

## Testimony Before the US House Small Business Committee

# The Impact of the 2025 Reconciliation Law's Tax Changes on Small Businesses and Lessons for Future Tax Reform

April 15, 2026

**Garrett Watson**

Director of Policy Analysis, Tax Foundation

---

Chairman Williams, Ranking Member Velázquez, and members of the committee, thank you for the opportunity to discuss the impact of the 2025 reconciliation law on small businesses and future opportunities to improve the tax code to encourage small business formation, investment, and contribution to economic growth.

As expected, 2025 was a major year for federal tax policy change. With the expiration of the 2017 Tax Cuts and Jobs Act (TCJA) looming, policymakers did not disappoint, delivering the largest set of tax changes since 2017 for businesses and individual taxpayers alike. In that legislation, small business owners won improved certainty over the shape of the business tax code in addition to tax changes that increase incentives for investment.

However, the tax code remains too complicated and confusing for small business owners who would rather focus on operating their businesses than complying with a maze of tax provisions. More can be done to stabilize the policy climate and encourage investment for small business owners through changes to cost recovery, tariff policy, and the tax treatment of losses.

In this testimony, I will review how the 2025 reconciliation law changed tax policy for small businesses and make recommendations to simplify the tax code for small business owners, improve incentives for investment, and maximize certainty in the years ahead.

## Permanency for Individual TCJA Provisions in the 2025 Reconciliation Law

The scheduled expiration of a suite of TCJA tax changes at the end of 2025 introduced considerable uncertainty for business owners planning investment and hiring decisions for 2026 and beyond.<sup>1</sup> The TCJA expirations would have increased tax liability for about 62 percent of taxpayers, many of whom either work for or are owners of small businesses.<sup>2</sup>

<sup>1</sup> Tim Shaw, "Uncertainty Abounds as TCJA Expiration Looms, Tax Pros Say," Thomson Reuters, Jun. 25, 2024, <https://tax.thomsonreuters.com/news/uncertainty-abounds-as-tcja-expiration-looms-tax-pros-say/>.

<sup>2</sup> Garrett Watson and Peter Van Ness, "2026 Tax Calculator: How the One Big Beautiful Bill Act's Tax Changes Will Affect You," Oct. 1, 2025, <https://taxfoundation.org/data/all/federal/tax-calculator-obbbba/>.

For small businesses, the scheduled expirations included the 20 percent Section 199A deduction, which allowed business owners to deduct up to 20 percent of qualified business income (QBI) from partnerships, S corporations, sole proprietorships, or real estate investment trusts (REITs), reducing their marginal tax rates by about 20 percent.

Additionally, lower ordinary income tax rates and consolidated brackets were set to expire, including the top ordinary income tax rate reverting from 37 percent to 39.6 percent, along with the phaseout of 100 percent bonus depreciation, five-year amortization of research and development (R&D) expenses, and a less generous deduction for business interest expenses, which began in 2022.

The 2025 reconciliation law made permanent the TCJA's consolidated set of ordinary income tax brackets and lower tax rates, which apply to pass-through business income. It also made Section 199A permanent and expanded it slightly by increasing the phase-in range for Section 199A limitations by \$25,000 (\$50,000 for joint filers) and adding a new minimum deduction of \$400 for taxpayers with \$1,000 or more of QBI for material participants.

While not all pass-through firms are considered small businesses, almost 93 percent of pass-through firm employment is in firms with fewer than 500 employees.<sup>3</sup>

Together, these changes have lowered tax rates on pass-through businesses: American Enterprise Institute tax scholar Kyle Pomerleau has estimated that pass-through businesses face a marginal effective tax rate of 12.6 percent and an average effective tax rate of 20.5 percent after the 2025 reconciliation law.<sup>4</sup>

Other individual TCJA provisions that were made permanent, such as the limitations to certain itemized deductions for state and local taxes (SALT) paid and the new cap on itemized deductions, indirectly increased marginal tax rates on business income. For most taxpayers, these increases are offset by the other individual and business tax changes within the law to produce net reductions in tax liability.

## Business Tax Improvements in the 2025 Reconciliation Law

The TCJA provided temporary improvements to small business cost recovery by providing 100 percent bonus depreciation for short-lived investments (those with asset lives of 20 years or less) from late 2017 to 2022. Providing immediate, full deductions for investment removes the tax penalty that otherwise arises because of the time value of money and inflation, both of which reduce the real value of tax deductions taken over time.<sup>5</sup>

After 2022, bonus depreciation began phasing down by 20 percentage points each year and is scheduled to fully phase out in 2027. Bonus depreciation's expiration reintroduced a penalty on business investment, which hits small businesses harder than larger firms because smaller businesses are less likely to have cash on hand to handle timing differences between their investment and deductions.

