Locking in a Tax Code That Works for American Small Businesses and Entrepreneurs

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Preston Brashers
Research Fellow for Tax Policy
Grover M. Hermann Center for the Federal Budget
The Heritage Foundation

My name is Preston Brashers. I am a Research Fellow for Tax Policy in the Grover M. Hermann Center for the Federal Budget at The Heritage Foundation. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

Overview

The 2017 Tax Cuts and Jobs Act included more than just tax cuts, but also structural reforms, simplifications, and base-broadening revenue raisers. In addition to some permanent changes, TCJA also temporarily suspended certain flawed elements of the tax code that had punished business owners and entrepreneurs who chose to invest in their workers and in the American economy.

TCJA addressed some of the more egregious problems that existed in the tax code until 2017. For example, it makes no sense to tax income from business investments before businesses actually earn that income. But that is effectively what happens when the tax system forces businesses to capitalize and depreciate such business expenses over many years or decades instead of allowing them to deduct those costs when determining their *current* taxable income. To address that problem, TCJA implemented full and immediate expensing for capital equipment and machinery. For five years, between 2018 and 2022, the tax treatment for these formerly depreciable capital assets was corrected, but unfortunately full and immediate expensing – also known as *bonus depreciation* – is now gradually sunsetting. One of Congress's top priorities now should be to lock in full and immediate expensing – not just for another few years, but permanently.

Similarly, Congress should address one of the unfortunate compromises of TCJA – the 5-year amortization of research and experimental costs. That provision is structured in a way that delays to a later year 90 percent of the value of deductions for expenses related to research and experimental activities (including employee compensation costs, material and supply costs, costs of obtaining a patent, and certain operations, management, and travel costs).[1] The resulting short-term financial hit from this artificially accelerated tax liability can be severe for start-up companies with limited cash flow and limited access to capital markets.

TCJA also expanded death tax (estate tax) exemptons, helping to shield family farms and businesses from a devastating 40 percent federal tax on assets passed down to family members. Allowing the death tax exemption to be cut in half (which will happen if TCJA expires) could be the death knell for some asset-rich but cash-poor small- and mid-size family businesses.

Finally, no other expiring provision in TCJA had a larger impact on the amount of taxes paid by entrepreneurs and small busineses owners than the 20% pass-through deduction, known as Section 199A. While some reforms or improvements to the design of 199A are certainly possible, simply letting the provision lapse would be unthinkable to millions of American business proprietors who claim the deduction.

This written testimony focuses on the expiring provisions that most impact small businesses. For a more comprehensive review of the expiring 2017 tax provisions, including both individual and businesss provisions, refer to the Special Report*, "What If the Trump Tax Cuts Expire? A Primer on What Is at Stake."*[2]

Expiring Business Provisions

TCJA made several changes to business tax deductions, including changes affecting the timing of business deductions. TCJA temporarily replaced the system of depreciation schedules of up to 20 years and instead allowed businesses to fully deduct the cost of equipment and machinery in the tax year that the assets are purchased and put in use. The law also required five-year amortization of research and experimental (R&E) expenditures. TCJA created a new deduction for individuals with pass-through business income (Section 199A) and added an annual limitation on how much non-business income i(ndividuals could offset with business losses in a given year. Many of TCJA's changes to business deductions are set to expire or are currently phasing out.

Phaseout of Full and Immediate Expensing for Machinery and Equipment

A key TCJA business provision—full and immediate expensing for machinery, equipment, and other assets with useful lives of up to 20 years—has been winding down since January 2023.[3] The provision, also called "bonus depreciation," allowed businesses in 2018–2022 to deduct 100 percent of the value of qualifying capital assets in the year those assets were placed in service instead of

[1] Internal Revenue Service, *Guidance on Amortization of Specified Research or Experimental Expenditures under Section 174*, Notice 2023-63, September 2023, https://www.irs.gov/pub/irs-drop/n-23-63.pdf (accessed April 3, 2025).

[2] Preston Brashers, "What If the Trump Tax Cuts Expire? A Primer on What Is at Stake," Heritage Foudnation *Special Report* No. 311, February 25, 2025, https://www.heritage.org/taxes/report/what-if-the-trump-tax-cuts-expire-primer-what-stake.

[3] 26 U.S. Code § 168(k)(6).

following the IRS's complex rules for depreciation of various asset classes.[4]

Under current law, the bonus depreciation percentage is scheduled to decrease by 20 percent per year in 2023–2026. Assuming no extension of TCJA, a company would be allowed to fully and immediately expense 40 percent of the basis of a qualifying asset purchased in 2025, while the remaining 60 percent of the asset would be subject to regular depreciation over up to 20 years (depending on the tax code classification of the asset in question).

