Section 179 and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 112th Congress, and Economic Effects

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Summary

Expensing is the most accelerated form of depreciation for tax purposes. Section 179 of the Internal Revenue Code (IRC) allows a taxpayer to expense (or deduct as a current expense rather than a capital expense) up to $125,000 of the total cost of new and used qualified depreciable assets it buys and places in service in 2012, within certain limits. Firms unable to take advantage of the Section 179 expensing allowance may recover the cost of qualified assets over longer periods, using the appropriate depreciation schedules. While the Section 179 expensing allowance is not targeted at firms that are relatively small in employment, asset, or receipt size, the rules governing its use limit its benefits to such firms, for the most part.

In addition, Section 168(k), which provides a so-called bonus depreciation allowance, generally allows taxpayers to expense half the cost of qualified assets bought and placed in service in 2012. Taxpayers that can claim the allowance have the option of monetizing any unused alternative minimum tax credits they have accumulated from tax years before 2006, within certain limits, and writing off the cost of the assets that qualify for the allowance over a longer period.

This report examines the current status, legislative history, and economic effects of the two expensing allowances. It also discusses initiatives in the 112th Congress to modify them. The report will be updated as legislative activity warrants.

The two expensing allowances have enjoyed broad bipartisan support in recent Congresses, and there is no reason to believe this consensus has frayed in the 112th Congress. The House passed a measure (H.R. 8) on August 1, 2012, that would raise the maximum Section 179 allowance to $100,000 and the phaseout threshold to $400,000 for the 2013 tax year, index both amounts for inflation, and allow purchases of off-the-shelf computer software eligible for the allowance through the 2014 tax year, among other things. A day later (August 2), the Senate Finance Committee reported a bill (S. 3521) that would raise the maximum Section 179 allowance to $500,000 and the phaseout threshold to $2 million in 2012 and 2013 and allow taxpayers to expense up to $250,000 of the cost of qualified leasehold property improvements in those years.

Since 2002, the allowances have served as one of several tax incentives for stimulating growth in the U.S. economy. This raises the question of their effectiveness. Though there are no studies that address the economic effects of the enhanced Section 179 allowances that were enacted in the previous eight years, several studies have examined the economic effects of the 30% and 50% bonus depreciation allowances that were available from 2002 to 2004. The two allowances applied to nearly the same property. Basically, the studies concluded that accelerated depreciation in general is a relatively ineffective tool for stimulating the economy.

Available evidence, as incomplete as it is, indicates that the expensing allowances probably have no more than a minor effect on the level, composition, and allocation among industries of business investment; the distribution of the federal tax burden among income groups; and the cost of tax compliance for smaller firms. On the one hand, an expensing allowance has the potential to spur increased small business investment in favored assets in the short run by reducing the user cost of capital and increasing the cash flow of investing firms. It also has the advantage of simplifying tax accounting for depreciation for firms that take the expensing allowance. On the other hand, an expensing allowance could interfere with the allocation of economic resources by diverting capital flows away from investments with more productive outcomes.

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Under current tax law, firms may expense (or deduct as a current rather than a capital expense) up to $125,000 of the total cost of new and used qualified assets they purchase and place in service in 2012 under Section 179 of the federal tax code. They also have the option under Section 168(k) of expensing half of the cost of qualified assets they buy and place in service the same year. Many assets qualify for both allowances.

Expensing is the most accelerated form of depreciation. As a result, it has the potential to stimulate business investment by reducing the cost of capital for favored investments and increasing the cash flow of firms making such investments. This explains why economists view the two allowances as a significant investment tax subsidy.

The 112th Congress has passed no legislation changing the status of either allowance, though a number of bills have been introduced that would extend one allowance or the other by one or more years, or permanently. In contrast, the 111th Congress passed four bills that enhanced the allowances, partly as a countercyclical measure: the American Recovery and Reinvestment Act of 2009 (ARRA; P.L. 111-5); the Hiring Incentives to Restore Employment Act of 2010 (HIRE Act; P.L. 111-147); the Small Business Jobs Act of 2010 (SBJA; P.L. 111-240); and the Tax Relief, Unemployment Compensation Reauthorization, and Job Creation Act of 2010 (TRUCA; P.L. 111-312).

