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Small Business Expensing Allowance: Current Status, Legislative Proposals, and Economic Effects

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Gary Guenther
Analyst in Business Taxation and Finance
Government and Finance Division

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Summary

Under current federal tax law, business taxpayers are allowed to deduct (or expense) at least $102,000 of the total cost of qualified assets placed in service in a single tax year from 2005 through 2007. In the absence of such a provision, firms would have to recover the cost over a longer period under allowable depreciation schedules. Certain rules governing the use of the allowance confine its benefits to relatively small firms.

The main focus of this report is the economic effects of the small business expensing allowance. It begins with an explanation of how the allowance works and a brief summary of its legislative history. The report then describes current legislative initiatives to modify the current allowance and concludes with an assessment of its implications for economic efficiency and equity and tax administration. It will be updated to reflect significant legislative activity in the 109th Congress.

Legislative action in the 108th Congress indicated broad bipartisan support for enhancing the allowance both as a means of stimulating increased business investment and aiding small business owners. Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the maximum allowance was raised from $25,000 to $100,000 and the phase-out threshold from $200,000 to $400,000 in 2003 through 2005; both amounts were indexed for inflation in 2004 and 2005; and packaged software qualified for expensing in 2003 through 2005. The American Jobs Creation Act of 2004 (P.L. 108-357) extended the enhancements made by JGTRRA through 2007.

Two bills to extend permanently most of the enhancements in the allowance made by JGTRRA have been introduced in the 109th Congress: H.R. 1091 and H.R. 1388. The only difference between the two proposals is that H.R. 1091 would increase the phase-out threshold to $500,000 from its current level of $400,00, as of January 1, 2006. Neither bill would allow the expensing of off-the-shelf software for business use beyond 2007. In addition, another bill (H.R. 1678) would extend the changes in the allowance made by JGTRRA through 2009. President Bush supports the permanent extension of these changes in his budget request for FY2006.

To most economists, the small business expensing allowance may have important implications for the allocation of business investment, the distribution of the federal tax burden among income groups, and the cost of tax compliance for smaller firms. These effects loosely correspond to the three traditional criteria for evaluating tax policy: efficiency, equity, and simplicity. When seen through the lens of conventional economic theory, the allowance takes on the appearance of a drain on economic efficiency that may worsen the deadweight loss associated with the current federal income tax. At the same time, because the allowance does not alter marginal income tax rates, it has no discernible impact on the distribution of the federal tax burden among income groups. In addition, the allowance has the benefit of simplifying tax accounting for firms able to claim it.

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Under certain circumstances, firms may deduct (or expense) more than $100,000 of the cost of qualified depreciable assets placed in service in a tax year between 2005 and 2007. This option for depreciation is known as the small business expensing allowance because certain rules governing the use of the allowance restrict its benefits to relatively small firms. In the absence of the expensing allowance, firms would have to recover the cost of qualified depreciable assets over longer periods through allowable depreciation deductions. The expensing allowance represents a significant tax subsidy for business investment because it has the potential to reduce substantially or even nullify the tax burden on the returns to investment in qualified assets.

This report examines the economic effects of the small business expensing allowance. It begins with an explanation of how the allowance works and a brief summary of its legislative history. The report moves on to describe proposals in the 109th Congress to modify the allowance. It concludes with a discussion of the allowance's likely economic effects, focusing in particular on its implications for economic efficiency, equity, and tax administration and its impact on business investment since the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003.

Current Expensing Allowance

Under section 179 of the Internal Revenue Code (IRC), business taxpayers purchasing qualified property (or assets) may deduct (or expense) some or all of its cost (depending on the amount) in the year in which it is placed into service, provided certain conditions are met. As an alternative to expensing, business taxpayers may elect to recover the cost over longer periods through allowable depreciation deductions. Between 2005 and 2007, the maximum expensing allowance is at least $102,000 for firms operating outside empowerment zones.[1] For firms conducting their trade or business within these zones, the maximum allowance in that period is the lesser of $137,000 or the cost of qualified property. In 2008, the maximum allowance is set to drop to $25,000 for firms operating outside empowerment zones and $60,000 for firms operating within the zones, their amounts

[1] The allowance is indexed for inflation in 2004 through 2007. In 2003, it was $100,000. In 2004, it was $102,000. The final amount for 2005 has not been determined yet.

before the enactment of Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-26).

