Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

MEMORANDUM

TO: Members of the Subcommittee on Economic Growth, Tax, and Capital Access

FROM: Committee Majority Staff

DATE: June 2, 2023

RE: Subcommittee Hearing Titled: "American Ingenuity: Promoting Innovation Through the Tax Code"

On **June 6, 2023 at 10:00 am**, the Subcommittee on Economic Growth, Tax, and Capital Access will hold a hearing titled "American Ingenuity: Promoting Innovation Through the Tax Code." The meeting will convene in room 2360 of the Rayburn House Office Building. The purpose of this hearing is to examine the impact changes to research and development (R&D) expensing and bonus depreciation have on small businesses.

I. Witnesses

- Ms. Julie Masser Ballay, Vice President and Chief Financial Officer, Sterman Masser Inc.
- Mr. Bill Wydra, President, Ashland Technologies
- Mr. Michael Kaercher, Director of the Climate Tax Project, The Tax Center at NYU Law

II. Background

American innovation requires businesses to invest in research and development (R&D). Often, R&D is a difficult investment for smaller businesses to make because of the high opportunity cost of capital and the longer time horizon to see a return on investment. To incentivize innovation, the U.S. tax code provides incentives for businesses to invest in R&D and necessary resources. The R&D tax credit and bonus depreciation provisions help small businesses make significant R&D investments.

R&D expensing and bonus depreciation are different tax provisions that allow businesses to recover the costs of investment in intangible and tangible assets, respectively. Since 1954, the United States has allowed for the immediate write-off of R&D expenditures to encourage R&D

spending in the private sector. World War II spurred additional federal investment and following the end of the war, Congress believed that investment in R&D was critical both to national security and Americans' quality of life.[1]

The Internal Revenue Act of 1954 created Section 174 of the Internal Revenue Code that allowed for the immediate expensing of qualifying R&D expenditures or amortizing them over a period of five or more years.[2] The immediate expensing option of Section 174 was repealed after the 2021 tax year. [3]

Bonus depreciation addresses the expensing of tangible assets such as equipment and machinery. The tax incentive was created by the Job Creation and Worker Assistance Act of 2002 following 9/11 to encourage investment and stimulate the economy. [4] From 2002 – 2017, businesses could write off 50 percent of eligible assets.[5]

TCJA included a provision allowing for the full and immediate expensing, known as 100 percent bonus depreciation, for qualifying purchases. Beginning in 2023, bonus depreciation will decrease by 20 percent each year (80 percent in 2023, 60 percent in 2024, 40 percent in 2025, 20 percent in 2026, 0 percent in 2027).[6]

The U.S. prides itself on being a top innovator across sectors, however, many of our economic competitors have tax incentives for R&D that match if not exceed the U.S. pre-TCJA R&D incentive structure. In 2020, tax support by federal and state governments accounted for only 9.5 percent of R&D spending in the U.S. economy.[7] Some experts argue that the U.S. would have to raise that rate to at least 15.5 percent for our country to remain competitive from an R&D standpoint.[8]

Before immediate expensing was repealed, China's R&D tax incentive was 2.7 times more generous than the U.S. and since then, the U.S. has fallen even further behind.[9] As of January 1, 2021, China allows manufacturers to deduct 200 percent of eligible R&D expenses. As of January 1, 2022, China allows small and medium sized technological enterprises, non-profit scientific and technological R&D institutions, and higher education institutions to deduct 200 percent of qualified expenses.[10]

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[1] RICHARD ROWBERG, CONG. RESEARCH SERV., 95-1209, FEDERAL R&D FUNDING: A CONCISE HISTORY, 1-3 (updated Aug. 14, 1998).
[2] The Internal Revenue Act of 1954, Pub. L. No. 83-591, §174 (1954).
[3] GARY GUENTHER, CONG. RESEARCH SERV., IN11887, TAX TREATMENT OF RESEARCH EXPENSES: CURRENT LAW AND POLICY ISSUES, 1-2 (updated Dec. 19, 2022).
[4] Job Creation and Worker Assistance Act, Pub. L. No. 107-147 (2017).
[5] *Tax and Accounting Glossary: Bonus Depreciation,* Thomson Reuters (Jan. 23, 2023).
[6] Tax Cuts & Jobs Act, Pub. L. No. 115-97, §13201 (2017).
[7] *U.S. Lags Competitors in R&D Tax Incentives, New ITIF Report Finds; Ranks Just 24th Among 34 Comparable OECD and BRIC Nations,* Information Technology & Innovation Foundation (Sep. 8, 2020).
[8] *Id.*
[9] Dean Zerbe, *R&D Tax Credit – An Update On A Lifeline For Small and medium Sized Businesses,* FORBES (April 24, 2023).
[10] *China, People's Republic of,* PWC Worldwide Tax Summaries (Dec. 30, 2022), https://taxsummaries.pwc.com/peoples-republic-of-china/corporate/deductions.

Small businesses are the backbone of the U.S. economy and play a pivotal role in keeping the U.S. a competitive innovator on the world stage. Small businesses make up 99.9 percent of all businesses and account for 44 percent of all domestic economic activity.[11] They also account for two-thirds of all jobs in the U.S.[12]

III. Conclusion

Changes to R&D expensing and bonus depreciation would alleviate some of the burdens on small businesses who are struggling through the current economic headwinds. At a time when U.S. adversaries are investing more and more in innovation, Congress must reflect on the impact that removing incentives to innovation will have on our nations job creators.

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[11] Press Release, SBA Office of Advocacy, Small Businesses Generate 44 Percent of U.S. Economic Activity (Jan. 30, 2019).
[12] Dock Treece, *Why Small Businesses Are Good for Local Economies*, BUSINESS NEWS DAILY (Feb. 21, 2023).