3 Garrett Watson, Huaqun Li, Erica York, Alex Muresianu, Alan Cole, Peter Van Ness, and Alex Durante, "One Big Beautiful Bill Act Tax Policies: Details and Analysis," Tax Foundation, Feb. 10, 2026, <https://taxfoundation.org/research/all/federal/big-beautiful-bill-senate-gop-tax-plan/>.

4 William McBride, Emily Kraschel, and Huaqun Li, "Tax Treatment of Pass-Through Business Sector: A Primer," Tax Foundation, Feb. 24, 2026, <https://taxfoundation.org/research/all/federal/199a-deduction-s-corp-sole-proprietorship/>, footnote 26.

5 Erica York and Alex Muresianu, "Expensing: It Pays to Be Permanent," Tax Foundation, Jan. 28, 2025, <https://taxfoundation.org/blog/permanent-bonus-depreciation-expensing-options/>.

On top of bonus depreciation's phaseout, R&D costs began to be amortized over 5 years (15 years for foreign R&D) starting in 2022, penalizing R&D investment compared to its prior law treatment that provided a full and immediate deduction for R&D.<sup>6</sup>

The TCJA also put in place a new limit on the amount of interest businesses can deduct, worth 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA) from 2018 through 2021. Starting in 2022, businesses used a less generous limitation based on earnings before interest and taxes (EBIT), excluding the value of depreciation and amortization and lowering the amount of deductible interest.

The 2025 reconciliation law permanently restored 100 percent bonus depreciation for property placed in service after January 19, 2025. The law also permanently restored expensing for domestic R&D investment starting in 2025 and provided retroactive R&D expensing for 2023 and 2024.

Permanency for bonus depreciation and R&D expensing was essential to maintain long-term investment incentives and encourage long-run economic growth.<sup>7</sup> These two combined provisions are the second largest source of economic growth in the reconciliation law, after the reduction in individual income tax rates, and the largest when adjusted for the size of their revenue cost.<sup>8</sup> Tax Foundation estimates that permanence for 100 percent bonus depreciation and R&D expensing will increase long-run economic output by 0.7 percent and increase hours worked by about 180,000 jobs.<sup>9</sup>

Another cost recovery improvement in the 2025 reconciliation law comes from a new, temporary 100 percent deduction for qualifying commercial structures associated with tangible production, including manufacturing.

Commercial structures are typically depreciated over 39 years, so an immediate deduction is a large improvement in their tax treatment. For example, assuming a 3 percent discount rate and a 2 percent inflation rate (both of which are conservative assumptions), a company will only recover about 44 percent of its real structures costs if required to depreciate the property over 39 years.<sup>10</sup>

Small businesses in manufacturing and tangible production stand to benefit most from the structures deduction. The new structures deduction is scheduled to expire in 2031 and is limited to only a subset of structures investment, which limits the provision's long-term growth potential.

The 2025 reconciliation law expanded Section 179 expensing, doubling the maximum expensing amount from \$1.25 million to \$2.5 million (indexed annually for inflation) with a phasedown starting when the cost of qualifying property exceeds an inflation-adjusted \$4 million.

---

6 Akusti Leino, "Improving Tax Treatment of R&D Would Boost Productivity and Growth," Tax Foundation, May 7, 2025, <https://taxfoundation.org/blog/us-rd-tax-full-expensing/>.

7 Erica York and Garrett Watson, "House Tax Package Could Double Economic Growth Impact by Prioritizing Permanence for TCJA Business Provisions," Tax Foundation, May 15, 2025, <https://taxfoundation.org/blog/house-tax-plan-economic-growth-impact-business-tax-permanent/>.

8 Watson, Li, York, Muresianu, Cole, Van Ness, and Durante, "One Big Beautiful Bill Act Tax Policies: Details and Analysis"; Erica York, "Which Provisions of the Tax Cuts and Jobs Act Should Be Made Permanent?," Tax Foundation, Jan. 9, 2024, <https://taxfoundation.org/blog/tax-cuts-and-jobs-act-permanent/>.

9 Ibid.

10 Alex Muresianu and Garrett Watson, "What to Expect from the New OBBBA Expensing for Manufacturing Structures," Tax Foundation, Oct. 27, 2025, <https://taxfoundation.org/blog/obbba-expensing-manufacturing-structures/>.

