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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 may deduct (or expense) up to $250,000 of the total cost of certain assets placed in service in 2008, within certain limits. Without such an option, firms would have to recover the cost over a longer period, using current depreciation schedules. The rules governing the use of the allowance limit most of its benefits to relatively small firms.

This report focuses on the economic effects of the small business expensing allowance. It begins by explaining how the allowance works; moves on to summarize its legislative history and describe legislation in the 110th Congress to modify the allowance; and concludes with a discussion of the allowance's implications for economic efficiency, the distributional effects of the federal income tax, and tax administration. The report will be updated to reflect significant legislative activity.

There has been substantial bipartisan support for enhancing the expensing allowance in the 110th Congress. In May 2007, the House and Senate passed a bill (H.R. 2206, P.L. 110-28) that included an increase in the expensing allowance to $125,000 and the phaseout threshold for the allowance to $500,000 in 2007, indexing both amounts for inflation from 2008 to 2010, and extending through 2008 the enhanced expensing allowance for qualified property used in the Gulf Opportunity Zone.

Then in February 2008, the House and Senate approved an economic stimulus bill (H.R. 5140, P.L. 110-185) that boosted the allowance to $250,000 and the phaseout threshold to $800,00 in 2008 only. Under current law, the allowance will revert to $125,000 and the threshold to $500,000 in 2009 and 2010.

Several other bills would permanently enhance the allowance or extend its reach, including S. 3119, S. 3162, and H.R. 6611. Companion bills in the House (H.R. 6587) and Senate (S. 3322) would greatly increase the expensing allowance and phaseout threshold for qualified assets placed in service in 2008 in areas of the Midwest that were declared presidential disaster areas in the summer of 2008.

The expensing allowance has a seemingly minor effect on the composition and 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 has the potential to spur increased small business investment by reducing the user cost of capital for eligible assets and increasing the cash flow of firms that claim the allowance, it can impair economic efficiency by encouraging higher investment in activities yielding relatively low pre-tax returns. At the same time, the allowance appears to have no measurable impact on the distribution of the federal tax burden among income groups. In addition, it has the advantage of lessening the burden of tax compliance by simplifying tax accounting for firms claiming it.

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Provided certain conditions are met, firms may expense (or deduct) up to $250,000 of the cost of qualified assets they place in service in 2008. Some refer to this option for capital cost recovery as the small business expensing allowance because the rules governing its use restrict the option's benefits mainly to firms that are relatively small in asset, employment, or revenue size. Firms unable to claim the expensing allowance can recover the cost of the same assets over longer periods through claiming allowable depreciation deductions. The expensing allowance represents a significant tax subsidy for small business investment because it can reduce 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 the allowance's design and summarizing its legislative history. It then discusses proposals in the 110th Congress to alter the current allowance. The report concludes with an assessment of the allowance's 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 full cost of qualified assets (or property) they purchase in the year when the assets are placed in service, within certain limits. Business taxpayers that are unable or unwilling to take advantage of this option for capital cost recovery may recover this cost over longer periods by claiming allowable depreciation deductions.

In 2008, the maximum expensing allowance is $250,000 for firms operating outside so-called enterprise and empowerment zones (EZs), renewal communities (RCs), and the areas affected the most by Hurricane Katrina (also known as the Gulf Opportunity Zone, or GOZ).[1] (For the sake of clarity, this allowance is henceforth referred to as the regular allowance.) For firms operating within all the special areas except the GOZ, the maximum allowance in 2008 is $285,000. For firms located in

[1] The allowance is indexed for inflation in 2004 through 2010. In 2003, it was $100,000; in 2004, $102,000; in 2005, $105,000; in 2006, $108,000; and in 2007, $125,000.

the GOZ, the maximum allowance in 2008 for qualified assets purchased on or after August 28, 2005, and placed in service by December 31, 2008, is $350,000.

The regular allowance is scheduled to fall back to $125,000 in 2009 and 2010, with each amount indexed for inflation. Assuming no change in current law, it is scheduled to revert to $25,000 (its level before the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003, or JGTRRA) in 2011 and each year thereafter for firms operating outside the special areas. In the same period, the allowance will fall to $60,000 for firms operating in all the special areas except the GOZ, and to $125,000 for firms operating in the GOZ.

