

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-0515

MEMORANDUM

TO: Small Business Committee Members
FROM: Nydia M. Velázquez, Chairwoman
DATE: Wednesday, July 24, 2019
RE: Full Committee hearing entitled “Is the Tax Cuts and Jobs Act a Help or Hinderance to Main Street?” on Wednesday, July 24, 2019 at 11:30 A.M. in Room 2360 of the Rayburn House Office Building.

The Committee on Small Business will hold a hearing entitled “Is the Tax Cuts and Jobs Act a Help or Hinderance to Main Street?” on Wednesday, July 24, 2019 at 11:30 A.M. in room 2360 of the Rayburn House Office Building.

Members will hear from experts on the changes the new tax law and its impact on small businesses, an overview of the current economic analysis of the bill, and whether it has lived up to the promises touted before passage. Small businesses will also provide testimony on how the current tax law has impacted them, and what outstanding issues still exist. Witnesses include:

- Jane Gravelle, Congressional Research Service, Senior Specialist in Economic Policy, Washington, D.C.
- Grafton H. Willey, IV, CPA and Small Business Owner, Portsmouth, RI; Testifying on Behalf of the National Small Business Association.
- Muneer Baig, Founder & CEO, SYSUSA, Inc., Manassas, VA; Testifying on Behalf of the Small Business Majority.
- Justin Conger, President, Conger Construction Group, Lebanon, OH.

Background

Small business owners have long been a critical stakeholder in tax discussions. This is, in part, because small businesses make uniquely valuable and substantial contributions to the U.S. economy in the form of employment and overall economic activity. Small businesses make up over 99 percent of all employers. Therefore, it is critical that federal tax law support small businesses to ensure job creation and economic growth in the overall economy.

Small business owners generally have agreed that their priorities for reforming the tax code are: (1) lowering the tax burden on small business income; (2) decreasing the cost of tax compliance for all small firms; (3) establishing parity between the tax rates for corporate and non-corporate net business income; and (4) creating certainty for small businesses. These objectives, following

passage of the Tax Cuts and Jobs Act (TCJA),¹ raised the question of how small businesses have fared since the new tax law was enacted.

Small Business Taxation Background

To understand how federal tax law changes affects small business income in general, it is necessary to consider how a small business is defined for tax purposes. Unfortunately, there is no uniform or standard definition. Rather, several different criteria are used (including assets, receipt, and employment size) in tax provisions targeted at small firms. Another factor that determines a business’s income tax liability is where the business is located. Domestic businesses have different tax obligations than multi-national corporations. Additionally, a major factor that determines tax liability is according to how a business is legally organized.

Generally, a business has two choices: to operate as a C corporation or a passthrough entity. A pass-through can be a partnership (including a limited liability company or LLC), S corporation, or sole proprietorship (i.e. a self-employed person).² The profits of a C corporation are taxed at two levels. First, they are taxed at the corporate level; then they are taxed a second time at the individual level of the owners when the profits are distributed to them as dividends. By contrast, the profits of passthrough entities (whether distributed or not) are taxed only once: at the individual level of the owners. Under the tax rules that applied to 2017 income, the top corporate income tax rate was 35 percent and the top individual income tax rate 39.6 percent. Capital gains and dividends were taxed at a top rate of 23.8 percent.³ This rate structure incentivized small firms to organize as a pass-through to avoid a corporate level of taxation.

Tax burden for a small business also depends on the statutory rate at which its income is taxed, and on any tax preferences it can claim (see Table 1 for top tax small business tax preference under the previous tax law).⁴ Tax preferences, such as credits, deductions, and exclusions, shrink the tax burden of companies by lowering their average effective tax rates. The federal income tax has had a graduated rate structure for corporate and non-corporate income. As a result, a firm’s marginal tax rate depends on both its taxable income and whether how it is organized.

Table 1

Top Small Business Tax Benefits Prior to P.L. 115-79 in FY 2018

Small Business Tax Preferences	Federal Tax Code Section	Estimated FY2018 Revenue Cost (\$ billions)
Limited expensing allowance	179	\$45.70
Graduated corporate income tax rates	11	3.1
Non-farm cash basis accounting	446	2.3

Source: CRS and the Joint Committee on Taxation.