Typically, businesses can deduct legitimate expenses as they are incurred, but depreciable assets, which are deducted over time, are the notable exception. By allowing full and immediate expensing for most capital assets, TCJA (temporarily) shifted the business tax system closer to a cash flow tax system. Under a cash flow tax system, a company's taxable income base in each period is the difference between business revenues and business expenses.[5] Such a system is simpler than one that requires capitalization of some expenses, and it has the advantage of neutrality by treating purchases of equipment and machinery the same as expenditures on supplies, utilities, or marketing. Neutrality helps ensure that companies' budget and cash flow decisions are driven by market forces, not by uneven tax treatment.

The punitive nature of long depreciation schedules for physical capital investments is especially harmful to capital-intensive industries such as manufacturing, construction, mining, and oil extraction. This unfavorable tax treatment reduces investment and inhibits the productivity and wages of workers in affected industries.

TCJA did not (temporarily or permanently) change the depreciation schedules for certain longer-lived assets such as non-residential structures and residential rental structures, which retained depreciation schedules of 39 years and 27.5 years, respectively.

Permanence for Amortization of Research Expenses

TCJA made R&E expenditures subject to five-year amortization schedules beginning in 2022.[6] Before TCJA, taxpayers could fully and immediately deduct R&E costs. Amortization, like depreciation, involves the capitalization of business expenditures—but specifically expenditures involved in creating intangible assets.

Although TCJA made R&E amortization permanent, many lawmakers and outside observers hoped it would never take effect. R&E amortization was included in the tax bill to help ensure the legislation remained within reconciliation budget constraints, but there is no sound economic basis for discouraging companies from engaging in research by denying them full and immediate expensing for those expenditures.[7]

R&E amortization follows a straight-line method, so deductions for R&E expenditures are spread

[4] 26 U.S. Code §§ 167 and 168.
[5] A cash flow tax would disregard business financing such as equity raised, loans taken, and dividends and interest paid.
[6] 26 U.S. Code § 174. Research conducted outside the United States is subject to 15-year amortization.
[7] Alex Muresianu, "R&D Amortization Hurts Economic Growth, Growth Industries, and Small Businesses," Tax Foundation, June 1, 2023, https://taxfoundation.org/blog/rd-amortization-impact/ (accessed October 22, 2024).

out evenly across a five-year period. It uses the midpoint convention, so the five-year period starts six months into the year.[8] Therefore, a $100 R&E expenditure in year 1 results in a deduction of $10 in the first tax year, $20 in years two through five, and $10 in year six.

The increase in interest rates in recent years made the delay in deductions related to amortization and depreciation more economically damaging by raising borrowing costs.

Although not technically a TCJA expiration, Congress could use the occasion of TCJA's expiration to restore full and immediate expensing for R&E.

Expiration of the Pass-Through Deduction

The 20 percent pass-through deduction is scheduled to sunset after 2025. This deduction—also known as the Section 199A deduction or the qualified business deduction—allows sole proprietors and individuals with pass-through business income to deduct 20 percent of qualifying business income.[9] The deduction effectively reduces the bottom individual tax bracket for qualifying small businesses from 10 percent to 8 percent and the top individual tax bracket from 37 percent to 29.6 percent.

The pass-through deduction does not apply to all business income of individuals. Some restrictions and limitations apply:

- Specified services trade and businesses—such as businesses engaged in health services, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services—face a pass-through deduction phaseout if individual taxable income exceeds $197,300 ($394,600 for married joint filers).[10]

- The pass-through deduction is limited to the greater of 50 percent of the company's W-2 wages related to the business or 25 percent of W-2 wages plus 2.5 percent of unadjusted basis in qualifying business property.[11]

TCJA included the pass-through deduction for owners of businesses that are perceived as being small or midsize to balance out TCJA's reduction in the corporate rate. (Although some large companies are organized as pass-through entities, most are structured as C corporations because of the S corporation 100 shareholder rule.[12])

While the corporate rate is lower than the current top effective pass-through tax rate, it is inaccurate to say the corporate rate is preferential.[13] Corporate income is also subject to an extra layer of tax at a 15 percent to 23.8 percent rate at the investor level when profits are ultimately distributed to the

[8] 26 U.S. Code § 174(a)(2)(B).
[9] 26 U.S. Code § 199A.
[10] 26 Code of Federal Regulations § 1.199A-5, and Internal Revenue Service, "IRS Releases Tax Inflation Adjustments for Tax Year 2025." Amounts listed are for 2024. These amounts are subject to an annual inflation adjustment.
[11] Joint Committee on Taxation, *General Explanation of Public Law 115-97*.
[12] 26 U.S. Code § 1361(b).
[13] Unlike the pass-through deduction, TCJA's reduction in the corporate rate was made permanent.

shareholders or when corporate stock is sold.