This report examines the current status, legislative history, and main economic effects (including their efficacy as an economic stimulus tool) of the Section 179 and bonus depreciation allowances. It also identifies legislative initiatives to extend them beyond 2012.

Current Expensing Allowances

Section 179

Under Section 179 of the Internal Revenue Code (IRC), firms in all lines of business and all sizes have the option, within certain limits, of expensing part or all of the cost of new and used qualified property (or assets) they acquire in the year when the assets are placed in service. Business taxpayers that cannot or choose not to claim the allowance may recover capital costs over longer periods by claiming the appropriate depreciation deductions under the MACRS or ADS.

Maximum Expensing Allowance

The maximum Section 179 expensing allowance is set at $125,000 for qualified assets bought and placed in service in 2012. Assuming no change in current law, the allowance will drop to $25,000 in 2013 and thereafter.

Qualified Property

Current law defines property that qualifies for the allowance as new and used tangible property—as specified in IRC Section 1245(a)(3)—that is depreciable under IRC Section 168 (which holds

the MACRS) and acquired for use in the active conduct of a trade or business. With a few exceptions, this property consists of machines and equipment used in manufacturing, mining, transportation, communications, the generation and transmission of electricity, gas and water distribution, and sewage disposal. Most buildings and their structural components (including heating and air conditioning units and lodging facilities) do not qualify for the allowance. But an exception was made for 2010 and 2011 only: taxpayers may expense up to $250,000 of the cost of qualified leasehold improvements, qualified retail improvement property, and qualified restaurant improvement property. Research and bulk storage facilities do qualify for the allowance, as do single-purpose agricultural structures, storage facilities for petroleum products, and railroad grading and tunnel bores. In addition, the cost of off-the-shelf computer software that is depreciable in three years and placed in service from 2003 to 2012 may be expensed under Section 179.

Limitations on Use of the Section 179 Allowance

Use of the allowance is subject to two limitations: an investment (or dollar) limitation and an income limitation.

Under the dollar limitation, the maximum allowance is reduced, dollar for dollar but not below zero, by the amount by which the aggregate cost of qualified property a firm buys and places in service during a tax year exceeds what is often referred to as a phaseout threshold. The threshold is set at $500,000 in 2012 and is scheduled to fall to $200,000 in 2013 and thereafter. (See **Table 1** for the amounts in tax years before 2011.) As a result, a taxpayer may claim no Section 179 expensing allowance for the cost of qualified property it acquires and places in service in 2012 when the cumulative cost is $625,000 or more.

The income limitation bars a taxpayer from claiming an allowance greater than its taxable income (including wages and salaries) from the active conduct of a trade or business. It is determined after the application of the investment limitation. So if a firm has $25,000 in taxable income from a business but may claim a Section 179 allowance no larger than $20,000 after applying the investment limitation, it could expense no more than $20,000 of the cost of qualified property and depreciate the remainder under the MACRS, if applicable. Though taxpayers cannot carry forward any allowance that is denied because of the investment limitation, they may carry forward indefinitely any allowance that is denied because of the income limitation.

Claiming the Allowance

Historically, an election to claim the Section 179 allowance could be revoked only with the consent of the Internal Revenue Service (IRS). But this rule has been suspended for tax years beginning in 2003 through 2012. During this time, a taxpayer may revoke any portion of an election to expense qualified property without the IRS's consent, regardless of whether the election was made on an original or an amended return (IRS regulation 1.179-5). A revocation is made by submitting an amended tax return for the tax year in question. To claim the allowance, a taxpayer must specify on Form 4562 the items to which the election applies and the portion of the cost of each item that is to be deducted immediately.

Table 1. Maximum Expensing Allowance and Investment Limitation from 1987 to 2013

Year	Maximum Expensing Allowance	Investment Limitation
1987-1992	$10,000	$200,000
1993-1996	$17,500	$200,000
1997	$18,000	$200,000
1998	$18,500	$200,000
1999	$19,000	$200,000
2000	$20,000	$200,000
2001 and 2002	$24,000	$200,000
2003	$100,000	$400,000
2004	$102,000[a]	$410,000[a]
2005	$105,000[a]	$420,000[a]
2006	$108,000[a]	$430,000[a]
2007	$125,000	$500,000
2008 and 2009	$250,000	$800,000
2010 and 2011	$500,000	$2,000,000
2012	$125,000	$500,000
2013 and beyond	$25,000	$200,000

Source: Internal Revenue Service, revenue procedures dating back to 1987

a. The $100,000 figure for the maximum allowance and the $400,000 figure for the investment limitation were both indexed for inflation from 2004 to 2006.