While there is overlap between Section 179 and bonus depreciation, some assets are eligible for Section 179 treatment but not bonus depreciation. The expansion improves the tax treatment of that investment. Expanding or repealing the Section 179 phaseout limits would remove the disincentive for small businesses to grow, as the current design discourages small businesses from moving above the qualifying property thresholds, as they would lose the benefit of Section 179 expensing.<sup>11</sup>

The 2025 reconciliation law permanently reverted the interest deduction limitation back to the EBITDA-based calculation, aligning US tax policy with international norms and removing the negative impact of a tighter interest deduction in a high-interest-rate financial environment.<sup>12</sup>

## Building on the 2025 Reconciliation Law

Even with improvements from the 2025 reconciliation law, several opportunities remain to reduce complexity, expand full expensing, and stabilize policy uncertainty.

Complexity is one of the biggest problems in the US tax code, amounting to \$536 billion in compliance costs and 7.1 billion hours spent complying with IRS tax filing and reporting requirements annually.<sup>13</sup> Of these compliance costs, over 70 percent of the burden is borne by businesses.<sup>14</sup>

The 2025 reconciliation law's new deductions for tipped income and overtime will require additional reporting by businesses starting in 2026 with specific tax rules on qualified income, creating a new layer of complexity that businesses will navigate over the next year.<sup>15</sup> Small businesses will be particularly impacted, as they are less likely to use payroll processing services, tax lawyers, and other resources to comply with the law compared to larger businesses.

The Section 199A deduction is another source of complexity, costing about \$20 billion per year in compliance costs in 2024.<sup>16</sup> This complexity is concentrated in the deduction's wage and capital limits for higher-income earners, which requires a separate form filing involving multiple schedules and more than 24 hours to complete per filer on average.<sup>17</sup>

Simplifying the wage and capital limits to encourage investment within Section 199A is one promising avenue for reform and could be paired with changes to more consistently apply the wage and capital limits to REITs and publicly traded partnerships.<sup>18</sup>

11 Alex Muresianu, "Section 179 Expensing: Good First Step?," Tax Foundation, Aug. 23, 2023, <https://taxfoundation.org/blog/section-179-expensing/>; Scott Greenberg, "Section 179 Really Does Benefit Small Business," Tax Foundation, Nov. 17, 2015, <https://taxfoundation.org/blog/section-179-really-does-benefit-small-businesses/>.

12 Garrett Watson and William McBride, "U.S. Businesses Face Growing Impact from Tightened Interest Deductions and Higher Interest Rates," Tax Foundation, Sep. 12, 2023, <https://taxfoundation.org/blog/ebitda-us-business-interest-expense-limitation/>.

13 Sam Cluggish and Alex Muresianu, "Tax Complexity Now Costs the US Economy over \$536 Billion Annually," Tax Foundation, Aug. 27, 2025, <https://taxfoundation.org/data/all/federal/irs-compliance-complexity-tax-costs/>.

14 Ibid.

15 Alex Muresianu, Sam Cluggish, and Rebecca Walker, "One Big Beautiful Bill Act Makes the Individual Income Tax More Complex," Tax Foundation, Sep. 9, 2025, <https://taxfoundation.org/research/all/federal/obbba-income-tax-complexity-tax-breaks/>.

16 Scott Hodge and Claire Rock, "Tax Complexity Now Costs the US Economy Over \$546 Billion Annually," Tax Foundation, Aug. 6, 2024, <https://taxfoundation.org/data/all/federal/irs-tax-compliance-costs/>.

17 McBride, Kraschel, and Li, "Tax Treatment of Pass-Through Business Sector: A Primer."

18 Ibid.

Expanding full expensing to other types of assets commonly used by small businesses—including structures, inventory, and intangible investment—is another opportunity for future reform. Ideally, all business investment would be fully and immediately deductible permanently, simplifying the existing system of tax depreciation for small firms and maximizing the growth potential from expensing.

The reconciliation law's structures expensing provision should ideally be made permanent and expanded to other types of structures to create a lasting positive economic impact. Small businesses currently must segment their investment in structures associated with qualifying production activity, which is an extra step that would be avoided with a broadening of the deduction.

Alternatively, structures depreciation deductions could be adjusted to account for their eroded value from inflation and the time value of money through a neutral cost recovery system.<sup>19</sup> Not only would this increase small business investment, but it could help address housing shortages and associated affordability problems.<sup>20</sup>

## Opportunities for Fundamental Tax Reforms to Help Small Businesses

While tax reform has improved policy certainty in some respects, this certainty was undermined by a constantly changing and still evolving tariff regime that would undermine the economic impacts of the 2025 reconciliation law.

