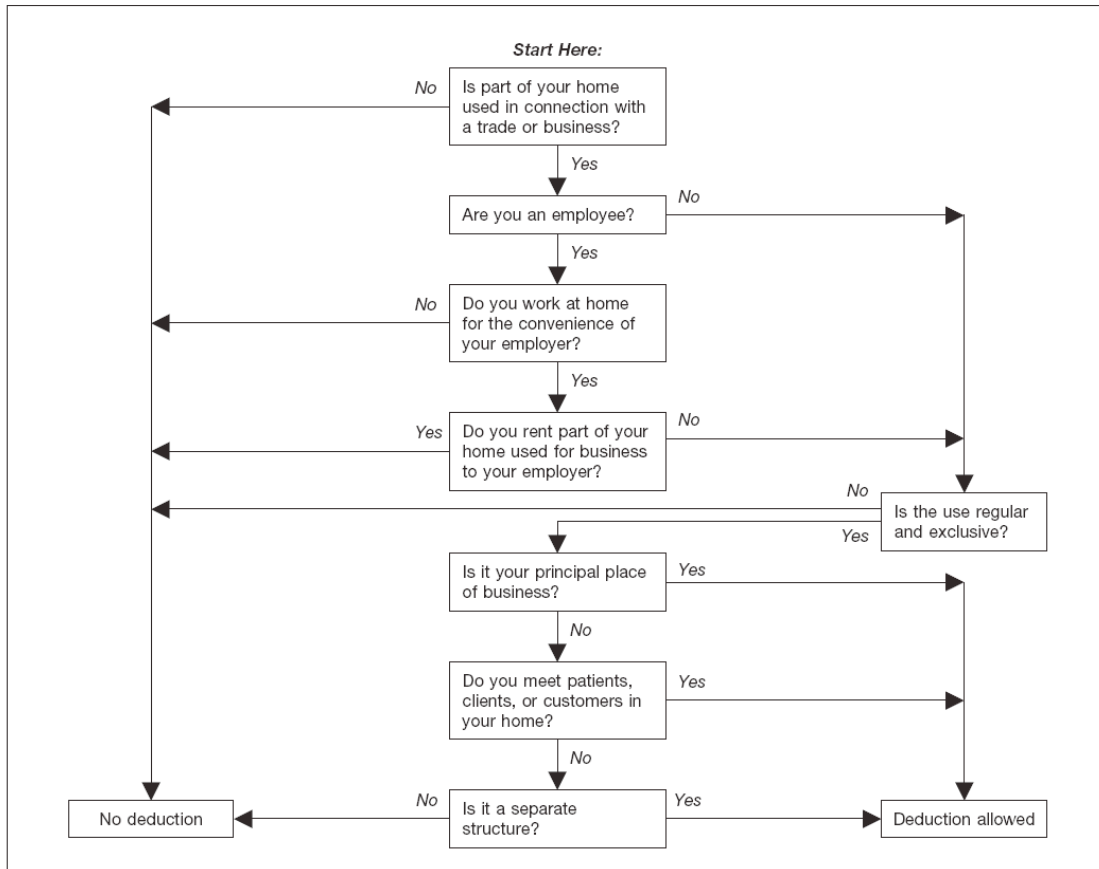
Some portions of the current tax code are needlessly complicated and get in the way of helping entrepreneurs get their start. One significant example is the current home office deduction, which the IRS Taxpayer Advocate has condemned as “too

complex” and “too time-consuming.”⁸ Fewer than one in three home-based small-business owners take the trouble to figure the deduction,⁹ and the complexity of the deduction is the top tax complaint among self-employed workers.¹⁰

Among other things, small business owners who want to take the deduction must allocate as business expenses a portion of their mortgage payments, utility bills and other expenses according to a complex formula and set of rules. The following flow-chart, which was taken from the 32-page IRS instruction booklet for the home office deduction, helps illustrate this lack of user-friendliness.