Bonus Depreciation Allowance

Besides the Section 179 expensing allowance, taxpayers have had in recent years the option of claiming an additional first-year (or bonus) depreciation allowance that entered the tax code (§68(k)) in 2002 and is scheduled to last through 2012, under current law. The allowance speeds up the depreciation of qualified property, increasing the present value of the tax savings from depreciation. As such, it is intended to stimulate higher levels of business investment in the short run than otherwise would occur.

The initial bonus depreciation allowance was a temporary 30% first-year depreciation deduction included in the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). It applied to property that was eligible for depreciation under the MACRS with recovery periods of 20 years or less, water utility property, off-the-shelf computer software, and qualified leasehold property. This property had to be acquired between September 12, 2001, and December 31, 2004, and placed in service before January 1, 2005. Taxpayers claiming the allowance had to be the original user of the property. They could apply it against the regular income tax and the AMT with no adjustments.

Under current law, a 50% bonus depreciation allowance is available for the same property acquired and placed in service in 2012. It is scheduled to expire on December 31 of this year.

Corporations have the option under Section 168(k)(4) to claim a portion of their unused alternative minimum tax (AMT) credits from tax years before 2006, in lieu of any bonus depreciation allowance they could take in 2012. The accelerated credit is refundable and limited to a corporation's bonus depreciation amount for the tax year. This amount cannot exceed what is known as the "maximum increase amount," which is the lesser of 6% of the sum of the corporation's unused AMT credits from tax years before 2006 or $30 million. In 2008, 2009, and 2010, a corporation was allowed to claim unused AMT and research credits from tax years before 2006, in lieu of any bonus depreciation allowance it could take.

Interaction with Other Depreciation Allowances, Including the Section 179 Allowance

In the case of assets that are eligible for both expensing allowances, a taxpayer is required to recover their cost in a prescribed order. The expensing allowance must be taken first, lowering the taxpayer's basis in the asset by the amount that is expensed. If there is a remaining basis, the taxpayer then may apply the bonus depreciation allowance to that amount, further reducing her basis in the property. Finally, the taxpayer is allowed to claim a depreciation allowance under the MACRS for any basis left after the first two adjustments, using the double declining balance method.

A simple example can illustrate how this three-step process is supposed to work. Assume the only investment a company made in 2009 involved the acquisition of 10 new machine tools at a total cost of $700,000. Such a purchase qualified for both the expensing and bonus depreciation allowances that were available that year. Consequently, the company took an expensing allowance of $250,000 on its federal tax return for that year, lowering its basis in the property to $450,000 ($700,000 - $250,000). It then claimed a bonus depreciation allowance of $225,000 ($450,000 x 0.5), further lowering its basis to $225,000 ($450,000 - $225,000). Finally, the company was allowed to take a deduction for depreciation under the MACRS on the remaining $225,000. Given that the MACRS recovery period for machine tools is five years, and that five-year property is depreciated with the double-declining-balance method, it took an additional depreciation deduction equal to 20% of $225,000, or $45,000, using the half-year convention. The company may recover the remaining basis of $180,000 ($225,000 - $45,000) through taking MACRS depreciation deductions over each of the next five years at rates of 32%, 19.2%, 11.52%, 11.52%, and 5.76%, respectively. Thus, the company may write off 74% of the cost of the machine tools in the year they were bought and placed in service: 2009. If the transaction had taken place in 2010 or 2011, the taxpayer would have been able to deduct the full cost of the equipment by taking the 100% bonus depreciation allowance.

Legislative History of the Two Expensing Allowances

Section 179

The Section 179 expensing allowance originated as a special first-year depreciation allowance that Congress included in the Small Business Tax Revision Act of 1958 (P.L. 85-866). Its purpose was the same as the current allowance: reduce the tax burden on small business owners, stimulate

small business investment, and simplify tax accounting for smaller firms. The original 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 tax life of six or more years.

