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

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Summary

Under the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5), business taxpayers may expense (or deduct as a current expense) up to $250,000 of the total cost of certain depreciable assets placed in service in 2009, within certain limits. One limit is a phaseout threshold, which is set at $800,000 in 2009. The act also allows business taxpayers to claim a so-called bonus depreciation allowance in 2009 that is equal to 50% of the cost of qualified assets placed in service that year. Firms unable to use either option for accelerated depreciation have to write off that cost over a longer period, using current 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 what is referred to as the small business expensing allowance. It begins by explaining how the allowance works, then summarizes its legislative history and describes legislation in the 111th Congress to modify the allowance, and concludes with a discussion of the allowance's implications for economic efficiency, equity, and tax administration. The report will be updated as necessary.

There was strong bipartisan support for enhancing the expensing allowance in recent Congresses, and there are some early signs that this support has not waned in the 111th Congress. Several bills to extend the enhanced allowance that was in effect in 2008 through 2009 or 2010 have been introduced, capped by H.R. 1, the American Recovery and Reinvestment Act of 2009. The version of H.R. 1 signed by President Obama contains a provision that would allow firms to claim the same enhanced expensing allowance in 2009 that was available in 2008. The act also extends through 2009 the 50% bonus depreciation allowance that applied to the purchase of qualified assets in 2008.

The expensing allowance appears to have a 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 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 and increasing the cash flow of firms that use the allowance, it can also harm economic efficiency by encouraging greater investment in activities with relatively low pre-tax rates of return. At the same time, the allowance appears to have no measurable impact on the distribution of the federal tax burden among income groups, but it simplifies tax accounting for firms claiming it.

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Provided certain conditions are met, firms may expense (or deduct as a current expense) up to $250,000 of the total cost of qualified assets they purchase and place in service in 2009. Some refer to this option for capital cost recovery as the small business expensing allowance, as the rules governing its use confine the allowance's benefits mainly to firms that are relatively small in asset, employment, or revenue size. Generally, firms that cannot use the expensing allowance may recover the cost of the same assets over longer periods by claiming allowable depreciation deductions. The expensing allowance represents a significant tax subsidy for small business investment, as it reduces the marginal effective rate at which the returns to investment in qualified assets are taxed.

The 111th Congress has already passed a bill (H.R. 1, the American Recovery and Reinvestment Act of 2009 or ARRA, P.L. 111-5) that extends through 2009 an enhanced version of the allowance that was available in 2008. It is hoped that such an investment tax subsidy will spur many small firms to spend more on new equipment in 2009 than they otherwise would.

This report examines the current status of the small business expensing allowance, initiatives in the 111th Congress to modify it, and its main economic effects The report begins by describing the allowance's design and summarizing its legislative history. It then discusses proposals in the current Congress to modify 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), firms in all lines of business have the option of expensing the cost of qualified assets (or property) they acquire in the year when the assets are placed in service, within certain limits. In general, business taxpayers that are unable or unwilling to take advantage of the expensing allowance may recover this cost over longer periods by using allowable depreciation deductions.

Maximum Expensing Allowance

The maximum expensing allowance is $250,000 for qualified assets placed in service in 2009 by firms located outside so-called enterprise and empowerment zones (EZs), renewal communities (RCs), and presidentially declared disaster areas (PDDAs).[1] (For the sake of clarity, this allowance is henceforth referred to as the regular allowance.) For firms operating within all special areas except PDDAs, the maximum allowance for qualified assets placed in service in 2009 is $285,000. For firms located in PDDAs, the maximum allowance for qualified assets placed in service in 2009 is $350,000.

In 2010, the regular allowance is scheduled to drop to $125,000, before adjustment for inflation; it will be $160,000 for firms located in special areas other than PDDAs, and $225,000 for PDDA firms; both amounts are indexed for inflation. Assuming no change in current law, the regular allowance is scheduled in 2011 and beyond to drop to $25,000, its amount before the enactment

[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; in 2007, $125,000; and in 2008, $250,000. The large increase in 2008 was temporary and resulted from a provision in the Economic Stimulus Act of 2008.

of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), with no adjustment for inflation. Beginning in 2011, the allowance will fall to $60,000 for firms operating in all special areas except PDDAs.