Qualified property is defined as certain new and used depreciable assets — as specified in IRC section 1245(a)(3) — acquired for use in the active conduct of a trade or business. With a few exceptions, this property embraces business machines and equipment used in connection with manufacturing or production, extraction, transportation, communications, electricity, gas, water, and sewage disposal. Transportation equipment with a gross, unloaded weight of more than 6,000 pounds may be expensed, but heating and air conditioning units are not eligible for the allowance. Most buildings and their structural components do not qualify for the allowance, but research and bulk storage facilities related to these commercial activities do qualify. In addition, purchases of off-the-shelf, packaged computer software for business use may be expensed from 2003 through 2007.

In assessing the impact of the expensing allowance on business investment, one should keep in mind that business taxpayers were also able to claim a temporary 30% first-year depreciation deduction under the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) for new (but not used) property depreciable under the modified accelerated cost recovery system (MACRS) and having a recovery period of less than 20 years. Under the act, qualified property acquired between September 11, 2001 and September 11, 2004 and placed in service before January 1, 2005 was eligible for the special 30% depreciation allowance, as well as regular depreciation deductions and the expensing allowance under IRC section 179. JGTRRA extended the deadline for acquiring qualified property to December 31, 2004. More important, it added a separate 50% first-year depreciation deduction for purchases of the same property between May 6, 2003 and January 1, 2005; the property must be placed in service by January 1, 2006. Business taxpayers were permitted to claim either the 30% or 50% first-year depreciation allowance, but not both. For property eligible for both the expensing and special depreciation allowances, a firm had to recover its cost for tax purposes in the following sequence: the expensing allowance is claimed first; then the special first-year depreciation allowance on the remaining basis in the property (if any) may be claimed; finally, the regular depreciation allowance under the MACRS on the remaining basis (if any) may be claimed.

The amount that a business taxpayer may deduct in a single tax year under section 179 is subject to two limitations: a dollar limitation and an income limitation. Under the dollar limitation, the maximum expensing allowance is reduced, dollar for dollar, by the amount by which the total cost of all qualified property placed in service during the year exceeds a phase-out threshold of at least $410,000 in 2005 through 2007.[2] In 2008 and thereafter, the threshold will revert to its pre-JGTRRA level of $200,000. As a result, none of the cost of qualified property placed in service in a single tax year from 2005 through 2007 may be expensed once this cost reaches $512,000 or more. Under the income limitation, the expensing allowance cannot exceed the taxable income a taxpayer earns from the active conduct

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[2] Like the maximum expensing allowance, the phase-out threshold is indexed for inflation in 2004 through 2007. In 2003, the threshold was $400,000. In 2004, it was $410,000. The final amount for 20005 has not been determined yet.

of the trade or business in which qualified assets are used. Although no deductions disallowed under the dollar limitation may be carried forward, deductions disallowed under the income limitation may be carried forward.

In addition, both the maximum expensing allowance and the phase-out threshold are indexed for inflation in 2004 through 2007.

Legislative History of the Expensing Allowance

The expensing allowance under IRC section 179 originated as a special first-year depreciation allowance enacted as part of the Small Business Tax Revision Act of 1958 (P.L. 85-866). It was intended to reduce the tax burden on small business owners, stimulate small business investment, and simplify tax accounting for smaller firms. The deduction was equal to $2,000 ($4,000 in the case of a married couple filing a joint return) of the cost of new and used business machines and equipment placed in service with a depreciation life of six or more years.

This allowance remained in force until the enactment of the Economic Recovery Tax Act of 1981 (ERTA, P.L. 97-34), which replaced the special deduction with a maximum expensing allowance of $5,000 and established a timetable for gradually increasing the allowance to $10,000 by 1986. Despite the changes made by ERTA, few firms took advantage of the allowance. Much of this tepid response could be blamed on a rule preventing business taxpayers from claiming the investment tax credit established by ERTA for the share of an asset's cost that was expensed.