¹ Pub. L. No. 115-97.

² Gary Guenther, IF10723, Cong. Research. Serv., *P.L. 115-97, the 2017 Tax Revision, and Small Business Taxation* (2018).

³ *Id.*

⁴ *Id.*

Tax Cuts and Jobs Act of 2017

The Tax Cuts and Jobs Act (TCJA) of 2017, was the largest tax overhaul in many years. The new tax law makes substantial changes to both the individual and corporate income taxes rates, cutting the corporate income tax rate to 21 percent, redesigning international tax rules, and implementing a new and complicated deduction for pass-through income, to name a few.⁵ The Joint Committee on Taxation (JCT) estimated that these changes would reduce tax revenue by \$1.5 trillion over 10 years, though new data has higher estimates.⁶ Unlike many small business related provisions that are set to expire over the coming years, C corporate tax provisions were made permanent.⁷ Below are select sections of the tax code that impact small firms.

Section 199A Deduction

The new tax law added under 199A, a new deduction for pass-through business income. The provision was an attempt to level the playing field with C corporations that received a nearly one-third tax rate cut. According to the IRS, pass-through firms filed 95 percent of the 33.4 million business tax returns. As stated before, most U.S. businesses are organized as pass-throughs: 72 percent were sole proprietors, 10 percent were partnerships, 13 percent were S corporations, 10 percent were partnerships and 5 percent were C corporations.⁸ A pass-through company itself is not subject to taxes. Rather, items of income/loss/gain/deduction/credit for the business are “passed-through” to the owners and any profits are taxed at the owners’ individual income tax rate. In other words, income from an S corporation is taxed once at the shareholder level.

The new deduction on its face seems relatively simple: it is equal to as much as 20 percent of qualified business income (QBI) in determining their taxable income from 2018 to 2025.⁹ Yet, many small businesses have complained that the deduction is of little or no use to them because of the complex rules around it.¹⁰ The provision requires multiple assessments and calculations, new information to be reported to the IRS by each pass through owner, and contains numerous limitations.¹¹ It generally requires a process to determine if the trade or business is: (1) a qualified service trade or business; (2) a determination of what income qualifies for the deduction; and (3) what income can be deducted.¹² It also treats businesses differently depending on the sector with which the business operates.¹³ The intent was to give small business and noncorporate businesses

⁵ Jane G. Gravelle & Donald J. Marples, R45736, Cong. Research Serv., *The Economic Effects of the 2017 Tax Revision: Preliminary Observations* (2019).

⁶ *Id.*

⁷ *Id.*

⁸ Gary Guenther, IF11122, Cong. Research Ser., *2019 Tax Filing Season (2018 Tax Year): Section 199A Deduction for Passthrough Business Income* (2019).

⁹ *Id.*

¹⁰ Joyce M. Rosenberg, SMALL BUSINESS TAX DEDUCTION HAS CPAs SCRATCHING THEIR HEADSTIMESFREEPRESS.COM (2019), <https://www.timesfreepress.com/news/edge/story/2019/feb/01/small-business-tax-deductihcpscratching-their/487140/> (last visited Jul 16, 2019).

¹¹ 26 U.S.C. § 199A.

¹² *Id.*

¹³ Owners of agricultural and horticultural cooperatives may also claim the deduction. The deduction does not affect a taxpayer’s adjusted gross income (AGI), as it is claimed “below the line.” Nor can a taxpayer claim the deduction as an itemized deduction. Nonetheless, the Section 199A deduction may be claimed by taxpayers who take the standard deduction and those who itemize their deduction. A taxpayer’s QBI is defined as the net amount of items of qualified income, loss, gain, and deduction for each qualified domestic trade or business an individual is actively or passively owns, in whole or in part. If a taxpayer owns more than one qualified business, then the QBI must be determined separately for each of them; those amounts are combined to determine total QBI in a tax year.

a tax cut comparable to the corporate income tax rate cut, which dropped from a 35 percent top rate to a single rate of 21 percent. The hearing will allow Members to discuss if this goal was achieved.