No change was made in the special allowance until the enactment of the Economic Recovery Tax Act of 1981 (ERTA; P.L. 97-34). ERTA raised the expensing allowance to $5,000 and laid down a timetable for gradually increasing the allowance to $10,000 by 1986. In spite of the substantial increase in the allowance, few firms took advantage of it. Some attributed the tepid response to the limitations on the use of an investment tax credit that ERTA established. A business taxpayer could claim the credit only for the portion of an eligible asset's cost that was not expensed; so the full credit could be used only if the company claimed no expensing allowance. For many firms, the tax savings from the credit alone reportedly outweighed the tax savings from combining the credit with the allowance.

In an effort to stop the growth in the federal budget deficit in the early 1980s, Congress passed the Deficit Reduction Act of 1984 (P.L. 98-369). Among other things, the act postponed from 1986 to 1990 the scheduled increase in the 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.

With the backing of Congress, the allowance rose to $10,000 in 1990, as scheduled, and remained at that level until the passage of the Omnibus Budget Reconciliation Act of 1993 (OBRA93; P.L. 103-66). OBRA93 increased the allowance to $17,500 (as of January 1, 1993) and created a variety of tax benefits for impoverished areas designated as enterprise zones and empowerment zones. The benefits included an enhanced expensing allowance for qualified assets placed in service in an EZ.[1] 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 enactment of the Small Business Job Protection Act of 1996 (P.L. 104-188), the regular allowance again moved upward but with a difference: scheduled annual (with one exception) increases over six years. Specifically, 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.

The Community Renewal Tax Relief Act of 2000 (P.L. 106-554) added so-called renewal communities (RCs) to the list of special areas and granted them the same tax benefits available to businesses in EZs, including the enhanced expensing allowance. In addition, it increased the premium for the allowance for qualified assets placed in service in special areas (including RCs) to $35,000 above the regular allowance.

In response to the economic losses associated with 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 aerial attacks on the World Trade Center. The act designated this area as the New York "Liberty Zone." Among the tax benefits offered to

[1] Firms placing qualified assets in service in an EZ were allowed to claim a maximum allowance that was $20,000 greater than the allowance available in other areas, with a phaseout threshold that was twice as large as that available in other areas.

firms operating in the zone was the same enhanced expensing allowance for qualified investments in EZs and RCs.

After the enactment of the Small Business Jobs Protection Act, no change was made in the allowance until the passage of JGTRRA. Under the act, the allowance rose four-fold to $100,000 (as of May 6, 2003), was to stay at that amount in 2004 and 2005, and then reset in 2006 and beyond at its level before JGTRRA ($25,000). JGTRRA also raised the phaseout threshold to $400,000 from May 2003 to the end of 2005, indexed 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 the same period.

The American Jobs Creation Act of 2004 (AJCA; P.L. 108-357) extended the changes made by JGTRRA through the end of 2007.

In an effort to aid economic recovery in the areas of Louisiana, Mississippi, and Alabama devastated by Hurricane Katrina in 2005, Congress passed the Gulf Opportunity Zone Act of 2005 (P.L. 109-135). Among other things, the act created what was known as a Gulf Opportunity Zone (GOZ) in those areas and offered a variety of tax incentives for 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, with a phaseout threshold that was $600,000 greater than that for the regular allowance. And the enhanced GOZ allowance applied to more assets than the regular allowance.

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

Under the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Appropriations Act, 2007 (P.L. 110-28), Congress further 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 for 2007 to 2010, and indexed both amounts for inflation in that period. The act also extended through 2008 the special GOZ allowance.

In an effort to boost business investment in the midst of an accelerating economic downturn, Congress increased the allowance to $250,000 and the phaseout threshold to $800,000 in 2008 only, by passing the Economic Stimulus Act of 2008 (ESA; P.L. 110-185). Those amounts were supposed to reset at $125,000 and $500,000 in 2009 and 2010, with adjustments for inflation.

During the 111th Congress, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5) extended the enhanced allowance created by ESA through 2009, and the Hiring Incentives to Restore Employment Act of 2010 (P.L. 111-147) extended it through 2010.