Qualified Property

Qualified property is defined as certain new and used depreciable assets—as specified in IRC Section 1245(a)(3)—acquired for use in the active conduct of a trade or business. With a few exceptions, this property 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 (including heavy-duty sport utility vehicles) is considered qualified property, but not heating and air conditioning units. In addition, the cost of 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, but research and bulk storage facilities do qualify.

The expensing allowance does not apply to qualified property placed in service in the following kinds of establishments located in EZs, RCs, and PDDAs: 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.

Limitations on the Use of the Expensing Allowance

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

Under the dollar limitation, the regular expensing allowance is reduced, dollar for dollar, by the amount by which the total cost of qualified property placed in service during the year exceeds a phaseout threshold. For firms operating in EZs, RCs, and the NYLZ, the expensing allowance is reduced by half of the amount by which the total cost of qualified property placed in service in a tax year exceeds the threshold. The threshold is set at $800,000 in 2009 for all firms except those operating in PDDAs, which face a threshold of $1,400,000.[2] As a result, a business taxpayer located outside the special areas may expense none of the cost of qualified property it places in service in 2009 when the total cost equals or exceeds $1,050,000. This means, for example, that if such a firm were to place in service in 2009 qualified property whose total cost came to $550,000, it could deduct the entire amount under IRC Section 179.

The phaseout threshold for the regular allowance is scheduled to fall to $500,000 in 2010, with an adjustment for inflation. Assuming no change in current law, the threshold is scheduled to revert to its pre-JGTRRA level of $200,000 (with no indexation for inflation) in 2011 and beyond.

Under the income limitation, the expensing allowance a firm claims cannot exceed its taxable income (including wages and salaries) from the active conduct of the trade or business in which

[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; in 2007, $500,000; and in 2008, $800,000.

the qualified assets are employed. For example, if the firm in the above example were to have taxable income in 2009 of $25,000 from the business in which the qualified property is used, it would be able to claim an expensing allowance of no more than $25,000. While business taxpayers are not allowed to carry forward any expensing allowance lost because of the dollar limitation, they may carry forward indefinitely any allowance denied because of the income limitation.

Business taxpayers can also expect to face a new restriction on their ability to take advantage of the expensing option in 2011. Under Internal Revenue Service (IRS) Regulation 1.179-5, taxpayers currently 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, however, an expensing election may be revoked only with the consent of the Commissioner.

Bonus Depreciation Allowance

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 were commonly referred to as bonus depreciation allowances and operated as partial expensing allowances. They applied to new (but not used) property eligible for depreciation under the modified accelerated cost recovery system (MACRS) and having a depreciation life 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 applied to qualified property bought between May 6, 2003 and January 1, 2005, and placed in service by January 1, 2006. Since there was an overlap of nearly 19 months between the two options for accelerated depreciation, business taxpayers were allowed to claim only one of them.

The Economic Stimulus Act of 2008 (P.L. 110-185) reinstated the 50% first-year bonus depreciation allowance that expired at the end of 2006. It applies to the same set of depreciable assets targeted by the earlier deduction. To benefit from this allowance, a firm had to buy qualified assets and place them in service between January 1, 2008, and December 31, 2008; an exception was made for assets with relatively long production schedules, such as aircraft. The allowance expired at the end of 2008.

As a result of the ARRA, the bonus depreciation allowance that was available in 2008 has been extended through 2009.

For property that is eligible for both the expensing and special depreciation allowances, a firm is required to write off the property's cost in a prescribed order. The expensing allowance must be taken first, an act that reduces a taxpayer's basis in the property by the amount of the allowance. Then the taxpayer may apply the 50% first-year bonus depreciation allowance to any remaining basis, further reducing the taxpayer's basis in the property. Finally, the taxpayer is allowed to claim a depreciation allowance under the MACRS on any remaining basis, using the double declining balance method. Firms using all three allowances realize a significant reduction in their cost of capital for investment in qualified property, as will be discussed below in some detail.