Section 179: Expensing

In the case of the Section 179 expensing allowance, the tax law allows for small businesses to make it more affordable for firms to buy business equipment, such as vehicles, machinery, computer, and other tangible capital investments, by allowing businesses to deduct up to \$1,000,000 per year in qualifying business equipment purchases from their taxable income. The tax law permanently raised the maximum amount deductible to \$1 million, and the phaseout threshold for the allowance to \$2.5 million, beginning in 2018; it also indexed both amounts for inflation starting in 2019.¹⁴ The law also expanded the definition of qualified property to include qualified improvement property, specified improvements (e.g. new roofs and heating systems) to nonresidential real property, and property used in connection with lodging.¹⁵ In another change, the \$25,000 expensing limit for heavy-duty sport utility vehicles imposed in 2003 was indexed for inflation starting in 2019.

While businesses were already allowed to deduct the value of eligible business equipment purchases, they could only deduct a portion of the purchase price each year. In prior years, qualified new assets that a business placed in service in 2017, firms could claim a 50 percent first-year bonus depreciation deduction, with used assets unable to qualify. In addition, 50 percent bonus depreciation was allowed for qualified improvement property. The new law allows a 100 percent expensing (or bonus depreciation) allowance for eligible property acquired and placed in service after September 27, 2017, and before January 1, 2023. The allowance is equal to 100 percent of the cost of qualified property. Under current law, this rate is expected to expire at the end of 2022, which will then be phased down by 20 percent each year.¹⁶

Qualified property with relatively long production times is allowed an extra year of bonus depreciation over this period. The wording of the final bill led to the unintended result that qualified improvement property became ineligible for bonus depreciation, as it no longer had a 15-year recovery period.¹⁷ As things now stand, such property is treated as 39-year nonresidential real property, unless Congress alters the language. The hearing gives Members the opportunity to discuss the changes with witnesses to gauge the provision's effectiveness.

Net Operating Loss (NOL)

A net operating loss (NOL) occurs when business expenses exceed income, this is particularly important for many new and young startup ventures. Prior to the tax law, taxpayers reporting an NOL were able to carryback the NOL at least two years prior, or carryforward the NOL against future income for a maximum of 20 years.¹⁸ This allowed small business owners to deduct losses

¹⁴ Gary Guenther, RL31852, Cong. Research Serv., *The Section 179 and Section 168(k) Expensing Allowances: Current Law and Economic Effects* (2018).

¹⁵ *Id.*

¹⁶ *Id.* 80 percent in 2023, 60 percent in 2024, 40 percent in 2025, 20 percent in 2026, and 0 percent for property acquired and placed in service in 2027 and thereafter.

¹⁷ *Id.*

¹⁸ Publication 536 (2018), Net Operating Losses (NOLs) for Individuals, Estates, and Trusts: Internal Revenue Service, (2019), <https://www.irs.gov/publications/p536> (last visited Jul 1, 2019).

the small business incurred from their income on their tax returns. Additionally, the NOL allows small businesses to better manage their cash flow and provides relief to businesses that suffer losses. Under the new tax law, taxpayers cannot apply an NOL to prior tax years (i.e., NOL carryback), but instead must carryforward an NOL for an unlimited amount of years until that NOL is exhausted. Additionally, under a new provision, taxpayers can deduct NOLs only up to 80 percent of taxable income in that year.¹⁹

State and Local Tax (SALT)

Many small businesses have asked for parity with big businesses during the tax reform debate. Like C Corporations, S Corporations pay state & local income taxes on their business income but unlike C Corporations, C Corporations can deduct state and local taxes paid by the entity without limitation. Many small businesses operate as pass-through entities that pass their tax obligations down to the owners. If these taxes on the business income are paid at the individual level, they become limited to the \$10,000 tax limits under tax reform.²⁰ In most cases, these small businesses will not be able to get a tax deduction for the payment of the state income taxes and creates a lack of parity among businesses. Further, many states have already started to set up work arounds to the SALT limitations but have come up against Treasury regulations.²¹

Preliminary Economic Effects

Tax Reform advocates argued that reforming the tax code would have broad economic benefits. These include an increase in wages for American workers, more economic growth via increased Gross Domestic Product, and would pay for themselves.