Under the Small Business Jobs Act of 2010 (P.L. 111-240), the maximum amount a taxpayer can expense was increased to $500,000, and the phaseout threshold was raised to $2 million, for tax years beginning in 2010 and 2011.

The Tax Relief, Unemployment Compensation Reauthorization, and Job Creation Act of 2010 raised the maximum expensing allowance to $125,000 and the phaseout threshold to $500,000 for the 2012 tax year, indexed those amounts for inflation, set the maximum allowance at $25,000 and the phaseout threshold at $200,000 for the 2013 tax year and each tax year thereafter, and

extended through 2012 the rule allowing off-the-shelf computer software to qualify for the allowance.

Bonus Depreciation Allowance

The Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) created the initial bonus depreciation allowance. It was equal to 30% of the adjusted basis of new qualified property acquired after September 11, 2001, and placed in service no later than December 31, 2004. A one-year extension of the placed-in-service deadline was available for certain property with a MACRS recovery period of 10 or more years and for transportation equipment.

Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27), the allowance became 50% for the same qualified property acquired after May 5, 2003, and placed in service before January 1, 2006. A one-year extension of that deadline was available for the same qualified property.

Congress passed the Economic Stimulus Act of 2008 in response to the financial crisis that emerged with devastating effects in the late summer and early fall of that year. Included in the act was a reinstatement of the 50% bonus depreciation allowance that expired at the end of 2005. To claim the allowance, a taxpayer had to acquire qualified property after December 31, 2007, and place it in service before January 1, 2009.

Later the same year, Congress passed a measure (the Housing Assistance Tax Act of 2008) intended to ease the impact of the financial crisis on the domestic housing market. It included a provision that gave corporations the option of trading any bonus depreciation allowance they could claim for eligible property they acquired between April 1 and December 31, 2008, for a refundable tax credit equal to the lesser of $30 million or 6% of the sum of any research and AMT credits that could be carried forward from tax years before 2006. Corporations choosing the option were required to depreciate the property that qualified for the allowance under the MACRS using the straight-line method; no AMT adjustment for depreciation was required.

The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) extended the deadlines by one year, to the end of 2009, for both the 50% bonus depreciation allowance and for the option of monetizing a portion of unused research and AMT credits from tax years before 2006.

Congress extended the 50% allowance so that it and the option to exchange it for an accelerated research and AMT credit applied to qualified property acquired and placed in service in 2010 by passing the Small Business Jobs Act of 2010 (P.L. 111-240).

Under the Tax Relief, Unemployment Compensation Reauthorization, and Job Creation Act of 2010 (P.L. 111-312), the bonus depreciation allowance increased to 100% for qualified property acquired after September 8, 2010, and placed in service before January 1, 2012. The act also established a 50% allowance for property acquired and placed in service in 2012. And it allowed corporations to claim a refundable credit for unused AMT credits (but not unused research credits) from tax years before 2006 in lieu of a bonus depreciation allowance for qualified property they acquired between January 1, 2011, and December 31, 2012.

Legislative Initiatives to Modify the Two Expensing Allowances in the 112th Congress

Support in the current Congress for retaining or enhancing the Section 179 and bonus depreciation allowances seems as robust as ever. But growing concerns over current and projected federal budget deficits and sharp disagreements between Democratic and Republican leaders in the House and Senate over what steps to take to lower or eliminate future budget deficits and federal debt may hinder efforts in the 112th Congress to pass legislation extending the current allowances.

Section 179 Expensing Allowance

Several bills have been introduced in the House and Senate to extend an enhanced allowance beyond 2011. Each bill is briefly described below.

House Bills

H.R. 15 would raise the maximum allowance to $250,000 and the phaseout threshold to $800,000 for 2013 only. It would also extend through 2013 the period during which purchases of qualified computer software are eligible for Section 179 expensing. The House passed the bill on

H.R. 8, which the House passed on August 1, 2012, would increase the maximum allowance to $100,000 and the phaseout threshold to $400,00 in the 2013 tax year, index both amounts for inflation, and allow purchases of off-the-shelf computer software to qualify for the allowance through the 2014 tax year.

H.R. 158 would remove all limits on the Section 179 expensing allowance, effectively converting it into a permanent 100% bonus depreciation allowance.