Business taxpayers choose the expensing option by following rules set forth by the Internal Revenue Service (IRS). Under IRS Regulation 1.179-5, these taxpayers may make or revoke an election under IRC Section 179 for property placed in service through 2010 without the consent of the IRS Commissioner by submitting an amended tax return for the tax year in question. For tax years beginning in 2011, 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 acquired for business use may be expensed through 2009. Most buildings and their structural components do not qualify for the regular allowance, although research and bulk storage facilities do qualify. In the case of firms located 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.

Under the dollar limitation, the regular expensing allowance is reduced by the amount by which the total cost of 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 half of the amount by which the cost of qualified property placed in service in a tax year exceeds the threshold. The threshold is set at $800,000 in 2008 for all firms except those operating in the GOZ,

which face a threshold of $1,400,000.[2] As a result of this dollar limitation, a business taxpayer operating outside the GOZ and the other special areas may expense none of the cost of qualified property it places in service in 2008 when the total cost of that property equals or exceeds $1,050,000. For example, if such a firm were to place in service qualified property whose total cost in 2008 were to come to $750,000, it would be allowed to deduct the entire amount under IRC Section 179.

The threshold for the regular allowance is scheduled to fall back to $500,000 in 2009 and 2010; it is indexed for inflation in both years. Assuming no change in current law, the threshold is scheduled to revert to its pre-JGTRRA level of $200,000 in 2011 and each year thereafter.

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 were to have taxable income in 2008 of $25,000 in the business in which the qualified property is used, it would be able to claim a maximum expensing allowance of $25,000, instead of the $750,000 it otherwise would be entitled to claim. Although business taxpayers may not carry forward any expensing allowance lost because of the dollar limitation, they may carry forward an allowance denied because of the income limitation.

In addition to the expensing allowance, business taxpayers were able to claim 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 deductions 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 30% depreciation deduction. The 50% deduction was available 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 the 50% deduction, but not both.

The Economic Stimulus Act of 2008 (P.L. 110-185) reinstated the temporary 50% first-year depreciation deduction that expired at the end of 2006. It applies to the same set of depreciable assets targeted by the earlier deduction. To benefit from the partial expensing allowance, a firm must buy qualified assets and place them in service between January 1, 2008, and December 31, 2008; an exception is made for certain assets (e.g., aircraft) with relatively long production periods. The allowance expires at the end of 2008.

For property eligible for both the expensing and special depreciation allowances, a firm is required to recover the property's cost in a prescribed order. The expensing

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[2] Like the maximum expensing allowance, the phase-out threshold is indexed for inflation in 2004 through 2010. In 2003, the threshold was $400,000; in 2004, $410,000; in 2005, $420,000; in 2006, $430,000; and in 2007, $500,000.

allowance must be claimed first, reducing the taxpayer's basis in the property by the amount of the allowance. Then the taxpayer may apply the 50% first-year depreciation allowance to any remaining basis, further reducing the taxpayer's basis in the property. Finally, the taxpayer may claim a depreciation allowance under the MACRS on any remaining basis, using the most advantageous depreciation method, which is 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 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 specified 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. A 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 expensing allowance for qualified assets placed in service in a special area that was $20,000 above the regular allowance, 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 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 upward path laid down by the Small Business Jobs Protection Act until the adoption of JGTRRA. Under JGTRRA, the maximum regular allowance rose four-fold to $100,000 in May 2003 and was to stay at that 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 list 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 designated these areas as the Gulf Opportunity Zone (GOZ), and offered a variety of tax incentives for new business investment in the GOA, 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.

The Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) extended the changes in the allowance made by JGTRRA through 2009.

Finally, in passing the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Appropriations Act, 2007 (P.L. 110-28), Congress extended the changes in the allowance made by JGTRRA through 2010, raised the maximum allowance to

$125,000 and the phaseout threshold to $500,000 in 2007 to 2010, and indexed both amounts for inflation from 2008 through 2010. The act also extended through 2008 the enhanced expensing allowance for qualified assets placed in service in the GOZ.

Congress boosted the allowance to $250,000 and the phaseout threshold to $800,000 in 2008 only by passing the Economic Stimulus Act of 2008 (P.L. 110-185). Those amounts revert back to $125,000 and $500,000 in 2009 and 2010, respectively.

Legislative Initiatives in the 110th Congress

Legislative activity in recent Congresses demonstrated that there was broad bipartisan support for enhancing the expensing allowance, as a means of both spurring increased business investment and funneling aid to small business owners.