Faced with large and growing federal budget deficits in the early 1980s, Congress passed the Deficit Reduction Act of 1984 (P.L. 98-369), which, among other things, postponed from 1986 to 1990 the scheduled increase in the expensing allowance to $10,000. Claims for the allowance rose markedly following the repeal of the investment tax credit by the Tax Reform Act of 1986.

The maximum allowance reached $10,000 in 1990, as scheduled, and remained there until the enactment of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), which boosted the maximum allowance to $17,500 on January 1, 1993.

With the passage of the Small Business Job Protection Act of 1996 (P.L. 104-188), the allowance embarked on a path punctuated by staggered ascents. Under the Act, the maximum allowance rose to $18,000 in 1997, $18,500 in 1998, $19,000 in 1999, $20,000 in 2000, $24,000 in 2001 and 2002, and $25,000 in 2003 and thereafter.

The allowance followed this path until the passage of JGTRRA. Under the Act, the allowance immediately rose to $100,000 in 2003; it was to remain there in 2004 and 2005 and return to $25,000 in 2006 and thereafter. JGTRRA also raised the phase-out threshold to $400,000 for the same period, indexed both amounts for inflation in 2004 and 2005, and made purchases of off-the-shelf software for business use eligible for expensing in 2003 through 2005.

Under the American Jobs Creation Act of 2004 (AJCA, P.L. 108-357), the changes in the allowance made by JGTRRA were extended by another two years, or through 2007.

Legislative Initiatives in the 109th Congress

Legislative action in the 108th Congress revealed broad bipartisan support for enhancing the allowance both as a means of stimulating increased business investment and aiding small business owners. On May 28, 2003, President Bush signed into law a version of H.R. 2 (the Jobs and Growth Tax Relief Reconciliation Act of 2003) that was passed by both houses a few days earlier. Under the act, the maximum allowance was raised from $25,000 to $100,000 and the phase-out threshold from $200,000 to $400,000 in 2003 through 2005; both amounts were indexed for inflation in 2004 and 2005; and packaged software qualified for expensing in 2003 through 2005. The American Jobs Creation Act of 2004 (P.L. 108-357), which the President signed on October 22, 2004, extended the enhancements made by JGTRRA through 2007.

Two bills to extend permanently all but one of the enhancements in the allowance made by JGTRRA have been introduced in the 109th Congress. H.R. 1091, introduced by Representative Phil English on March 3, 2005, would keep the maximum expensing allowance at $100,000 after 2007, raise the phase-out threshold to $500,000 on January 1, 2006, and allow both amounts to be indexed for inflation beyond 2007. H.R. 1388, introduced by Representative Wally Herger on March 17, 2005, would keep the maximum expensing allowance at $100,000 and the phase-out threshold at $400,000 and allow both amounts to be indexed for inflation beyond 2007. Neither bill would allow business taxpayers to expense purchases of off-the-shelf software for business use under IRC Section 179 beyond 2007.

In addition, a bill introduced by Representative Marilyn Musgrave on April 19, 2005 would extend the changes in the allowance made by JGTRRA through 2009.

If either measure were to pass both houses of Congress intact, it is likely that the President would sign it. In his budget request for FY2006, President Bush is proposing to extend permanently all the enhancements in the expensing allowance under JGTRRA.

Economic Effects of the Expensing Allowance

To many policymakers, the expensing allowance represents a desirable policy tool for aiding small business and stimulating the economy at the same time. And to many small business owners, the allowance represents a prized vehicle for delivering a desirable tax benefit. But to most economists, the allowance has effects that extend beyond its direct impact on the tax burden of small business owners. In their view, the allowance may have important implications for the allocation of business investment, the distribution of the federal tax burden among major income groups, and the cost of tax compliance for smaller firms. These effects loosely

correspond to the three traditional criteria for evaluating tax policy: efficiency, equity, and simplicity. Each is examined below.

Efficiency Effects

Efficiency is both a central concept and guiding principle in economic analysis. It refers to the impact of the allocation of resources in an economy on the welfare of consumers and producers. When such an allocation leads to the greatest possible total economic surplus — or the total value to buyers of the goods and services they consume, as measured by their willingness to pay, minus the total cost to sellers of providing these goods and services — it is said to be efficient. If an allocation is less than efficient, then some of the possible gains from trade among buyers and sellers are not being realized. For example, an allocation is inefficient when a good is not being produced by sellers with the lowest cost. In this case, a shift in production from high-cost producers to low-cost producers, driven perhaps by an unleashing of previously restrained market forces, would lower the total cost to sellers of providing the good, raising the total economic surplus.