H.R. 206 would permanently set the maximum allowance at $125,000, and the phaseout threshold at $500,000, starting in the 2012 tax year. It would also permanently index those amounts for inflation beginning in the 2013 tax year, permanently extend the rule allowing off-the-shelf computer software eligibility for the expensing allowance, and permanently allow taxpayers to revoke claims for the allowance without the permission of the IRS.

H.R. 1773 would permanently set the maximum allowance at $250,000, and the phaseout threshold at $800,000, for tax years beginning in 2012.

H.R. 1792 would make automated fire sprinkler systems permanently eligible for expensing under Section 179.

H.R. 3302 would permanently extend the allowance at the amount of $500,000 and the phaseout threshold at the amount of $2 million and make eligible computer software a permanent part of Section 179 property.

H.R. 3476 would extend the current expensing allowance and dollar limitation through 2014 and the inflation adjustment for both amounts through 2015; it would also continue the treatment of off-the-shelf computer software as qualified property through 2016.

Senate Bills

S. 12 would permanently extend the $500,000 maximum allowance and the $2 million phase out threshold for tax years beginning in 2011. It would also permanently extend the rules allowing off-the-shelf computer software to qualify for Section 179 expensing and taxpayers to revoke an election for Section 179 expensing for any property without the permission of the IRS.

S. 727 would permanently grant qualified small companies an unlimited expensing allowance for qualified property, under Section 179. A company would qualify for this treatment if its average annual gross receipts did not exceed $1 million in the three previous tax years.

S. 1801 would extend the current expensing allowance and dollar limitation through 2012, the inflation adjustment for both amounts through 2013, and the eligibility of computer software for the allowance through 2014.

S. 1866 would make the same changes in the Section 179 allowance as H.R. 3476.

S. 1873 would make the same changes in the allowance as S. 1801 would make.

S. 2050 would extend the generous expensing allowance that was available in 2011 through 2012.

S. 3401 would extend the $500,000 maximum expensing allowance that was available in the 2010 or 2011 tax years to include 2012 and 2013. It would also extend the $2 million phaseout threshold that was available in 2010 or 2011 to include 2012. Starting in 2013 and for each subsequent tax year, the maximum allowance would be set at $25,000 and the phaseout threshold at $200,000. In addition, the bill would extend the eligibility of computer software and certain leasehold property for the expensing allowance through the 2013 tax year.

S. 3412 would make the same changes in the Section 179 allowance as H.R. 15.

S. 3417 would raise the maximum allowance to $500,000, and the phaseout threshold to $2 million, in 2012 and 2013. It would also extend the eligibility of off-the-shelf computer software through 2013 and allow taxpayers to expense up to $250,000 in qualified leasehold over the same period.

S. 3442 would increase the maximum expensing allowance to $500,000 and the phaseout threshold to $2 million for the 2013 tax year. Starting in 2014 and for each subsequent tax year, the maximum allowance would be set at $25,000 and the phaseout threshold at $200,000. The bill would also extend the eligibility of computer software and certain leasehold property for the expensing allowance to include the 2013 tax year.

S. 3521 (as reported by the Senate Finance Committee on August 2, 2012) would raise the maximum allowance to $500,000 and the phaseout threshold to $2 million in 2012 and 2013. It would also allow taxpayers to expense up to $250,000 of the cost of qualified leasehold property improvements made in those years.

President's Budget Request for FY2013

There is no provision in President Obama's budget request for FY2013 that would further enhance the Section 179 allowance in tax years beyond 2012.

Bonus Depreciation Allowance

Several bills to extend the current 100% bonus depreciation allowance have been introduced in the House and Senate. Each is briefly described below.

House Bills

H.R. 12 would extend the 100% allowance through 2012 and allow firms to claim a 50% allowance for qualified property acquired and placed in service in 2013.

H.R. 660 would extend through 2013 both the 100% allowance and the option to monetize unused AMT credits from tax years before 2006.

H.R. 3476 would extend through 2014 both the 100% allowance and the option to exchange unused AMT credits from tax years before 2006 for any bonus depreciation allowance that could be claimed in the current tax year.