Increase in Wages

Since the beginning of 2019, new research and reports have been released on the economic impact the TJCA had on the economy. Notably, the Congressional Research Service (CRS), an independent, nonpartisan Congressional resources for members and staff, has highlighted the limited, if any, first-year effect the tax law had on the economy and wages.²² In short, CRS stated real wages grew more slowly (2.0 percent) than projected by the White House's Chief Economic Advisors (CEA), while real wage rate for production and nonsupervisory workers, the traditional wage indicator for average workers, grew at a much lower rate (1.2 percent).

¹⁹ *Id.*

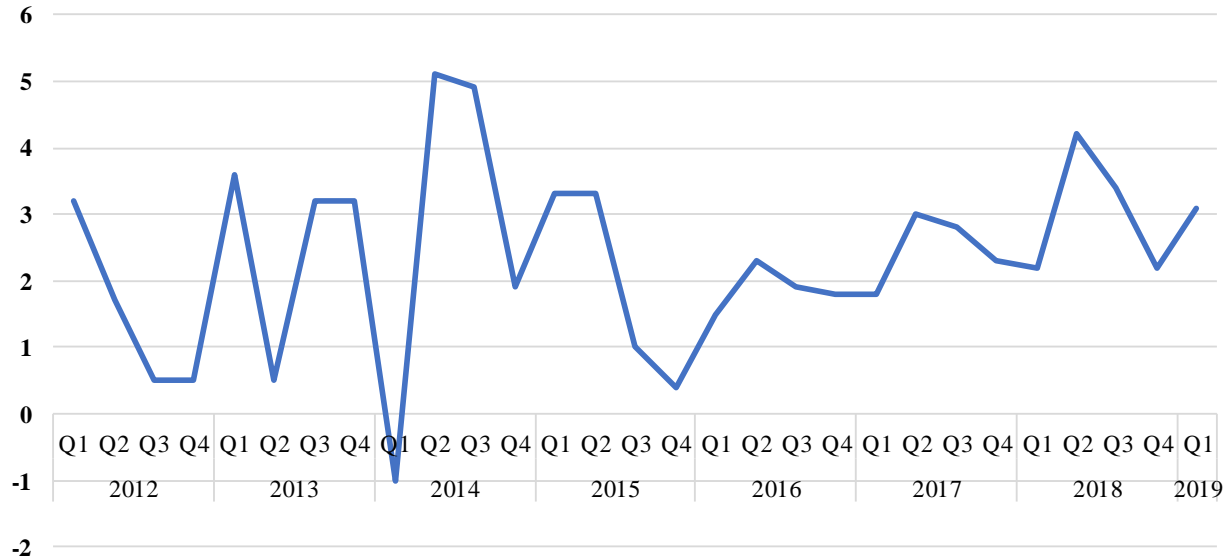
²⁰ With New SALT Limit, IRS Explains Tax Treatment of State and Local Tax Refunds (2019), <https://www.irs.gov/newsroom/with-new-salt-limit-irs-explains-tax-treatment-of-state-and-local-tax-refunds> (last visited Jul 1, 2019).

²¹ Laura Davison & Kelly Zegers, IT'S OVER: STATES LOSE FIGHT AGAINST SALT DEDUCTION CAP (2019), <https://www.bloomberg.com/news/articles/2019-06-12/it-s-over-as-states-lose-fight-against-salt-deduction-limit> (last visited Jun 12, 2019).

²² R45736, *supra* note 5.

Graph 1

Percent Change From Preceding Quarter in Real Gross Domestic Product



Source: Bureau of Economic Analysis – National Income, 2019.
Note: Seasonally adjusted at annual rates.

Distributional analysis of the tax changes shows that the “tax revision favored higher-income taxpayers, in part because most of the tax cut benefited corporations and in part because the individual income tax cut largely went to higher-income individuals.”²³

Impact on Growth

The White House’s CEAs projected Gross Domestic Product (GDP) at over 3 percent annually as a result of the Tax Cuts and Jobs Act. The U.S. economy has not experienced “dynamic” growth projections have, the tax reform was promised to bring. In fact, 2019 GDP is expected to come in below the 2 percent mark for the second quarter of this year and below 3 percent overall.²⁴ In its June meeting, the Federal Reserve’s Open Market Committee projected much lower growth this and coming years, with the highest estimates projected at roughly 2.4 percent.²⁵ Finally, the tax reform advocates, as they have made in the past, argued that tax cuts will pay for themselves through added growth. Once again, these claims prove to be without merit. The Congressional

²³ Molly F Sherlock & Donald J Marples, THE 2017 TAX REVISION (P.L. 115-97): COMPARISON TO THE 2017 TAX LAW (2018).