Sample instructions for the home office deduction¹¹

Figure A. **Can You Deduct Business Use of the Home Expenses?** Do not use this chart if you use your home for the storage of inventory or product samples, or to operate a daycare facility. See *Exceptions to Exclusive Use*, earlier, and *Daycare Facility*, later.



THE SOLUTION

Two new and simple tax breaks for budding entrepreneurs

Congress should offer small business owners two new tax breaks to help them get off the ground and sustain their businesses: (1) a doubling of the deduction for start-up costs from \$5,000 to \$10,000 and (2) the option of a standard home office deduction for home-based entrepreneurs equal to the lesser of \$2,500 or the annual gross income from the taxpayer's home business.

These proposals would help millions of small businesses.

These proposals would help the more than 600,000 Americans who start their own business every year¹² and the roughly 9 million small business owners who operate out of their homes.¹³

Home-based businesses are growing in number, thanks to the advent of the Internet, which enables small business owners to reach customers halfway around the world with the click of a mouse. Nearly half of all small-businesses are home-based, including a majority of businesses owned by women.¹⁴ The majority of small businesses also start at home, including three-fourths of businesses run by solo entrepreneurs.¹⁵ Home-based businesses contribute \$314 billion to the U.S. economy,¹⁶ and they are also potentially an ideal option for mothers with young children who want to ease back into the workforce while retaining flexibility and control over their lives. Both the Small Business Administration and the National Federation of Independent Business support a standard home office deduction as one of the most important changes that can be made to the tax code to help out small business owners.¹⁷

The new tax breaks would help simplify the tax code.

The complexity of the current home office deduction is a relic of an earlier time, when home-based businesses were a rarity, not the norm. Offering the option of a standard home office deduction would eliminate pages of red tape and hours of needless frustration for small business owners. And it would dramatically reduce the number of compliance errors. It would also make the tax code fairer by making it much easier for small business owners to get the tax break they are intended to receive.

Doubling the deduction for start-up costs would also help small businesses by enabling more small businesses to deduct costs in the first year and avoid the complicated calculations associated with depreciating and amortizing capital equipment purchases over a period of many years.

These proposals are affordable.

Doubling the current deduction for business start-up costs from \$5,000 to \$10,000 would cost only \$700 million per year, \$4 billion over five years and \$9 billion over 10 years.¹⁸ A standard home office deduction would cost \$3.6 billion per year, \$20.3 billion over five years and \$46.3 billion over 10 years. All of these savings would go to jobs-producing small businesses and entrepreneurs.¹⁹

THE ROLLOUT

Ideas for launching and publicizing the new small business tax breaks

- **Hold a press conference** with local entrepreneurs, including small business owners who work out of their homes.
- **Release a short report** documenting the number of small businesses in the state and their contributions to the local economy in terms of the number of

jobs created and the total number of new businesses. Highlight the new ideas and innovations being created.

- **Reproduce a chart** showing the complicated tax system on the books today.

CRITIQUES & RESPONSES

New small business tax breaks

It's too expensive.

Doubling the deduction for start-up costs would cost only \$700 million per year, while a standard home office deduction would cost \$3.6 billion per year. This is a small price to pay to keep small businesses—the engine of American job growth and innovation—growing.

Encouraging the growth of small businesses will also help grow and sustain the middle class. Owning your own business is a big part of the American dream for many people, and the federal government should be doing more, not less, to help people reach those aspirations of success.

Increasing the home office deduction will encourage tax fraud.

If anything, it would do the opposite by creating the option of a single, standardized deduction. The current law involves numerous complex calculations and accounting, which creates much more temptation for some people to “fudge” the numbers.

APPENDIX

Details of the double deduction for start-up costs and the standard home office deduction

Double deduction for start-up costs

This proposal would double the allowable deduction for business start-up costs from \$5,000 to \$10,000.