H.R. 3630 (as passed by the House) would extend through 2012 both the 100% bonus depreciation allowance and the option to claim a refundable credit for unused AMT credits instead of a bonus depreciation allowance. In addition, it would modify the limit on the refundable credit a corporate taxpayer may take in a tax year so that it is equal to the lesser of 50% of a taxpayer's AMT credit for the first tax year after 2011 or the current-year ATM credit taking into account "only the adjusted minimum tax for taxable years ending before January 1, 2012 (determined by treating credits as allowed on a first-in, first-out basis)."

H.R. 4196 would extend the 100% allowance through 2012.

Senate Bills

S. 1801 would extend through 2012 both the 100% bonus depreciation allowance and the option to monetize unused AMT credits from tax years starting before 2006.

S. 1866 would make the same changes in the allowance as H.R. 3476.

S. 1873 would make the same changes as S. 1801 would make.

S. 2237 would reinstate the 100% allowance for qualified property acquired and placed in service in 2012 and allow a 50% allowance for 2013.

S. 2240 would make the same changes in the allowance as H.R. 3630.

President's Budget Request for FY2013

The Obama Administration supports an extension of the 100% bonus depreciation allowance for one year, through 2012.

Economic Effects of the Section 179 and Bonus Depreciation Allowances

For many lawmakers, the expensing allowance represents a desirable policy tool for promoting the growth of small firms and stimulating the economy. For many small business owners, the allowance represents a desirable tax benefit in that it raises after-tax rates of return on investments in qualified property and simplifies tax accounting. But for most public finance economists and some other analysts, the allowance represents a source of inefficiency in the use of resources within the U.S. economy. In their view, the allowance has the potential to affect the allocation of capital within the economy, the distribution of the federal tax burden among income classes, and the cost of tax compliance for smaller firms in ways that might produce inefficient or less equitable outcomes. These effects correspond to three traditional criteria for evaluating tax policy: efficiency, equity, and simplicity. Each is discussed below, following a review of what is known about the effectiveness of the Section 179 and bonus depreciation expensing allowances as a policy tool for economic stimulus.

The Allowances as Tools for Economic Stimulus

Since 2003, five bills have been enacted that included either a temporary enhancement of the Section 179 expensing allowance and the phaseout threshold, or a temporary extension of an already enhanced allowance: JGTRRA, the Economic Stimulus Act of 2008, ARRA, SBJA, and TRUCA. Since 2002, six bills have been enacted to extend or enhance the bonus depreciation allowance. Each of these bills was intended, in part, to spark an increase in small business investment, as part of a broader government effort to stimulate the economy. It is reasonable to expect that an enhanced allowance might have this effect, since it lowers the user cost of capital for investment in qualified property and expands the short-term cash flow of companies that claim it.

The user cost of capital plays a significant role in a firm's investment decisions. This cost comprises the opportunity cost of an investment (i.e., the highest pre-tax rate of return a company could earn by investing the same amount in a low-risk asset like a Treasury bond) and its direct costs, such as depreciation, the actual cost of the asset, and income taxes.[2] 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, in theory, many firms would respond by increasing the amount of capital they wish to own, boosting business investment in the short run.

[2] The user cost of capital is the real rate of return an investment project must earn to break even. In theory, a firm will undertake an investment provided the after-tax rate of return exceeds 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 inserting assumed values for each variable in 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.

So how does expensing affect the user cost of capital? As the most accelerated form of depreciation, expensing lowers the cost of capital by reducing the tax burden on the returns to an investment. This reduction can be considerable.[3] Allowing a firm to expense the cost of an asset is equivalent 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. Several recent studies have shown that investment in equipment is somewhat sensitive to changes in the user cost (or rental price) of capital. Estimates of the price elasticity of demand for equipment (which is the percentage change in spending on equipment divided by the percentage change in the user cost of capital) range from -0.25 to -0.66, with some economists maintaining the elasticity is probably close to -0.50.[4] An elasticity of that size means that a 10% decline in the user cost of capital should result in a 5% rise in business spending on equipment, all other things being equal.

Cash flow can also affect the investment behavior of firms.[5] A firm's owners or senior managers may prefer to finance new investment from retained earnings in order to limit their exposure to external debt and the risk of default it entails. Or retained earnings may be the only feasible option for financing new investment in the case of firms that have limited or no access to debt and equity markets because the owners know more about their products and potential for growth than investors and lenders, including banks. For firms in this position, the cost of internal funds is probably lower than the cost of external funds, which means they would be better off financing new investments out of retained earnings.