²⁴ Pattidom, LATEST DATA SHOWS SURPRISE SLOWING IN US, CHINA ECONOMIES AS TRADE WAR ESCALATES CNBC(2019), <https://www.cnbc.com/2019/05/15/latest-data-show-surprise-slowing-in-us-china-economies-as-trade-war-escalates.html> (last visited Jul 15, 2019).

²⁵ Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents Under Their Individual Assessments of Projected Appropriate Monetary Policy, June 2019, (2019), <https://www.federalreserve.gov/monetarypolicy/files/fomcproptabl20190619.pdf> (last visited Jun 19, 2019).

Graph 2

**Percent Change From Preceding Quarter of
Nonresidential Investments Subcomponent**



Source: Bureau of Economic Analysis – National Income, 2019.
Note: Seasonally adjusted at annual rates.

Budget Office has recently indicated that the tax cut will add \$2.3 trillion to the federal deficits over the 2018 to 2018 period.²⁶

Conclusion

In 2017, the Treasury Department published the Unified Framework for Fixing Our Broken Tax Code, published in 2017, the baseline used to establish the TCJA,²⁷ outlined four main principles to tax reform: (1) make the tax code simple, fair, and easy to understand; (2) give American workers a pay raise; (3) level the playing field for American businesses and workers; and (4) repatriate trillions of offshore dollars to reinvest here at home. The hearing will address if the law has met these goals and what more could be done to better meet the needs of small firms. In particular, the hearing will allow Members to discuss if the tax reform bill is meeting the needs of small businesses by create simplicity and parity between small and large businesses, analyze provisions intended to benefit small firms, and if it is providing incentives to our entrepreneurs and startups have that allows them to grow and succeed.

²⁶ Cong. Budget Office, How the 2017 Tax Act Affected CBO’s GDP and Budget Projections Since January 2017, Feb. 28, 2019, https://www.cbo.gov/publication/54994?utm_source=feedblitz&utm_medium=FeedBlitzEmail&utm_content=812526&utm_campaign=0.

²⁷ Unified Framework for Fixing Our Broken Tax Code, (2017), <https://www.treasury.gov/press-center/press-releases/documents/tax-framework.pdf> (last visited Jul 17, 2019).