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 (or $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 effect 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 laid down a timetable for gradually increasing the allowance to $10,000 by 1986. Despite these enhancements, few firms took advantage of the new allowance. Some analysts ascribed the tepid response to the limitations on the use of the investment tax credit that was also established by ERTA. A business taxpayer claiming the credit for the acquisition of an asset that also was eligible for the expensing allowance could claim the credit only for the portion of the cost that was not expensed; so the full credit could be used only if no expensing allowance was claimed. For many firms, the tax savings from the credit only evidently outweighed the tax savings from a combination of the credit and the allowance.

In a bid to counter the growing federal budget deficits of the early 1980s, Congress passed the Deficit Reduction Act of 1984 (P.L. 98-369). One of its provisions postponed from 1986 to 1990 the scheduled increase in the maximum expensing allowance to $10,000. Use of 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 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. One of these benefits was an expensing allowance for qualified assets placed in service in an EZ that was $20,000 greater than the regular allowance, with a phaseout threshold twice as large as the phaseout threshold for the regular allowance. To be designated as an EZ, an area had to meet 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 yet 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.

Under the Community Renewal Tax Relief Act of 2000 (P.L. 106-544), Congress expanded the list of special areas to include renewal communities 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 all special areas (including RCs) to $35,000 above the regular allowance.

In response to the economic effects of 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 investing 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 set 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 as of May 6, 2003 and was supposed to stay at that amount in 2004 and 2005, before returning to its amount before the enactment of JGTRRA ($25,000) in 2006 and thereafter. JGTRRA also raised the phaseout 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 from May 6, 2003 through December 31, 2005.

The American Jobs Creation Act of 2004 (AJCA, P.L. 108-357) extended the changes in the allowance made by JGTRRA through the end of 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 GOZ, including an enhanced expensing allowance for qualified assets purchased on or after August 28, 2005, and placed in service by December 31, 2007. This allowance could be as much as $100,000 above the regular allowance. In addition, it began to phase out when the total cost of qualified assets placed in service in a tax year exceeded a threshold that was $600,000 above the phaseout threshold for the regular allowance. Finally, more assets were eligible for the enhanced allowance than 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.

Under 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 yet again (through 2010), raised the maximum allowance to $125,000 and the phaseout threshold to $500,000 from 2007 through 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.

In a bid to boost business investment in the midst of an accelerating downturn in economic activity, Congress increased the allowance to $250,000 and the phaseout threshold to $800,000 for 2008 only through the Economic Stimulus Act of 2008 (P.L. 110-185). Those amounts return to $125,000 and $500,000 (both amounts adjusted for inflation) in 2009 and 2010.

The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) extended the enhanced allowance created by the Economic Stimulus Act of 2008 through 2009.

Legislative Initiatives in the 111th Congress

There are some early signs that congressional interest in enhancing the expensing allowance to boost small business investment remains as robust as ever in the 111th Congress. Several bills to

extend through 2009 or 2010 the enhanced allowance that was available in 2008 have been introduced, capped by H.R. 1(ARRA, P.L. 111-5). The version of H.R. 1 signed by President Obama contains a provision that allows firms to claim a maximum expensing allowance of $250,000, with a phaseout threshold of $800,000, for qualified assets placed in service in 2009. The act also extends through 2009 the 50-percent bonus depreciation allowance that applied to the purchase of qualified assets in 2008.

Economic Effects of the Expensing Allowance

For many lawmakers, the expensing allowance represents a desirable policy tool for lowering the tax burden on small business owners and stimulating business investment at the same time. And for many small business owners, the allowance represents a desirable tax benefit. But for most public finance economists, the allowance generates economic effects that go beyond its impact on the tax burden of small business owners. In their view, the allowance could 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 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 traditional economic theory and analysis. It refers to the allocation of resources in an economy and how that allocation shapes the welfare of consumers and producers. When the allocation of resources produces 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 the allocation is less than efficient, some of the possible gains from exchange among buyers and sellers are not realized. For example, economists deem an allocation of resources inefficient when most suppliers of a good fail to produce it at the lowest marginal cost allowed by existing technologies. In this case, a shift in sources of supply from relatively high-cost producers to relatively low-cost producers, driven perhaps by an unleashing of consumer demand, would lower the total economic cost of providing the good, thereby raising the overall economic surplus.