By all accounts, this support remains as robust as ever in the current Congress. Bills to extend the enhancements in the regular allowance made by JGTRRA and to enhance temporarily the current allowance as a way to spur faster domestic economic growth have been enacted. Other bills to further enhance the allowance on a permanent basis have been introduced.

Between late March and mid-May 2007, the House and Senate passed two bills (H.R. 1591 and H.R. 2206) that included further enhancements of the expensing allowance. Specifically, each measure would have raised the maximum allowance to $125,000 and the phaseout threshold to $500,000 from 2007 through 2010, indexed both amounts for inflation in 2008 to 2010, extended through 2010 all other features of the allowance that are set to expire in 2009, and extended through 2008 the enhanced expensing allowance under IRC Section 1400(N) for qualified property placed in service in the GOZ. President Bush vetoed H.R. 1591 on May 1, 2007, but he signed H.R. 2206 (P.L. 110-28) on May 25.

Faced with mounting evidence of a pronounced slowdown in domestic economic activity, Congress showed a renewed interest in using the allowance as a tool for stimulating faster economic growth in early 2008. On January 24, the leaders of the House and the Bush Administration announced they had reached an agreement on an economic stimulus package that included an increase in the allowance to $250,000 and in the threshold to $800,000 in 2008 only. Five days later, the House passed a measure (H.R. 5140) incorporating the terms of that agreement. The Senate did likewise on February 7. President Bush signed the legislation on February 13. Under the law, the allowance and threshold will revert to preexisting law in 2009 and beyond.

There are some indications that this interest has not abated a good deal in the months since the enactment of the stimulus legislation. Several bills to enhance permanently the allowance and its phaseout threshold have been introduced in recent months. S. 3119 would permanently raise the maximum allowance to $128,000 and the phaseout threshold to $500,000 in 2009 and beyond and adjust both amounts for inflation. S. 3162 would permanently set the maximum allowance at $125,000 and

the phaseout threshold at $500,000 in 2009 and thereafter, adjust both amounts for inflation, and make purchases of off-the-shelf computer software for business use permanently eligible for the expensing allowance; and H.R. 6611 would permanently increase allowance to $250,000 and the phaseout threshold to $800,000 and adjust both for inflation, starting in 2009.

In addition, companion bills in the House (H.R. 6587) and Senate (S. 3322) would offer temporary tax relief for taxpayers located in areas of certain Midwestern states that were declared presidential disaster areas as a result of severe storms, flooding, and tornados that occurred early in the summer of 2008. Each bill contains a provision that would raise the expensing allowance to $350,000 and the phaseout threshold to $1.4 million for qualified assets placed in service in 2008 in any of the disaster areas. To qualify for this treatment, an asset would have to be eligible for the Section 179 expensing allowance and meet the definition of qualified Gulf Opportunity Zone property under IRC Section 1400N(d)(2).

The Bush Administration has signaled that it would back a further enhancement of the expensing allowance. Its budget request for FY2009 includes a permanent increase in the maximum allowance to $200,000 and the phase-out threshold allowance to $800,000 and a permanent indexation of these amounts for inflation, starting in 2009.[3] According to the Treasury Department, these changes in the allowance would result in an estimated revenue loss of $7.6 billion from FY2009 to FY2018.[4]

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 tax benefit. But to most public finance economists, the allowance has economic effects that extend beyond its implications for the tax burden of small business owners. In their view, the allowance may affect 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 lies at the heart of economic theory and analysis. It refers to the allocation of resources in an economy and how it shapes the welfare of consumers and producers. When such an allocation generates the greatest possible economic surplus — defined as the total value to buyers of the goods and services they

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[3] U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2009 Revenue Proposals* (Washington: Feb. 2008), pp. 17-18.

[4] Ibid., p. 18.

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 permitted by existing technologies. In this case, a shift in supply 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 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, which is a condition where the amount of revenue raised by a tax is less than the loss of economic welfare it engenders.

The expensing allowance has the potential to affect 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 more productive 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 a temporary 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.[5]

As one would expect, the user cost of capital plays a major role in a firm's investment decisions. 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 fewer 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, boosting overall business investment in the short run.

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[5] 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%.