One important policy issue raised by the small business expensing allowance concerns its effect on the allocation of resources in general and the allocation of business investment in particular. In theory, all taxes except lump-sum taxes have adverse efficiency effects because they affect the decisions of consumers and producers in ways that leave one group or the other — or perhaps both — worse off. Taxes do this because they distort the incentives facing taxpayers, inducing them to allocate resources according to the impact of taxes on the costs and benefits of the goods and services they buy and sell rather than their actual costs and benefits. Such a distortion entails what economists call a deadweight loss, a condition where the amount of revenue raised by a tax falls short of the reduction in the economic welfare of taxpayers.

The allowance affects the allocation of resources in the U.S. economy by encouraging firms to invest in assets that qualify for the allowance at the expense of other assets, tangible and intangible. There are two channels through which the allowance has this effect. The more important of the two is a reduction in the user cost of capital for investment in qualified assets relative to other assets. A second channel is an increase in the cash flow or internal funds of firms whose cost of internal funds is significantly lower than the cost of external funds. Because of the phase-out threshold for the allowance, most of the firms taking advantage of it are likely to be relatively small in asset size.[3]

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[3] This point is difficult to substantiate because of a paucity of reliable, publicly available data on capital spending by firm size. One way around this difficulty is to use depreciation allowances as a proxy for capital spending. Such an assumption appears reasonable because of the strong correlation over time between industry asset size, capital outlays, and depreciation allowances for tax purposes. According to IRS data, in 1999, the average depreciation deduction for corporations with assets of $250 million and over was $4.1 million; by comparison, the average depreciation deduction for corporations with less than $250 million in assets came to $32.5 thousand, or 0.8% of the average for the larger corporations.

The user cost of capital exerts a significant influence on a firm's decision to invest, because it encompasses both the opportunity cost of undertaking an investment and the direct costs of that investment, such as depreciation, the cost of the asset, and income taxes. In effect, the user cost of capital is the after-tax rate of return an investment project must earn in order to be profitable — and thus worth undertaking. In general, the higher the user cost of capital, the lower the number of profitable projects that a firm might undertake, and the lower its desired capital stock. When a change in tax policy reduces the user cost of capital, the reduction may increase the amount of capital that firms wish to hold, boosting business investment in the short run.

How does expensing reduce the user cost of capital for affected assets? In essence, expensing is the most accelerated form of depreciation because the entire cost of an asset is written off in its first year of use, regardless of the asset's actual economic or useful life. Allowing a firm to expense is equivalent to the U.S. Treasury providing the firm (or its owners) with a tax rebate equal to the tax rate multiplied by the cost of the asset. Accelerated depreciation — along with other investment tax subsides such as an investment tax credit — can reduce the user cost of capital by decreasing the pre-tax return a firm must earn in order to attain a given after-tax return.[4] This reduction gets larger as the period over which the asset's cost is written off contracts, and as the proportion of the cost that is written off in the beginning of that period expands. Expensing yields the largest possible reduction in the user cost of capital attributable to depreciation. The reduction can be considerable.[5]

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[4] The user cost of capital is the real rate of return an investment project must earn to be profitable. In theory, a firm will undertake an investment provided the after-tax rate of return exceeds or at least equals the user cost of capital. Rosen has expressed this cost in terms of a simple equation. Let **C** stand for the user cost of capital, *a* for the purchase price of an asset, *r* for the after-tax rate of return, *d* for the economic rate of depreciation, *t* for the corporate tax rate, *z* for the present value of depreciation deductions flowing from a $1 investment, and *k* for the investment tax credit rate. Then $\mathbf{C} = a \times [(r + d) \times (1-(t \times z)-k)]/(1-t)$. Under expensing, *z* is equal to one. By plugging assumed values for each variable into the equation, it becomes clear that **C** increases as *z* gets smaller. Thus, of all possible methods of depreciation, expensing yields the lowest user cost of capital. For more details, see Harvey S. Rosen, *Public Finance*, 6th ed (New York: McGraw-Hill/Irwin, 2002), pp. 407-409.

