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

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Summary

Under current federal tax law, business taxpayers are allowed to deduct (or expense) $108,000 of the total cost of certain assets placed in service in 2006, within certain limits. In the absence of such an option, firms would have to recover the cost over a longer period under allowable depreciation schedules. The rules governing the use of the allowance confine most of its benefits to relatively small firms.

This report focuses on the economic effects of the small business expensing allowance and legislation in the 109th Congress to modify the allowance. It begins by explaining how the allowance works and concludes with an assessment of its implications for economic efficiency, and equity and tax administration. The report will be updated to reflect significant legislative activity in the current Congress.

In recent Congresses, there was broad bipartisan support for enhancing the allowance as a means of stimulating increased business investment and aiding small business owners. By all indications, this support has not diminished in the 109th Congress. A number of bills to extend or modify the current allowance have been introduced in the 109th Congress. In the House, H.R. 1091 would permanently extend and enhance the current allowance; H.R. 1388 and H.R. 3841 would permanently extend the current allowance; H.R. 1678 would extend the current allowance through 2009; and H.R. 4297, a tax reconciliation bill passed by the House on December 8, 2005, would extend the current allowance through 2009. In the Senate, S. 1523 would permanently extend the current allowance, and S. 2020/H.R. 4297, the tax reconciliation bill passed by the Senate on November 18, would also extend the current allowance through 2009.

In its budget request for FY2007, the Bush Administration is asking Congress to extend permanently the temporary features of the existing allowance, raise the allowance to $200,000 and its phase-out threshold to $800,000, and index both amounts for inflation. Companion bills introduced in the House (H.R. 4790) and the Senate (S. 2287) would implement these proposed changes.

The 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. While the allowance seeks to stimulate small business investment by reducing the user cost of capital for eligible assets and increasing the cash flow of firms able to claim the allowance, it can also serve as a drain on economic efficiency by encouraging an increased flow of capital into uses that may not be as productive as others. Moreover, because the allowance does not directly alter the income tax rates faced by owners of firms that benefit from it, the allowance has no discernible impact on the distribution of the federal tax burden among income groups. At the same time, the allowance reduces the compliance burden for business taxpayers by simplifying tax accounting for firms able to claim it.

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Under certain conditions, current federal tax law allows firms to expense (or deduct) up to $108,000 of the cost of qualified assets placed in service in 2006.[1] Some refer to this option for capital cost recovery as the small business expensing allowance because the rules governing its use effectively limit the option's benefits to firms that are relatively small in asset, employment, or revenue size. Firms unable to claim the expensing allowance may recover the cost of the same assets over longer periods through allowable depreciation deductions. The expensing allowance represents a significant tax subsidy for small business investment because it has the potential to reduce substantially the marginal effective rate at which the returns to investment in qualified assets are taxed.

This report examines the current status of the small business expensing allowance, its main economic effects, and initiatives in Congress to modify it. The report begins by explaining how the allowance works and summarizing its legislative history. It then discusses proposals in the 109th Congress to alter the current allowance. The report concludes with an assessment of the allowance's likely economic effects, focusing on its implications for economic efficiency, equity, and tax administration.

Current Expensing Allowance

Under section 179 of the Internal Revenue Code (IRC), business taxpayers have the option of deducting (or expensing) the cost of qualified assets (or property) they purchase in the year when the assets are placed in service, within certain limits. Business taxpayers unable or unwilling to take advantage of this option for capital cost recovery may recover the cost over longer periods through allowable depreciation deductions. In 2006, the maximum expensing allowance is $108,000 for firms operating outside so-called enterprise and empowerment zones (EZs), renewal communities (RCs), the areas devastated by Hurricane Katrina (also known as the Gulf Opportunity Zone, or GOZ), and the portion of lower Manhattan directly affected by the terrorist attacks of September 11, 2001 (also known as the New York Liberty Zone, or NYLZ).[2] (For the sake of clarity, this allowance is henceforth

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[1] See Internal Revenue Service Revenue Procedure 2005-70.