Business start-up costs include intangible expenses that are incurred before the commencement of business operations, such as advertising, travel, surveys, training and professional fees paid to lawyers and accountants.²⁰ This deduction allows small business owners to receive a larger tax break on intangible expenses other than capital equipment costs for computers, equipment, furniture, etc., which can be deducted separately.

Standard home office deduction

This proposal would give small business owners the *option* of taking a standard home office deduction equal to the lesser of \$2,500 or the annual gross income from the taxpayer's home business in lieu of calculating the deduction under current law. Small business owners who would benefit more from the current credit would retain the option not to use the standard home office deduction.

This proposal would greatly simplify the tax code for small business owners while giving more home-based businesses an opportunity to take advantage of the intended tax break.

Endnotes

¹ Small Business Administration, "The Small Business Economy for Data Year 2006: A Report to the President," December 2007, available at http://www.sba.gov/advo/research/sb_econ2007.pdf.

² Ibid. Small firms employed 50.9 percent of the private sector work force and generated 50.7 percent of the nonfarm private gross domestic product in 2004.

³ Ibid.

⁴ Small Business Administration, "Small Business Share of Economic Growth," 2001.

⁵ Small Business Administration, "An Empirical Approach to Characterize Rural Small Business Growth and Profitability," February 2006, available at <http://www.sba.gov/advo/research/rs271tot.pdf>.

⁶ U.S. Small Business Administration, "Expected Costs for Startup Ventures," November 2003, available at <http://www.sba.gov/ADVO/research/rs232tot.pdf>.

⁷ Ibid. Solo entrepreneurs invest an average of \$8,026 of their own money into their businesses. For team ventures, the average amount invested is \$37,975.

⁸ U.S. Internal Revenue Service, "National Taxpayer Advocate's 2007 Annual Report to Congress," January 2008, available at <http://www.irs.gov/advocate/article/0,,id=177301,00.html>.

⁹ U.S. Small Business Administration, *The Small Business Advocate*, Vol. 27, No. 4, April 2008, available at <http://www.sba.gov/ADVO/april08.pdf>

¹⁰ National Association of the Self-Employed, "Business Tax Questions Leave Micro-Businesses Searching for Answers from the IRS," 2008.

¹¹ IRS Publication 587, "Business Use of Your Home (Including Use by Day Care Providers)," available at <http://www.irs.gov/pub/irs-pdf/p587.pdf>.

¹² Small Business Administration, "The Small Business Economy for Data Year 2006: A Report to the President," December 2007, available at http://www.sba.gov/advo/research/sb_econ2007.pdf. In 2006, 649,700 new small businesses were created.

¹³ Small Business Administration, "The Small Business Economy for Data Year 2006," December 2007, available at http://www.sba.gov/advo/research/sb_econ2007.pdf. Approximately 49% of the 16.7 million respondents in the Small Business Administration's survey of small business owners had home-based businesses.

¹⁴ Small Business Administration, "The Small Business Economy for Data Year 2006," December 2007, available at http://www.sba.gov/advo/research/sb_econ2007.pdf.

¹⁵ U.S. Small Business Administration, "Expected Costs for Startup Ventures," November 2003, available at <http://www.sba.gov/ADVO/research/rs232tot.pdf>.

¹⁶ U.S. Small Business Administration, "Expected Costs for Startup Ventures," November 2003, available at <http://www.sba.gov/ADVO/research/rs232tot.pdf>.

¹⁷ U.S. Small Business Administration, "Simplifying Home Office Deduction Would Help Small Businesses," *The Small Business Advocate*, available at <http://www.sba.gov/advo/april08.pdf>. See also www.NFIB.org

¹⁸ Third Way estimate based on the current take-up rate for this deduction and the potential number of small businesses that could be eligible for the benefit.

¹⁹ Third Way estimate based on the number of existing home-based businesses potentially eligible for the credit.

²⁰ See IRS Publication 535 for details on deduction of small business start-up expenses, available at <http://www.irs.gov/publications/p535/ch08.html#d0e5397>.