[5] In a 1995 study, Douglas Holtz-Eakin compared the cost of capital for an investment under two scenarios for cost recovery. In one, the corporation making the investment used expensing to recover the cost of the investment; and in the other, the cost was recovered under the schedules and methods permitted by the modified accelerated cost recovery system. He further assumed that the interest rate was 9%, the inflation rate 3%, and the rate of economic depreciation for the asset acquired through the investment 13.3%. Not only did expensing substantially reduce the cost of capital, its benefit was proportional to the firm's marginal tax rate. Specifically, Holtz-Eakin found that at a tax rate of 15%, expensing lowered the cost of capital by 11%; at a tax rate of 25%, the reduction was 19%; and at a tax rate of 35%, the cost of capital was 28% lower. See Douglas Holtz-Eakin, "Should Small Businesses Be Tax-Favored?," *National Tax Journal*, Sept. 1995, p. 389.

How beneficial is expensing? One way to illustrate the tax benefits from expensing is to explain how it affects the marginal effective tax rate on the returns to a new investment. Expensing has the effect of taxing the stream of income earned by the affected asset over its lifetime at a marginal effective rate of zero.[6] This means that if the entire cost of an investment is expensed, the after-tax rate of return on the investment becomes equal to its before-tax rate of return.[7] This convergence occurs because expensing reduces after-tax returns and costs for eligible investments by the same factor: namely, the investor's marginal tax rate (whether the investor is a corporation or an individual acting as a small business owner). If the tax rate is 35% and the cost of the investment is expensed, then the government bears 35% of the cost of the investment. By contrast, if the cost of the same investment were recovered at a rate reflecting the actual decline over time in the economic value of the underlying assets and no tax preferences for depreciation were available, then the returns would be taxed at current statutory rates. As a result of JGTRRA, the maximum federal corporate and individual income tax rate is 35% in 2004 and 2005.

Some argue that expensing can also spur business investment by augmenting the cash flow of firms, especially those that rely heavily on internal funds or retained earnings to finance new investment. In the world of business finance, the term "cash flow" does not necessarily have a universal meaning. Cash flow can be thought of as the difference between a firm's revenue and its payments for all factors or inputs used to generate its output, including capital equipment.

All other things being equal, expensing increases a firm's cash flow more than other allowable depreciation methods. A major reason why a firm's ability to invest could hinge on its cash flow is that it has limited or no access to debt and equity markets mainly because of insufficient information on the part of potential lenders or investors. In this case, the cost of internal funds would be lower than the cost of external funds, making it reasonable for the firm to attempt to finance most of its new investment out of retained earnings. Some studies have found a significant positive correlation between changes in a firm's net worth or supply of internal funds and its investment spending.[8] What is more, this correlation is strongest for firms facing serious barriers to raising funds in debt and equity markets because of insufficient information on the part of investors or lenders. Nevertheless, it would be erroneous to construe these findings as providing conclusive evidence that firms with relatively high cash flows invest more than firms with relatively low or negative cash flows. A correlation offers no proof of the existence of a cause-and-effect relationship between two variables. It may be the case that firms with relatively high cash flows invest more, on average, than firms with relatively low cash flows for reasons that

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[6] For a discussion of the economic logic behind such an outcome, see Jane G. Gravelle, "Effects of the 1981 Depreciation Revisions on the Taxation of Income from Business Capital," *National Tax Journal*, March 1982, p. 5.

[7] For an example, see Joseph J. Cordes, "Expensing," in *The Encyclopedia of Taxation and Tax Policy*, Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, eds. (Washington: Urban Institute Press, 1999), p. 114.

[8] For a review of the recent literature on this topic, see R. Glenn Hubbard, "Capital Market Imperfections and Investment," *Journal of Economic Literature*, vol. 36, March 1998, pp. 193-225.

have little or nothing to do with the relative cost of internal and external funds. The links between cash flow and business investment are complex, and further research is needed to clarify them.