How does expensing affect the user cost of capital? 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.[6] Expensing yields the largest possible reduction in the user cost of capital from accelerated depreciation. This reduction can be considerable.[7]

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 effective rate of zero.[8] This is because expensing reduces the after-tax returns and costs for eligible investments by the same factor: an investor's marginal tax rate. For example, if the income received by a small business owner is taxed at a rate of 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. Conversely, expensing

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[6] 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.

[7] 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*, September 1995, p. 389.

[8] 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.

allows the small business owner to receive 65% of the returns from the investment but to bear 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.[9]

Expensing could also support a sustained rise in business investment by augmenting the cash flow of firms that rely heavily on internal funds or retained earnings to finance the bulk of their investments and have positive net incomes.[10] Expensing can increase a firm's cash flow in the short run because it allows the firm 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 want to limit their exposure to external debt and the risks it entails. Another reason is that the firm has limited or no access to debt and equity markets, mainly because of a lack of accurate information on its assets, strategies, or 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 how increases in cash flow in the aggregate affect 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.[11] 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 conclusive evidence that firms with relatively high cash flows invest more than firms with relatively low or negative cash flows. 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 complicated; further research is needed to clarify it.

Is there reason to believe that the expensing allowance has 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 impact of the allowance on capital formation over time, and empirical evidence is incomplete. Given that the expensing

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[9] 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.

[10] 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.

[11] 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.

allowance lowers the cost of capital and may boost cash flow for many firms able to claim it, and that investment in many of the assets eligible for the allowance seems somewhat sensitive to reductions in the cost of capital, one might be justified in concluding that the allowance has caused domestic investment in those assets to be greater than it otherwise would have been.[12] Yet there are equally compelling reasons to infer that much of this investment would have taken place without the expensing allowance.[13] Most economists would probably agree that investment in assets eligible for the expensing allowance is likely 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.[14] This view finds some support in 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.[15]

When seen 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 highly profitable productive uses and into tax-favored uses. Conventional economic theory holds that in an economy free of significant market failures and dominated by competitive markets, a policy of neutral or uniform taxation of capital income would minimize the efficiency losses brought on by income taxation. The expensing allowance, however, subtly encourages 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

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[12] 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.

[13] 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.

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

[15] 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.

allowance's phase-out range ($500,000 to $625,000 in 2007).[16] Douglas Holtz-Eakin, the former Director of the Congressional Budget Office, has labeled this incentive effect a "tax on growth by small firms."[17]

Equity Effects

Equity is another basic concept in economic analysis. It generally refers to the distribution of income among the individuals or households in a geographic area.

In the context 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 kinds 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 or standards of living. And a tax system is said to be vertically equitable if the burdens it imposes vary according to an individual's or household's ability to pay. The principle of vertical equity provides the foundation for any progressive income tax system. Under such a system, an individual's total tax liability, measured as a fraction of income, rises with income.

The current federal income tax system seems to lean more in the direction of vertical equity than horizontal equity. Many individuals with similar incomes before taxes 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, a significant share of individuals with similar before-tax incomes also end up being taxed at significantly different rates. At the same time, those with relatively high pre-tax incomes are generally taxed at significantly higher rates than those with relatively low pre-tax incomes.

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

To answer this question, it is necessary to consider the tax benefits associated with the expensing allowance, who receives them, and how they affect the recipients' federal income tax burdens. 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 critically on the proportion of the asset's 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

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[16] 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.

[17] 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.

change the *actual marginal rates* at which this income is taxed. This is because accelerated depreciation does not, in theory, reduce the total amount of taxes (measured in current dollars) 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 substantially boost the present discounted value of the tax savings from depreciation allowances.

Most of the assets eligible for the allowance are owned by smaller firms. As a result, it would be reasonable to assume that most of the tax savings generated by the allowance end up in the pockets of small business owners. But such an inference is implausible, since the allowance does not alter the income tax rates facing small business owners — and thus has no direct effect on the distribution of the federal income tax burden among income groups. As the allowance leaves the distributional effects of the income tax unchanged, it has 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 economists 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 hinges on three factors: (1) the records that must be kept in order to comply with tax laws, (2) the complexity of those laws, and (3) the types of income subject to taxation.

Many public finance economists would also 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 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 that cost over a longer period applying complicated depreciation schedules. At the same time, the rules governing the use of the credit in and out of specially designated areas add a layer of complexity to the administration of the allowance by the IRS.

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.[18]

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[18] 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.