A 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 economic outcomes because they sway 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 economic choices facing individual and business taxpayers, leading them more often than not to allocate resources on the basis of how taxes affect the cost and benefit of the goods and services they buy and sell, rather than according to 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 could affect the allocation of resources in an economy by encouraging firms 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 produce such an inefficient outcome. One channel is a reduction in the user cost of capital for investment in

qualified assets relative to investment in all other assets. A second channel is a temporary increase in the cash flow or retained earnings of firms that acquire qualified assets. Restraining the allowance's influence on the allocation of resources is its phaseout threshold, which effectively confines the benefits of the allowance to relatively small firms.[3]

Not surprisingly, the user cost of capital plays a major role in a firm's investment decisions. This cost embraces both the opportunity cost of an investment and its direct costs, such as depreciation, the actual cost of the asset, and income taxes. In effect, the user cost of capital establishes 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 projects a firm can profitably undertake, and the lower its desired capital stock. When a change in tax policy decreases the user cost of capital, it is reasonable to expect many firms to respond by increasing the amount of capital they wish to own, boosting overall business investment in the short run.

So 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 economic or useful life. Allowing a firm to expense its acquisition of an asset is akin to the U.S. Treasury providing the firm 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 particular after-tax rate of return.[4] Expensing yields the largest possible reduction in the user cost of capital from accelerated depreciation. As some studies have shown, this reduction can be considerable.[5]

How beneficial is expensing? One way to illustrate the tax benefit from expensing is to assess how it affects the marginal effective tax rate on the returns to investment in an asset whose cost is expensed. Expensing has the effect of taxing the stream of income earned by an asset over its lifetime at a marginal effective rate of zero.[6] This is because expensing reduces the after-tax

[3] 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%.

[4] The user cost of capital is the real rate of return an investment project must earn to be profitable. In theory, a firm will undertake an investment provided the after-tax rate of return exceeds or at least equals the user cost of capital. Rosen has expressed this cost in terms of a simple equation. Let **C** stand for the user cost of capital, *a* for the purchase price of an asset, *r* for the after-tax rate of return, *d* for the economic rate of depreciation, *t* for the corporate tax rate, *z* for the present value of depreciation deductions flowing from a $1 investment, and *k* for the investment tax credit rate. Then $\mathbf{C} = a \times [(r + d) \times (1-(t \times z)-k)]/(1-t)$. Under expensing, *z* is equal to one. By plugging assumed values for each variable into the equation, 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.

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

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

return and cost for an investment by the same factor, which is 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 the cost of a depreciable asset he or she buys is recovered through expensing, 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 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.[7] This equivalence implies that expensing results in an effective marginal tax rate of 0.

Expensing could also spur a rise in business investment by augmenting the cash flow of firms that rely heavily on retained earnings to finance their investments.[8] 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 in the tax year the firm places them into service. There are several reasons why a firm's investments could depend on its cash flow. One is that the firm's owners or senior managers want to limit their exposure to external debt and the risk of default it entails. Another reason is that the firm has limited or virtually no access to debt and equity markets, because potential investors and lenders lack sufficient information about the firm's products and competitive strategies. For firms in such a position, the cost of internal funds could be lower than the cost of external funds, in which case the firm clearly would be better off financing its investments out of retained earnings.

Nevertheless, the impact of increases in cash flow on business investment remains uncertain. Some studies found a significant positive correlation between changes in a firm's net worth and its investment spending.[9] This correlation was strongest for firms that had very limited access to debt and equity markets. Yet it would be a mistake to interpret these findings as proof 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 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 relationship between cash flow and business investment is complicated, and further research is needed to clarify it.

Has the expensing allowance made significant contributions 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, largely because there are no studies analyzing the impact of the allowance on capital formation over time, and available empirical evidence is incomplete. Given that the expensing allowance lowers the cost of capital and may boost cash flow for firms using it, and that investment in many of the assets eligible for the allowance seems somewhat sensitive to changes in the cost of capital, one might be justified in concluding that the allowance has caused

[7] 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.

[8] 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.