Even after the Supreme Court struck down the legal basis for the tariffs imposed under the International Economic Emergency Powers Act (IEEPA) in February 2026, President Trump's remaining tariffs amount to a \$600 average tax increase per US household in 2026 and will reduce long-run US GDP by 0.2 percent.<sup>21</sup> Much of this economic damage falls on small businesses that rely on imports as a key part of their supply chains, especially those that cannot build an economy of scale through domestic production.

Small businesses may pass on higher input costs to consumers, but to the extent they are unable to do so, they will bear the burden directly, reducing how much they are able to pay workers and invest. Further, heightened policy uncertainty adds to the negative economic effects of tariffs as businesses delay or cancel investment and hiring decisions amid the ever-changing tariff landscape.

If the Section 232 tariffs remain in place long-term, they will offset nearly one-third of the long-run economic benefits of the 2025 reconciliation law while paying for about one-sixth of its cost.<sup>22</sup> Repealing the tariffs would remove this headwind, preserving the full benefits of the reconciliation law for small business owners and their workers and customers.

---

19 Alex Muresianu and Erica York, "Why Neutral Cost Recovery Matters," Tax Foundation, Sep. 6, 2024, <https://taxfoundation.org/blog/neutral-cost-recovery-matters/>.

20 Garrett Watson, "Testimony: Tax Policy's Role in Expanding Affordable Housing," Tax Foundation, Mar. 7, 2023, <https://taxfoundation.org/testimony/expanding-affordable-housing/>; Alex Muresianu, "Tax Policy Can Lower Housing Costs. Here's How," Tax Foundation, Mar. 23, 2026, <https://taxfoundation.org/blog/lower-housing-costs-tax-policies/>.

21 Erica York and Alex Durante, "Tracking the Impact of the Trump Tariffs & Trade War," Mar. 13, 2026, <https://taxfoundation.org/research/all/federal/trump-tariffs-trade-war/>.

22 Erica York and Alex Durante, "Trump Tariffs Threaten to Offset Much of the 'Big Beautiful Bill' Tax Cuts," Tax Foundation, Mar. 3, 2026, <https://taxfoundation.org/blog/trump-tariffs-tax-cuts/>.

**Table 1. Summary of Economic and Revenue Effects of Imposed Tariffs and the 2025 Reconciliation Law**

	2025 Reconciliation Law	Section 232 Tariffs in Effect Feb. 25, 2026, Before Retaliation
GDP	+0.7%	-0.2%
Capital Stock	-1.1%	-0.1%
Hours Worked in FTEs	828,000	-154,000
Conventional Deficit Change, Before Interest Costs, 2025-2034, Billions	\$4,100.0	-\$660.2
Dynamic Deficit Change, Before Interest Costs, 2025-2034, Billions	\$3,262.8	-\$514.9

Source: Tax Foundation General Equilibrium Model, February 2026.

More broadly, small business uncertainty about the trajectory of long-term tax policy is a concern. Tax policy has become increasingly partisan, with each new Congress advancing sharply different agendas, ranging from wealth taxes, higher top rates, and new business taxes to temporary tax cuts.

These swings undermine stability and complicate long-term planning, even when provisions like permanent cost recovery are in place. Greater consistency in the tax code should be a priority to give business owners the certainty they need to focus on running and growing their operations.

Small businesses also face challenges in accessing tax credits for incremental research and development. While the goal is to encourage greater innovation beyond what the private sector would otherwise deliver, small businesses have historically benefited less from R&D credits due to the complexity involved with claiming them.<sup>23</sup> Small businesses stand to benefit the most from the credits because they often lack liquidity in early years, but given the complexity, they are more likely to avoid taking them.

A study conducted by the US Small Business Administration in 2013 found that of the \$6.9 billion allocated to the tax credit for increasing research activities, only \$0.2 billion went to small businesses, or just under 3 percent of the total. Meanwhile, of the \$5.4 billion in benefits of expensing for R&D, small businesses received \$0.5 billion, or about 9.2 percent of the total. Simplifying the administrative burdens and expense eligibility requirements would help address the R&D credit claims gap between small and larger firms.<sup>24</sup>

The tax treatment of losses is another important area for small business tax reform. Entrepreneurs and startups often run losses before turning a profit, and some firms never turn a profit at all before dissolving.