To what extent has the expensing allowance contributed to shifts in the size and composition of the domestic capital stock in the 23 years it has existed in its present form? There appear to be no studies analyzing these effects. Nonetheless, considering the effect of expensing on the cost of capital and cash flow among small firms and available evidence that investment in many of the assets eligible for the allowance is somewhat sensitive to reductions in its cost of capital, it is possible that the allowance has caused domestic investment in qualified assets to be greater than it otherwise would have been.[9] At the same time, it is possible that much of this investment would have taken place without the expensing allowance.[10] In analyzing the efficacy of investment tax incentives such as the expensing allowance, one should keep in mind that the decisions by business managers and owners to invest in equipment and software tend to be driven more by their assessments of future sales prospects, the nature of the capital goods themselves, and financing conditions than by tax considerations.[11]

Unpublished federal tax return data made available by the Internal Revenue Service (IRS) suggest that the allowance may influence a significant share of business investment in equipment. Between 1997 and 1999, 23% of corporations filing federal tax returns claimed the allowance, and the total value of IRC section 179 deductions claimed by corporations accounted for 2% of total corporate deductions for depreciation reported on those tax returns.[12] In the same period, the total value of IRC section 179 property placed in service equaled 14% of domestic gross investment in equipment, according to data released by the U.S. Commerce Department.

When seen through the lens of conventional economic theory, the expensing allowance takes on the appearance of a drain on efficiency that may worsen the deadweight loss associated with the current federal tax code. Under the plausible assumption that the amount of capital in the economy is fixed in the short run, a tax subsidy like the allowance has the potential to draw capital away from more

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[9] Two studies from the 1990s found that a 1% decline in the user cost of capital was associated with a rise in business equipment spending of 0.25% to 0.66%. See CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, by Jane G. Gravelle, p. 4.

[10] There is some anecdotal evidence to support this supposition. At a recent hearing held by the House Small Business Subcommittee on Tax, Finance, and Exports, Leslie Shapiro of the Padgett Business Services Foundation stated that expensing "may be an incentive in making decisions to buy new equipment, but it's not the dominant force." His firm provides tax and accounting services to over 15,000 small business owners. See Heidi Glenn, "Small Business Subcommittee Weights Bush's Expensing Boost," *Tax Notes*, April 7, 2003, p. 17.

[11] See Roger W. Ferguson, Jr., "Factors Influencing Business Investment," speech delivered on Oct. 26, 2004, available at [http://www.federalreserve.gov/boarddocs/speeches/2004/20041026/default.htm].

[12] Data on business claims for the expensing allowance were obtained via e-mail from Nina Shumofsky of the Statistics of Income Division at IRS on March 27, 2003.

productive uses. Conventional economic theory leads to the conclusion that in an economy free of market failures and dominated by competitive markets, a policy of neutral or uniform taxation of capital income would minimize the efficiency losses associated with income taxation. The expensing allowance, however, subsidizes investment in specific assets by relatively small firms. Such a subsidy can prevent financial capital from migrating to its economically most valuable applications by making it possible for business owners to earn higher after-tax rates of return on new investment in assets eligible for expensing than on new investment in other assets with higher expected pre-tax rates of return. In addition, the expensing allowance appears to give firms able to claim it a significant incentive to restrain their growth. This unintended outcome stems from the rise in marginal effective tax rates on the returns to investment in the allowance's phase-out range (presently, $400,000 to $500,000).[13] Douglas Holtz-Eakin has labeled this incentive effect a "tax on growth by small firms."[14]

Equity Effects

Equity is another important fundamental concept and guiding principle in economic analysis. In general, it refers to the distribution of economic welfare (as measured by income) among the individuals or households in a country. In the case of income taxation, equity signifies the distribution of the tax burden among taxpayers organized by income groups. Economists who analyze the equity effects of income taxes tend to focus on two distinct concepts of fairness: horizontal equity and vertical equity. Some individuals earn similar incomes. A tax system is said to be horizontally equitable if it imposes similar burdens on such individuals. At the same time, some individuals earn more than others. A tax system is said to be vertically equitable if the burdens it imposes vary according to an individual's ability to pay. The principle of vertical equity provides the foundation for a progressive income tax system. Under such a system, an individual's total tax liability, as a fraction of income, rises with income.