[2] The allowance is indexed for inflation in 2004 through 2007. In 2003, it was $100,000, and it was set at $102,000 for 2004. Given that the rate of inflation as measured by the

(continued...)

referred to as the regular allowance.) For firms operating within all the special areas except the GOZ, the maximum allowance in 2006 is $143,000. For firms located in the GOZ, the maximum allowance in 2006 for qualified assets purchased on or after August 28, 2005, and placed in service by December 31, 2007, is $208,000. The regular allowance is indexed for inflation in 2005 through 2007. Unless current law is changed, it is scheduled to drop to $25,000 beginning in 2008 and thereafter for firms operating outside the special areas;$60,000 for firms operating in all the special areas except the GOZ; and $125,000 for firms operating in the GOZ.

Business taxpayers choose the expensing option under rules set forth by the Internal Revenue Service (IRS). Under IRS Regulation 1.179-5, these taxpayers are allowed to make or revoke an election under IRC section 179 for property placed in service from 2003 through 2007 without the consent of the IRS Commissioner by submitting an amended tax return for the tax year in question. For tax years beginning in 2008, an expensing election may be revoked only with the consent of the Commissioner.

Firms in all lines of business may claim the regular expensing allowance. The same is true of the enhanced expensing allowance available to firms operating in the special areas, with certain exceptions. More specifically, the allowance does not apply to qualified property placed in service in the following establishments located in EZs, RCs, and the newly created GOZ: private or commercial golf courses, country clubs, massage parlors, hot-tub and suntan facilities, stores whose principal business is the sale of alcoholic beverages, racetracks, and facilities used for gambling.

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 notable exceptions, this property consists of business machines and equipment used in connection with manufacturing or production, extraction, transportation, communications, electricity, gas, water, and sewage disposal. Transportation equipment with an unloaded gross weight of more than 6,000 pounds may be expensed, but not heating and air conditioning units. In addition, packaged computer software for business use may be expensed through 2007. Most buildings and their structural components do not qualify for the regular allowance, but research and bulk storage facilities do qualify. In the case of firms operating in the GOZ, however, certain residential and commercial properties do qualify.

The maximum amount of qualified property that may be expensed in a single tax year under IRC section 179 is subject to two limitations: a dollar limitation and an income limitation.

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[2] (...continued)
consumer price index for items consumed by urban consumers has been higher in the first seven months of 2005 compared to the same period in 2004, the maximum allowance in 2006 is likely to be higher than it is in 2005.

Under the dollar limitation, the regular 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. But in the case of firms operating in EZs, RCs, and the NYLZ, the expensing allowance is reduced by $0.50 for each dollar by which the cost of qualified property placed in service in a tax year exceeds the phase-out threshold. In 2006, the threshold is set at $430,000 for all firms except those operating in the GOZ, where the threshold is $1,030,000.[3] As a result, a business taxpayer may expense none of the cost of qualified property placed in service in 2006 in areas outside the GOZ once its total cost reaches or exceeds $538,000. For example, if a firm operating outside the special areas were to place in service qualified property whose total cost in 2006 was $500,000, the firm could expense $38,000 of that amount, and the remaining $462,000 would be recovered under the regular tax depreciation rules. The threshold for the regular allowance is indexed for inflation in 2005 through 2007. In 2008 and thereafter, it is scheduled to revert to its pre-JGTRRA level of $200,000.

Under the income limitation, the expensing allowance a firm claims cannot exceed the taxable income (including wages and salaries) it earns from the active conduct of the trade or business in which the qualified assets are used. For example, if the firm in the above example had taxable income of $25,000 in the business in which the qualified property was used, then the expensing allowance it could claim would be $25,000 instead of the $38,000 that it was eligible to claim. Although business taxpayers may not carry forward any expensing allowances lost because of the dollar limitation, they may carry forward allowances denied because of the income limitation.