Comparing 2017 Law and "Tax Cuts and Jobs Act," 2018



	2017 Law					Tax Cuts and Jobs Act (Conference Committee)				
	Taxable Income (\$)				Tax rate (%)	Taxable Income (\$)				Tax rate (%)
	Single Filers		Married Couples Filing Jointly			Single Filers		Married Couples Filing Jointly		
	Over	But not over	Over	But not over		Over	But not over	Over	But not over	
Individual tax rates	0	9,525	0	19,050	10	0	9,525	0	19,050	10
	9,525	38,700	19,050	77,400	15	9,525	38,700	19,050	77,400	12
	38,700	93,700	77,400	156,150	25	38,700	82,500	77,400	165,000	22
	93,700	195,450	156,150	237,950	28	82,500	157,500	165,000	315,000	24
	195,450	424,950	237,950	424,950	33	157,500	200,000	315,000	400,000	32
	424,950	426,700	424,950	480,050	35	200,000	500,000	400,000	600,000	35
	426,700	and over	480,050	and over	39.6	500,000	and over	600,000	and over	37
Individual alternative minimum tax	AMT exemption equal to \$55,400 (single), \$86,200 (joint); Phases out above \$123,100 (single), \$164,100 (joint);					AMT exemption equal to \$70,300 (single), \$109,400 (joint); Phases out above \$500,000 (single), \$1,000,000 (joint); Individual AMT changes sunset after 2025 ^a				
Standard deduction	\$6,500 (single), \$13,000 (joint), \$9,550 (head of household); Indexed for inflation					\$12,000 (single), \$24,000 (joint), \$18,000 (head of household); Indexed for inflation; Sunsets after 2025 ^a				
Personal and dependent exemptions	\$4,150; Indexed for inflation					Repealed; Sunsets after 2025 ^a				
Child tax credit	Credit equal to \$1,000 per qualifying child under 17; Phases out above \$75,000 (single), \$110,000 (joint); Refundable portion equals 15% of earnings in excess of \$3,000					Credit equal to \$2,000 per qualifying child under 17, \$500 for other dependents; Phases out beginning at \$400,000 for joint filers; Refundable portion equals 15% of earnings in excess of \$2,500 up to \$1,400 per qualifying child; Maximum refundable portion indexed for inflation; Requires Social Security number to claim nonrefundable and refundable portions of \$2,000 child credit; Sunsets after 2025 ^a				
Higher education ^b	American Opportunity Tax Credit; Lifetime Learning Credit; Tuition and Fees Deduction (expired after 2016); Student Loan Interest Deduction					Unchanged				
State and local tax itemized deduction	Real estate, personal property, and either income or sales taxes are deductible					Real estate, personal property, and either income or sales taxes up to \$10,000 (single and joint filers) are deductible; Sunsets after 2025 ^a				
Mortgage interest itemized deduction	Interest payments on up to \$1.1 million of debt (including \$100,000 of home equity debt) are deductible; Applicable to principal and one other residence					Interest payments on up to \$750,000 of new acquisition debt are deductible; Applicable to principal and one other residence; Sunsets after 2025 ^a				
Medical expense itemized deduction	Out-of-pocket medical expenses in excess of 10% of AGI are deductible					Out-of-pocket medical expenses in excess of 7.5% of AGI are deductible in 2017 and 2018; Reverts to current law in 2019				
Overall limit on itemized deductions	Itemized deduction phases out starting at AGI of \$266,700 (single), \$320,000 (joint); Amounts indexed for inflation					Repealed; Sunsets after 2025 ^a				
Top capital gains tax rate	23.8% (20% plus 3.8% Net Investment Income Tax)					Unchanged				
Inflation index	Consumer price index (CPI)					Chain-weighted consumer price index (C-CPI)				
Income from pass-through businesses	Taxed at ordinary income rates (maximum rate of 39.6%)					Provides 20% deduction (maximum rate of 29.6%); Deduction limited above \$157,500 (single), \$315,000 (joint) for personal service income and based on compensation paid or investment property; Sunsets after 2025 ^a				
Top corporate income tax rate	35%					21%				
Corporate alternative minimum tax	Yes					Repealed				
New investment purchases	2018: 40% "bonus" depreciation for qualified property; 2019: 30% "bonus" depreciation for qualified property; 2020: 20% "bonus" depreciation for qualified property Small business (Section 179) expensing up to \$500,000					100% "bonus" depreciation for qualified property; Phases down from 100% by 20% per year starting in 2023; Small business (Section 179) expensing up to \$1,000,000				
Business interest deduction	Fully deductible (generally)					Disallowed for net interest in excess of 30% of business income (excluding depreciation after 2022); Exemption for businesses with gross receipts of \$25 million or less				
Taxation of US multinational companies	Worldwide system with deferral and foreign tax credit					Modified territorial system with base erosion provisions; "Anti-abuse" tax on certain payments to foreign corporations; One-time tax on unrepatriated foreign earnings at 8% (15.5% for liquid assets)				
Estate tax	Top rate of 40% on estates above \$5.6 million; \$11.2 million (couples); Amounts indexed for inflation					Top rate of 40% on estates above \$11.2 million; \$22.4 million (couples); Amounts indexed for inflation; Sunsets after 2025 ^a				
ACA individual mandate penalty ^c	Individuals without adequate health insurance coverage must pay a tax penalty or claim a coverage exemption.					Repealed				

Source: Conference report to accompany H.R. 1, the "Tax Cuts and Jobs Act," December 15, 2017. <http://docs.house.gov/billssthisweek/20171218/CRPT-115HRPT-%20466.pdf>

(a) Provisions revert to current law in 2026. Inflation indexed tax parameters are computed using the chain-weighted consumer price index.

(b) For more information, see <http://www.taxpolicycenter.org/briefing-book/what-tax-incentives-exist-help-families-pay-college>

(c) For more information, see <https://www.irs.gov/affordable-care-act/individuals-and-families/aca-individual-shared-responsibility-provision-calculating-the-payment>