If TCJA expires outright, sole proprietors and pass-through businesses in the top tax bracket could be at a competitive disadvantage compared to corporations. The top pass-through tax rate of 39.6 percent would be similar to the combined corporate and long-term capital gains rate, but owners of pass-throughs have to pay their full tax rate up-front on all earnings, including earnings retained by the businesses. In contrast, corporate shareholders can defer investor-level taxes on earnings retained by the corporations, only paying taxes when they ultimately realize income from their investments (e.g., through dividends or stock sales).[14]

The expiration of the pass-through deduction would make organizing as a pass-through business less attractive than it is now. Some businesses would respond by reorganizing as C corporations.

Expiration of Business Loss Limitations

If TCJA expires, the current annual limitation on business losses that can be deducted on personal taxes would expire. In 2018, individuals, estates, and trusts were limited to using $250,000 of business losses ($500,000 for married joint filers) to offset income from other sources.[15] With inflation adjustments, those limits now stand at $313,000 and $626,000.[16] Individuals can carry forward any disallowed losses indefinitely to future tax years as net operating losses.

The annual cap on deductible business losses is scheduled to expire after 2025. However, some pre-existing limitations on passive business losses would continue to apply.[17]

Expansion of Death Tax (Estate and Gift Taxes)

If TCJA expires, the estate and gift tax exemption amount would be halved in 2026. TCJA temporarily doubled the estate and gift tax exemptions, allowing a total of $11.18 million (in 2018) in lifetime gifts or transfers upon death to be untaxed before the estate and gift taxes take effect.[18] The exemption amount is adjusted for inflation and stands at $13.99 million as of 2025 (it would be $7 million if not for TCJA's temporary changes).[19] The top estate tax rate is 40 percent and was unchanged by TCJA.[20] The higher tax exemption amount is scheduled to expire after 2025, but the estate tax rates would remain unchanged.

Despite the steep 40 percent tax rate, estate and gift tax revenues represent a comparatively small

[14] Before TCJA, corporations could defer investor-level taxes, as they can today. However, because the pre-TCJA corporate tax rate stood at 35 percent, there was usually a significant tax advantage to organizing as a pass-through business where circumstances allowed.
[15] 26 U.S. Code § 461(l).
[16] Internal Revenue Service, "IRS Releases Tax Inflation Adjustments for Tax Year 2025."
[17] Joint Committee on Taxation, *General Explanation of Public Law 115-97*.
[18] *Ibid.*
[19] Internal Revenue Service, "IRS Releases Tax Inflation Adjustments for Tax Year 2025."
[20] 26 U.S. Code § 2001. After taxpayers use up the $13.99 million exemption, taxable estates and gifts are subject to progressive tax brackets that max out at 40 percent. Tax rates ranging from 18 percent to 39 percent apply to taxable estates and taxable gifts below $1 million.

revenue source (averaging about 0.6 percent of federal revenues in the past decade).[21] Following TCJA, estate and gift tax revenues did not fall as dramatically as some expected. The JCT estimated that the 2018–2025 increase in the estate and gift tax exemption would reduce overall tax receipts by a total of $83 billion compared to if TCJA had not been enacted.[22] In fact, while estate and gift tax collections fell by about $6 billion each in the 2019 and 2020 fiscal years relative to 2017 and 2018, 2023 estate and gift tax collections were up by about $11 billion compared to 2017.[23]

Although the estate tax represents a minor revenue source for the United States, it can have severe ramifications for family farms and family businesses. Owners of family farms, in particular, are often "asset rich but cash poor," so the family members who inherit them are often unable to raise the funds needed to pay the estate tax unless they sell off the inherited property.

Conclusion

Small businesses are already disadvantaged by the enormous burden of federal, state, and local regulations and the challenge of tax compliance. Unlike large corporations, most small business owners and entrepreneurs must navigate these complexities with little to no help from outside consultants or in-house teams of lawyers and accountants. Small businesses cannot absorb government-imposed burdens to the extent that larger corporations can. The last thing that small businsses need is an enormous tax increase.

Collectively, the expiring TCJA provisions that benefit small businesses were an indispensable part of the 2017 legislation's success. If lawmakers hope to revitalize the economy and ensure that American small business owners and entreprenerus have the ability to succeed and thrive, then extending these provisions should be a top priority.

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[21] Office of Management and Budget, "Table 2.1—Receipts by Source: 1934–2029."
[22] Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R.1, the Tax Cuts and Jobs Act*, December 18, 2017, https://www.jct.gov/publications/2017/jcx-67-17/ (accessed October 18, 2024).
[23] Office of Management and Budget, "Table 2.1—Receipts by Source: 1934-2029." TCJA's changes to the estate and gift tax may have also affected income tax receipts, though the effect on income taxes is unclear.

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