In addition to the regular expensing allowance, business taxpayers were able to claim in recent tax years a temporary 30% first-year depreciation deduction under the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) or a temporary 50% first-year depreciation deduction under Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-26). Both allowances applied to new (but not used) property depreciable under the modified accelerated cost recovery system (MACRS) and having a recovery period of less than 20 years. Qualified property acquired between September 11, 2001 and December 31, 2004, and placed in service before January 1, 2005, was eligible for the special 30% depreciation allowance. The 50% depreciation allowance could be claimed for qualified property bought between May 6, 2003, and January 1, 2005, and 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 was required to recover the property's cost in a prescribed order. The expensing allowance was claimed first, reducing the taxpayer's basis in the property by the amount of the allowance. Then the taxpayer applied the temporary 30% or 50% first-year depreciation allowance to any remaining basis, further reducing the

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[3] Like the maximum expensing allowance, the phase-out threshold is indexed for inflation in 2004 through 2007. In 2003, the threshold was $400,000, and in 2004, $410,000. The threshold for 2006 is likely to be higher than it is in 2005.

taxpayer's basis in the property. Finally, the taxpayer could claim a depreciation allowance under the MACRS on any remaining basis, using the most advantageous depreciation method: the double declining balance method.

Legislative History of the Expensing Allowance

The expensing allowance under IRC section 179 originated as a special first-year depreciation allowance that was included in 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 limited 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 with a depreciation life of six or more years.

This allowance remained in force until the passage of the Economic Recovery Tax Act of 1981 (ERTA, P.L. 97-34). ERTA replaced the special deduction with a maximum expensing allowance of $5,000 and set forth a timetable for gradually increasing the allowance to $10,000 by 1986. Despite these changes, few firms took advantage of the new allowance. Some analysts ascribed such a tepid response to the limitations on the use of the investment tax credit also established by ERTA. Any business taxpayer claiming the credit for the purchase of an asset that also was eligible for the expensing allowance could claim the credit only for the portion of the asset's cost that was not expensed. For many firms, the potential tax savings from claiming the credit evidently outweighed the potential tax savings from claiming both the credit and the allowance.

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 maximum 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 at that amount until the passage of the Omnibus Budget Reconciliation Act of 1993 (OBRA93, P.L. 103-66). OBRA93 retroactively raised the maximum allowance to $17,500 (as of January 1, 1993) and added a variety of tax benefits for special areas known as enterprise zones and empowerment zones (EZs). One of these benefits was an enhanced expensing allowance for qualified assets placed in service in a special area of $20,000 above the regular allowance, paired with a phase-out threshold twice as large as the phase-out threshold for the regular allowance. To be designated as an EZ, an area had to satisfy a variety of eligibility criteria relating to population, poverty rate, and geographic size.

With the passage of the Small Business Job Protection Act of 1996 (P.L. 104-188), the regular allowance embarked on another upward path: the act raised the maximum allowance 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.

Through the Community Renewal Tax Relief Act of 2000 (P.L. 106-544), Congress expanded the list of special areas to include so-called "renewal communities" (RCs) and granted them the same tax benefits available to EZs, including an enhanced expensing allowance. The act also increased the maximum allowance for qualified assets placed in service in a tax year in the special areas (including RCs) to $35,000 above the regular allowance.

In response to the terrorist attacks of September 11, 2001, Congress established a variety of tax benefits through the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) to encourage new business investment in the section of lower Manhattan in New York City that bore the brunt of the attacks on the World Trade Center. The act designated this area as the New York "Liberty Zone." Among the tax benefits offered to firms located in the zone was the same enhanced expensing allowance available for qualified investments in EZs and RCs.

The regular allowance remained on the ascending path laid down by the Small Business Jobs Protection Act until JGTRRA was enacted in 2003. Under JGTRRA, the maximum regular allowance rose four-fold to $100,000 in May 2003 and was to stay at that lofty amount in 2004 and 2005, before returning to $25,000 in 2006 and thereafter. JGTRRA also raised the phase-out threshold to $400,000 over the same period, indexed both the regular allowance and the threshold for inflation in 2004 and 2005, and added off-the-shelf software for business use to the pool of depreciable assets 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 another two years, or through 2007.

In an effort to spur economic recovery in the areas of Louisiana, Mississippi, and Alabama devastated by Hurricane Katrina, Congress passed the Gulf Opportunity Zone Act of 2005 (P.L. 109-135). Among other things, the act offered a variety of tax incentives for new business investment in these areas, including an enhanced expensing allowance for qualified assets purchased on or after August 28, 2005, and placed in service by December 31, 2007. The expensing allowance can be as much as $100,000 above the regular allowance. In addition, it begins to phase out when the total cost of qualified assets placed in service by a business taxpayer in a tax year exceeds a threshold that is $600,000 above the phase-out threshold for the regular allowance. Finally, the range of assets eligible for the enhanced allowance is greater than that for the regular allowance.