[9] 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.

domestic investment in those assets to be greater than it otherwise would have been.[10] But there are some compelling reasons to argue that much of this investment would have taken place without the expensing allowance.[11] Most economists would be likely to agree that investment in assets eligible for the expensing allowance is driven more by expectations for future growth in sales by firms that purchase these assets, the nature of the assets, and conditions in debt and equity markets than by tax considerations.[12] 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 in that period was equal to only 5% of domestic gross investment in equipment and computer software.[13]

When seen through the lens of conventional economic theory, the expensing allowance has efficiency effects 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 is likely to lure some capital away from highly profitable 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 minimizes the efficiency losses associated with income taxation. But the expensing allowance 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 pre-tax rates of return.

In addition, the expensing allowance gives smaller firms an incentive to limit their growth. This unintended effect stems from the rise in marginal effective tax rates on the income earned by an asset eligible for the allowance in the allowance's phaseout range ($530,000 to $663,000 in 2009).[14] Douglas Holtz-Eakin, a former Director of the Congressional Budget Office, has called this incentive effect a "tax on growth by small firms."[15]

[10] 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*, coordinated by Jane G. Gravelle, p. 4.

[11] 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.

[12] 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.

[13] 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.

[14] 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.

[15] 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.

Equity Effects

Equity is another basic concept in conventional economic analysis. It generally refers to the distribution of income among the individuals or households in a particular 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 is said to be horizontally equitable if it imposes similar burdens on individuals with similar incomes or living standards. 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 lays the foundation for a progressive income tax system. Under such a system, an individual's tax liability, measured as a fraction of income, rises with income.

The current federal income tax system arguably leans 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 so many tax preferences in the form of deductions, preferential rates, deferrals, exclusions, exemptions, and credits have been enacted in recent decades, a significant share of individuals with similar before-tax incomes end up being taxed at different rates. At the same time, those with relatively high pre-tax incomes are generally taxed at higher rates than those with relatively low pre-tax incomes.

How does the expensing allowance 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 from the allowance is a reduction in the *marginal effective tax rate* on the income earned by assets eligible for expensing. How much of a reduction depends critically on the proportion of an asset's cost that is expensed. As was noted earlier, if the entire cost is expensed, then the marginal effective rate falls to zero. Yet the allowance does not change the *actual marginal rates* at which this income is taxed. This is because accelerated depreciation does not reduce the total amount of taxes (measured in current dollars) owed on the stream of income earned by an asset over its useful life. Rather, accelerated depreciation simply moves forward the timing of depreciation deductions in a way that substantially raises the present discounted value of the tax savings from depreciation deductions.

Most of the assets eligible for the allowance are held by smaller firms. Therefore, it seems reasonable to conclude that most of the tax savings attributable to the allowance ends up in the pockets of small business owners. But such a conclusion is somewhat misleading, as the allowance does not alter the income tax rates that apply to the income earned by small business owners—and thus has no direct effect on the distribution of the federal income tax burden among income groups. Nonetheless, the allowance does lower the tax burden on the returns to a portion of small business investment, which means that the allowance may indirectly violate the principle of vertical equity by decreasing the effective tax rate on income earned by small business owners.

Tax Administration

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

Most public finance economists agree that a desirable income tax system is one that imposes relatively low costs for administration and compliance. Research indicates 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.

Most public finance economists also agree that the current federal income tax system fails this 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 growing complexity of the federal tax code. Many small business owners have long complained about the costs 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 the firms that 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 writing off that cost over a longer period using allowable depreciation schedules. At the same time, the rules governing the use of the regular allowance and the use of the allowance in special areas like EZs and RCs add a layer of complexity to the administration of the tax code by the IRS.

Tax simplification is a longstanding policy objective for a majority of small business owners. A primary motivation for this quest is the relatively high costs small firms evidently bear in complying with federal tax laws. These costs were the main focus of a 2001 study prepared for the Office of Advocacy at the Small Business Administration. The study found that the cost per U.S. 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.[16] This finding appears to lend further support to what is regarded as a well-established truth about the costs to firms of tax compliance: namely, that these costs are[17] regressive to firm size in that "as a fraction of any of a number of size indicators, the costs are lower for larger companies."

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[16] 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.

[17] Joel Slemrod, "Small Business and the Tax System," in *The Crisis in Tax Administration*, Henry J. Aaron and Joel Slemrod, eds. (Washington: Brookings Institution Press, 2004), p. 81.