The tax code penalizes businesses that have large, upfront losses. Firms with a profit are subject to an immediate tax liability, but firms with losses are not entitled to an immediate tax benefit. Instead, losses are carried forward, sometimes over many years, until the small business is profitable, eroding the real value

<sup>23</sup> Alex Muresianu and Garrett Watson, "Reviewing the Federal Tax Treatment of Research & Development Expenses," Tax Foundation, Apr. 13, 2021, <https://taxfoundation.org/research/all/federal/research-and-development-tax/>.

<sup>24</sup> Akusti Leino, "Improving Tax Treatment of R&D Would Boost Productivity and Growth," Tax Foundation, May 7, 2025, <https://taxfoundation.org/blog/us-rd-tax-full-expensing/>.

of the losses due to inflation and the time value of money.<sup>25</sup> To partially rectify this problem, businesses could receive an adjusted carry-forward net operating loss deduction to offset the cost of waiting to take the deduction.

Similarly, capital losses—losses associated with investing in a business—are also common for smaller firms and entrepreneurs starting out, and the tax treatment of these losses penalizes risky investment.

Capital losses can offset capital gains, but losses beyond that must be carried forward if they are more than \$3,000 (\$1,500 for married individuals filing separately). These carry-forwards are also eroded in value from inflation and the time value of money, creating a tax policy-induced penalty when investing in risky business ventures. Reforming and expanding capital loss rules, with reasonable guardrails to prevent gaming, would be a sensible way to increase outside investment opportunities for startups and small businesses.

In addition to efforts supporting innovation and entrepreneurship, policymakers can consider wider reforms. For example, the US pass-through tax system that small businesses mostly rely on for tax filing is more complex than our international peers. Other countries within the Organisation for Economic Cooperation and Development (OECD), such as the United Kingdom and Canada, rely on entity-level reporting rather than individualized reporting systems that increase complexity in the US tax code.<sup>26</sup>

Going further, a larger tax reform that replaces the US pass-through system with a simplified business tax system that taxes profits distributed to owners, like Estonia and Latvia have implemented, would greatly simplify the tax code for smaller firms and boost economic growth.<sup>27</sup>

These and other systems of corporate integration that eliminate the double taxation of corporate income at the entity and individual levels would neutralize the relative tax differences between pass-through and corporate business forms, simplifying one aspect of small business decision-making.<sup>28</sup>

## Conclusion

The 2025 reconciliation law improved certainty and strengthened investment incentives for small businesses by making permanent key TCJA individual provisions and enhanced cost recovery. These changes provide a more stable foundation for long-term planning and growth, but persistent complexity, uneven treatment across different types of investment, and policy uncertainty, especially from tariffs and shifting tax priorities, continue to limit the full potential of these reforms.

25 Kyle Pomerleau, "Testimony: The Tax Code as a Barrier to Entrepreneurship," Tax Foundation, Feb. 15, 2017, <https://taxfoundation.org/testimony/tax-code-barrier-entrepreneurship/>; Garrett Watson and Nicole Kaeding, "Tax Policy and Entrepreneurship: A Framework for Analysis," Tax Foundation, Apr. 3, 2019, <https://taxfoundation.org/research/all/federal/tax-policy-entrepreneurship/>.

26 McBride, Kraschel, and Li, "Tax Treatment of Pass-Through Business Sector: A Primer."

27 William McBride, Huaqun Li, Garrett Watson, Alex Durante, Erica York, and Alex Muresianu, "A Tax Reform Plan for Growth and Opportunity: Details and Analysis," Tax Foundation, Jun. 29, 2023, <https://taxfoundation.org/research/all/federal/growth-opportunity-us-tax-reform-plan/>; William McBride, Garrett Watson, and Erica York, "Taxing Distributed Profits Makes Business Taxation Simple and Efficient," Tax Foundation, Mar. 1, 2023, <https://taxfoundation.org/blog/distributed-profits-tax-us-businesses/>.

28 Kyle Pomerleau, "Eliminating Double Taxation through Corporate Integration," Tax Foundation, Feb. 23, 2015, <https://taxfoundation.org/research/all/federal/eliminating-double-taxation-through-corporate-integration/>; Scott Greenberg, "What is Corporate Integration?," Tax Foundation, May 16, 2016, <https://taxfoundation.org/blog/what-corporate-integration/>.

Policymakers should broaden and make permanent full expensing for additional asset classes and pursue structural reforms that reduce distortions in how businesses are taxed. A more consistent and predictable policy environment, paired with targeted improvements to loss treatment, R&D incentives, and compliance burdens, would give small business owners greater confidence to invest, hire, and grow.

Thank you again for having me, and I look forward to your questions.