Legislative Initiatives in the 109th Congress

Legislative activity in recent Congresses showed there was broad bipartisan support for enhancing the expensing allowance as a means of simultaneously spurring increased business investment and aiding small business owners. By all indications, support for the current allowance appears undiminished in the current Congress.

For the sake of exposition, legislative initiatives in the 109th Congress that would modify the existing expensing allowance can be divided into two categories: (1) those that would extend or further enhance the regular allowance, and (2) those that would offer an enhanced expensing allowance to firms making qualified investments in specific geographic areas characterized by relatively high levels of poverty or other kinds of economic distress.

Initiatives to Extend or Enhance the Current Allowance

Bills to further extend most or all of the enhancements in the regular allowance made by JGTRRA have been introduced in both houses.

In the House, H.R. 1091 (introduced by Representative Phil English on March 3, 2005) would keep the regular allowance from falling below $100,000 after 2007, raise its phase-out threshold to a minimum of $500,000 on January 1, 2006, and allow both amounts to be indexed for inflation beyond 2007. Two other measures (H.R. 1388, introduced by Representative Wally Herger on March 17, 2005, and H.R. 3841, introduced by Representative Donald Manzullo on September 21, 2005) would establish permanent floors for the regular allowance of $100,000 and for its phase-out threshold of $400,000 and allow both amounts to be indexed for inflation beyond 2007. None of the three bills 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 (H.R. 1678) introduced by Representative Marilyn Musgrave on April 19, 2005, would extend the current regular allowance through 2009.

In the Senate, S. 1523, introduced by Senator Olympia Snowe on July 28, 2005, would make the same changes in the regular allowance as H.R. 1388 and H.R. 3841, but it would also permanently add off-the-shelf-software for business use to the pool of qualified assets.

More important, the House and Senate have approved differing versions of a tax reconciliation bill (H.R. 4297), both of which include a provision that would extend the existing regular allowance another two years. A conference committee has been formed to reconcile the differences between the two versions. Given that some of the differences are contentious, there is no certainty that a conference agreement likely to win approval in both houses will emerge anytime soon.[4]

There is little doubt that the Bush Administration would back any of these legislative initiatives. Its budget request for FY2007 calls for the permanent extension of all the temporary features of the current allowance, including the eligibility of off-the-shelf computer software for the allowance.[5] But the Administration also favors taking the added step of significantly enhancing the allowance to encourage increased business investment and entrepreneurship. The same budget proposal asks Congress to enact legislation that would increase the

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[4] See Wesley Elmore, "Further Movement on Tax Cuts Unlikely as Session Winds Down," *Tax Notes*, Dec. 26, 2005, p. 1624.

[5] U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007* (Washington: GPO, 2006), p. 252.

expensing allowance to $200,000 and the phase-out threshold for the allowance to $800,000 for qualified property placed in service in 2007 and thereafter, and would index these amounts for inflation for tax years starting in 2008.[6] According to an estimate by the Treasury Department, the Administration's proposed enhancement of the expensing allowance, including the permanent extension of its temporary features, would result in a revenue loss of $12.4 billion from FY2007 through FY2011.[7]

Companion bills to implement the Administration's proposed changes in the expensing allowance have been introduced in the House (H.R. 4790) and the Senate (S. 2287). Each bill would raise the expensing allowance to $200,000 and the phase-out threshold for the allowance to $800,000 starting in 2007 and thereafter, index these amounts for inflation starting in 2008 and thereafter, allow taxpayers to make or revoke expensing elections without the consent of the IRS Commissioner, and permanently add off-the-shelf computer software to the pool of depreciable assets eligible for the expensing allowance.

Initiatives to Create an Enhanced Allowance for Firms Making Qualified Investments in Designated Geographic Areas

Bills to enhance the current allowance would also increase the allowance for qualified property placed in service in the special areas, such as EZs and RCs.