The federal income tax system incorporates both concepts. Income is used to measure an individual's ability to pay. Individuals filing singly or jointly or as heads of household in the same income group are taxed at the same marginal rate. At the same time, those in higher income groups are taxed at higher rates than those in lower income groups. Obviously, a key issue in assessing the fairness of the distribution of the federal income tax burden is the measurement of income. Because of various tax preferences in the form of deductions, deferrals, exclusions, exemptions, and credits enacted over many years, the definition of income under the federal tax code can be somewhat elastic. As a result, individuals earning the same income can end up paying different amounts in taxes.

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[13] Jane Gravelle of CRS estimated that, assuming a corporate tax rate of 28% and a rate of inflation of 3%, in the phase-out range for the expensing allowance the marginal effective tax rate on the returns to favored assets is 36%, compared to a rate of 0% for each dollar of investment up to $200,000 and a rate of 22% for all corporations.

[14] U.S. Congress, Senate Committee on Finance, *Small Business Tax Incentives*, hearings on S. 105, S. 161, S. 628, S. 692, S. 867, and H.R. 1215, 104th Cong., 1st sess., June 7, 1995 (Washington: GPO, 1995), pp. 11-12.

The expensing allowance constitutes a tax preference, albeit for investment in certain tangible business assets. How does it affect vertical and horizontal equity?

In order to answer this question, it is necessary to understand what tax benefits derive from the expensing allowance, who receives them, and how they affect the recipients' federal income tax liabilities. The main tax benefit generated by the allowance is a reduction in the **marginal effective tax rate** on the returns to new investment in qualified assets. How much of a reduction depends largely on the proportion of the asset's acquisition cost that is expensed. As was noted earlier, if the entire cost is expensed, then the marginal effective rate falls to zero. Nevertheless, the allowance does not change the **marginal rates** at which these returns are taxed. This is because accelerated depreciation in and of itself does not reduce the amount of taxes that are paid on the stream of income earned by an asset over its useful life. Rather, accelerated depreciation changes the timing of tax payments in ways that are advantageous for business owners. Most assets eligible for the allowance are owned by smaller firms. As a result, it is fair to assume that most of the tax benefit generated by the allowance is captured by small business owners. A recent analysis of federal income tax return data for individuals by William Gale of the Tax Policy Center finds that few small business owners face the highest marginal income tax rates, and that more than two-thirds of tax returns reporting small business income are in the lowest two tax brackets.[15]

Because the allowance does not alter marginal income tax rates, it has no direct effect on the distribution of the federal income tax burden among income groups. And because the allowance leaves the distributional effects of the tax untouched, it can have no impact on vertical and horizontal equity.

Tax Administration

Yet another interesting policy question raised by the expensing allowance concerns its impact on the cost of tax compliance.

Many would agree that one of the desirable characteristics of any income tax system is that it impose relatively low costs for administration and compliance. Research has shown that the administrative cost of a tax system varies according to numerous factors. The primary ones are the records that must be kept in order to comply with tax laws, the complexity of those laws, and the types of income subject to taxation.

Many would also agree that the federal income tax system fails the test of having relatively low costs for administration and compliance. In their view, the costs of collecting income taxes and enforcing compliance with the tax laws are needlessly high, and the primary cause is the complexity of the federal tax code. Many small business owners in particular have long bitterly complained about the costly burdens imposed on them by the record keeping and filings required by the federal income tax.

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[15] William G. Gale, "Small Businesses and Marginal Income Tax Rates," *Tax Notes*, April 26, 2004, p. 471.

The expensing allowance addresses this concern by simplifying tax accounting for firms able to claim it. Less time and paperwork are involved in writing off the entire cost of a depreciable asset in its first year of use than in recovering its cost over a longer period. Tax simplification has long been a primary policy objective for most small business owners, largely because of the relatively high costs they must bear in complying with federal tax laws. These costs were addressed in a 2001 study prepared for the Office of Advocacy of the Small Business Administration. According to the study, in 2000, the cost per employee for tax compliance was an estimated $665 for all firms, $1,202 for firms with fewer than 20 employees, $625 for firms with 20 to 499 employees, and $562 for firms with 500 or more employees.