In addition, the current Congress has established a new special area with an enhanced expensing allowance. On December 16, 2005, the House and Senate passed a bill (H.R. 4440, P.L. 109-135) that, among other things, created a variety of tax incentives to foster economic recovery in the areas devastated by Hurricane Katrina in late August 2005. Among the incentives was an enhanced expensing allowance for qualified assets purchased on or after August 25, 2005, and placed in service no later than December 31, 2007, in a so-called "Gulf Opportunity Zone." The allowance can be as much as $100,000 above the regular allowance; it begins to phase out at an amount $600,000 above the phase-out threshold for the regular allowance. Unlike the regular allowance, the enhanced allowance applies to commercial real estate and residential rental property.

Economic Effects of the Expensing Allowance

To many lawmakers, the expensing allowance represents a desirable policy tool for aiding small business owners and stimulating the economy at the same time. To many small business owners, the allowance represents a desirable vehicle for delivering a generous tax benefit. But to most public finance economists, the allowance has effects that go beyond its direct impact on the tax burden of small business owners. In their view, the allowance is likely to have important implications

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[6] Ibid., p. 254.

[7] U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2007 Revenue Proposals* (Washington: Feb. 2006), p. 20.

for the allocation of investment capital within the private sector, 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 discussed below.

Efficiency Effects

Efficiency is a cornerstone of economic theory and analysis. It refers to the allocation of resources in an economy and how it affects the welfare of consumers and producers. When such an allocation leads to the greatest possible economic surplus — defined as the total value to buyers of the goods and services they consume minus the total cost to sellers of providing these goods and services — the allocation is said to be efficient. But when an allocation is less than efficient, some of the possible gains from exchange among buyers and sellers are not being realized. For example, an allocation is deemed inefficient when most suppliers of a good fail to produce it at the lowest marginal cost under existing technologies. In this case, a shift in production from relatively high-cost producers to relatively low-cost producers, driven perhaps by an unleashing of market forces, would lower the total economic cost of providing the good, thereby raising the overall 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 investment capital within the private sector in particular. In theory, all taxes except lump-sum taxes lead to inefficient outcomes because they influence the decisions of consumers and producers in ways that leave one group or the other — or perhaps both — worse off. Non-lump-sum taxes have this effect because they inevitably distort the incentives facing individual and business taxpayers, leading them to allocate resources according to the effects of the 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, or a condition where the amount of revenue raised by a tax is less than the loss of economic welfare it engenders.

The expensing allowance affects the allocation of resources in the U.S. economy by encouraging firms able to claim it to invest in assets that qualify for the allowance, possibly at the expense of other assets. There are two channels through which the allowance can have such an effect. The more important of the two is thought to be a reduction in the user cost of capital for investment in qualified assets relative to all other assets. A second channel is an increase in the cash flow or internal funds available to firms that purchase qualified assets. Restraining the allowance's influence over the allocation of resources is its phase-out threshold, which effectively confines the benefits of the allowance to firms that are relatively small in asset size.[8]

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[8] According to unpublished IRS estimates, a total of $55.161 billion in assets eligible for the IRC section 179 expensing allowance were placed in service in 2003. Firms with assets of $10 billion or less accounted for 49% of this investment, whereas firms with assets of $100 billion or more accounted for 16%.

The user cost of capital plays a major role in a firm's decision to invest. This cost encompasses both the opportunity cost of 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 determines the after-tax rate of return an investment 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 a firm can undertake, and the lower its desired capital stock. When a change in tax policy decreases the user cost of capital, many firms can be expected to respond by increasing the amount of capital they wish to own, perhaps boosting overall business investment in the short run.

How does expensing affect the user cost of capital? Unlimited expensing is the most accelerated form of depreciation: under expensing, the entire cost of an asset is written off in its first year of use, regardless of the asset's actual or useful life. Allowing a firm to expense its acquisition of an asset is equivalent to the U.S. Treasury providing the firm (or its owners) with a tax rebate equal to the firm's marginal tax rate multiplied by the cost of the asset. Accelerated depreciation — along with other investment tax subsidies such as an investment tax credit — reduces the user cost of capital by lowering the pre-tax rate of return on investment a firm must earn in order to realize a desired after-tax rate of return.[9] Expensing yields the largest possible reduction in the user cost of capital from accelerated depreciation. This reduction can be considerable.[10]

How beneficial is expensing? One way to illustrate the tax benefit from expensing is to show how it affects the marginal effective tax rate on the returns to investment in an asset that is expensed for tax purposes. Expensing has the effect of taxing the stream of income earned by an asset over its lifetime at a marginal

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[9] 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, one sees 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.

[10] 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.

effective rate of zero.[11] This is because expensing reduces after-tax returns and costs for eligible investments by the same factor: an investor's marginal tax rate (whether the investor is a corporation or a small business owner). For example, if the tax rate faced by a small business owner is 35% and a depreciable asset he or she buys is expensed, then the federal government effectively becomes a partner in the investment with an interest of 35%. Through the tax code, the federal government assumes 35% of the cost of the asset by allowing its entire cost to be deducted in the first year of the asset's use, and it receives 35% of the income earned by the investment in subsequent years. By the same token, because of expensing, the small business owner receives 65% of the returns from the investment but bears only 65% of the cost. Such an outcome implies that for each dollar spent on the asset, the owner earns the same rate of return after taxes as before taxes.[12]

Expensing could also stimulate what might be described as a self-reinforcing rise in business investment by augmenting the cash flow of firms that rely on internal funds or retained earnings to finance the bulk of their investments and have positive tax liabilities.[13] Expensing can increase a firm's cash flow in the short run because it allows it to deduct the full cost of qualified assets it purchases in the tax year when they are placed into service. There are a variety of reasons why a firm's investments could hinge on its cash flow. One is that the firm's owners or senior managers wish to limit their exposure to external debt and the risks it entails. Another reason is that the firm has restricted or no access to debt and equity markets, mainly because of a lack of accurate information on its assets, strategies, and prospects for achieving relatively high rates of return on equity. For a firm in such a position, the cost of internal funds could be lower than the cost of external funds, in which case the firm and its owners would be better off if the firm were to finance most of its investments out of retained earnings.

What is unclear is the extent to which increases in cash flow in the aggregate boost overall business investment. 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.[14] What is more, this correlation was strongest for firms facing serious obstacles to raising funds in debt and equity markets because of insufficient information on the part of investors or lenders. Nevertheless, it would be a mistake to interpret these findings as providing conclusive evidence that firms with relatively high cash flows invest more than firms with relatively low or negative cash flows.

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[11] 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.

[12] Raquel Meyer Alexander, "Expensing," in *The Encyclopedia of Taxation and Tax Policy*, Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, eds. (Washington: Urban Institute Press, 2005), p. 129.

[13] In the realm of business finance, the term "cash flow" can take on different meanings. Here it denotes the difference between a firm's revenue and its payments for all the factors or inputs used to generate its output, including capital equipment.

[14] 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.

After all, a strong correlation between two variable factors does not prove the existence of a cause-and-effect relationship between them. 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 have little or nothing to do with the relative cost of internal and external funds. The link between cash flow and business investment is complex, and further research is needed to clarify it.

To what extent has the expensing allowance contributed to shifts in the size and composition of the domestic capital stock in the 25 years the allowance has existed in its present form? This question is difficult to answer because there are no studies analyzing the effects of the allowance on capital formation over time, and relevant empirical evidence is incomplete. Given that the expensing allowance lowers the cost of capital and raises cash flow for many firms able to claim it, and that there is some evidence that investment in many of the assets eligible for the allowance is somewhat sensitive to reductions in the cost of capital, one might be justified in thinking that the allowance has caused domestic investment in those assets to be greater than it otherwise would have been.[15] Yet there are equally compelling reasons to think that much of this investment would have taken place without the expensing allowance.[16] Most economists agree that investment in assets eligible for the expensing allowance tends to be driven more by business expectations for future growth in sales, the nature of the capital goods themselves, and conditions in debt and equity markets than by tax considerations.[17] This view gains some support from available data on use of the expensing allowance: although 22% of corporations filing federal tax returns claimed the allowance from 1999 through 2003, the total value of IRC section 179 property placed in service was equal to only 5% of domestic gross investment in equipment and computer software.[18]

When filtered through the lens of conventional economic theory, the expensing allowance acts like a drain on efficiency that may worsen the deadweight loss caused by the federal tax code. Under the reasonable 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 lure some capital away from more productive uses and into tax-favored investments. Conventional economic theory holds that in an economy free of significant market failures and ruled mostly by competitive markets, a policy of

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[15] 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.

[16] 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 Weighs Bush's Expensing Boost," *Tax Notes*, April 7, 2003, p. 17.

[17] 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].

[18] Various data on business claims for the expensing allowance were obtained via e-mail from the Statistics of Income Division at IRS on March 21, 2006.

neutral or uniform taxation of capital income would minimize the efficiency losses brought on by income taxation. The expensing allowance, however, fosters investment in specific assets by relatively small firms. Such a subsidy can interfere with the flow of financial capital to its most profitable uses by making it possible for business owners to earn higher after-tax rates of return on investment in assets eligible for the allowance than on investment in other assets with higher expected pre-tax rates of return. In addition, the expensing allowance gives firms able to claim it an incentive to restrain their growth. This unintended incentive stems from the rise in marginal effective tax rates on the income earned by an asset eligible for the allowance in the allowance's phase-out range ($430,000 to $538,000 in 2006).[19] Douglas Holtz-Eakin, the former Director of the Congressional Budget Office, has labeled this incentive effect a "tax on growth by small firms."[20]

Equity Effects

Equity is a key principle of economic analysis. In general, it refers to the distribution of income among the individuals or households in a geographic unit. In the case of income taxation, equity usually denotes the distribution of the tax burden among taxpayers divided into income groups. Economists who analyze the equity effects of income taxes tend to focus on two distinct concepts of equity: horizontal equity and vertical equity. A tax system is said to be horizontally equitable if it imposes similar burdens on individuals with similar incomes. And 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, measured as a fraction of income, rises with income.

The federal income tax system seems to lean more in the direction of vertical equity than horizontal equity. Individuals with the similar incomes before taxes can end up being taxed at the same marginal rate. But because of various tax preferences in the form of deductions, preferential rates, deferrals, exclusions, exemptions, and credits enacted over many years, individuals with similar before-tax incomes can also end up being taxed at significantly different rates. At the same time, those with relatively high pre-tax incomes are almost uniformly taxed at significantly higher rates than those with relatively low pre-tax incomes.

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

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[19] Jane Gravelle of CRS has estimated that, with a corporate tax rate of 28% and a rate of inflation of 3%, the marginal effective tax rate on the income earned by assets eligible for the expensing allowance is 36% in the phase-out range for the allowance. By contrast, under the same assumptions, the marginal effective tax rate on the income earned by qualified assets is 0% for each dollar of investment in those assets up to $430,000.

[20] 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.

To answer this question, it is necessary to consider 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 income earned by assets eligible for the allowance. 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 **actual marginal rates** at which this income is taxed. This is because accelerated depreciation does not, in theory, reduce the taxes that will be paid on an asset's expected stream of income over its useful life. Rather, accelerated depreciation simply changes the timing of depreciation deductions in ways that are advantageous for business owners or shareholders. Most assets eligible for the allowance are owned by smaller firms. As a result, it is reasonable to assume that most of the tax benefit associated with the allowance falls into the hands of small business owners. This benefit does not involve a reduction in their marginal tax rates.

Because the allowance does not alter the income tax rates facing small business owners, 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 income tax unchanged, it can have no impact on vertical or horizontal equity.

Tax Administration

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

Most public finance experts would agree that a desirable income tax system is one that imposes 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 public finance experts would also likely agree that the current federal income tax system fails this crucial test. 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 have long complained bitterly about the costly burdens imposed on them by the record keeping and filings required by the federal income tax.

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 under complicated depreciation schedules.

Tax simplification has long been a key 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 examined in a 2001 study prepared for the Office of Advocacy of the Small Business Administration. According to the study, the cost per employee for tax compliance in 2000 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.[21] crsphpgw

[21] W. Mark Crain and Thomas D. Hopkins, *The Impact of Regulatory Costs on Small Firms* (Washington: Office of Advocacy, Small Business Administration, 2001), p. 32.