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. Nevertheless, the impact of increases in cash flow on business investment remains uncertain. Some studies have found a significant positive correlation between changes in a firm's net worth and its investment spending.[6] This correlation was strongest for firms with very limited access to debt and equity markets. Yet it would be a mistake to interpret these findings as conclusive 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 necessarily mean that one is a primary cause of the other. 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

[3] 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.

[4] See Jonathan Gruber, *Public Finance and Public Policy* (New York: Worth Publishers, 2005), p. 675; and CRS Report R41034, *Business Investment and Employment Tax Incentives to Stimulate the Economy*, by Thomas L. Hungerford and Jane G. Gravelle.

[5] 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.

[6] 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.

relative cost of internal and external funds.[7] The relationship between cash flow and business investment is complicated, and further research is needed to clarify it.

While these considerations suggest that an enhanced Section 179 or generous bonus depreciation expensing allowance has the potential to boost small business investment, they say little about their actual efficacy as a policy tool for economic stimulus. How effective might these forms of accelerated depreciation be in boosting economic output and employment in the short run?

There are several reasons why an enhanced Section 179 allowance would likely have no more than a modest effect on the economy during a downturn or a period of stagnation. The design of the allowance, especially the phaseout range, sharply limits its potential to affect economic activity. The allowance offers little or no tax benefit for investments in inventory, structures, and land. And among qualified assets, it provides a greater tax benefit for investment in longer-lived items (such as machine tools) than it does for investment in shorter-lived ones (such as computer systems). Consequently, spending on assets eligible for the allowance tends to account for a small slice of overall investment in those assets: the total value of Section 179 property placed in service from 1999 to 2003 accounted for 5% of total investment in equipment and software in that period. Spending on Section 179 assets makes an even smaller contribution to overall economic activity: the total value of Section 179 property placed in service between 1999 and 2003 represented 0.4% of cumulative gross domestic product, measured in current dollars.

In addition, enhanced versions of either allowance are likely to have less of a stimulative effect when an economy is mired in a recession or growing too slowly to reduce the unemployment rate than when it is in the midst of a robust expansion. This is because business investment in general is driven more by the outlook for sales and economic growth than it is by temporary tax incentives. So an increase in the expensing allowance when the economy is contracting and more and more companies, large and small, have excess capacity is more likely to affect the timing of planned qualifying investments than the amount of those investments. Companies may be able to accelerate the timing of some planned investments to take advantage of an enhancement in an expensing allowance, but little new investment would be likely to occur while the short-term sales and profit outlook for most companies remains bleak, despite the availability of a relatively generous but temporary expensing allowance.

Three studies, two from 2006 and the other from 2007, provide additional support for the view that temporary accelerated depreciation is largely ineffective as a policy tool for economic stimulus. In one study, Matthew Knittel of the Office of Tax Analysis at the Treasury Department found that take-up rates for the bonus depreciation allowances available in the 2002 to 2004 tax years ranged from 54% to 61% for C corporations and from 65% to 70% for S corporations.[8] Knittel attributes the surprisingly low take-up rates to firms that had relatively large stocks of accumulated net operating losses and the many states that elected not to conform their tax codes to the bonus depreciation allowances. The second study noted that though over half of all C and S corporations claimed bonus depreciation in the 2002-2004 tax years, a variety of surveys indicated that no more than 10% of companies deemed the allowances an important consideration in determining the timing or level of qualifying investments.[9] This suggests that many of the

[7] Harvey S. Rosen and Ted Gayer, *Public Finance*, 8th edition (New York: McGraw-Hill Irwin: 2008), p. 448.

[8] Matthew Knittel, *Corporate Response to Accelerated Depreciation: Bonus Depreciation for Tax Years 2002-2004*, Department of the Treasury, Office of Tax Analysis, Working Paper 98 (Washington: May 2007), http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota98.pdf.

[9] Darrel S. Cohen and Jason Cummins, *A Retrospective Evaluation of the Effects of Temporary Partial Expensing*, (continued...)

investments in that period that benefited from bonus depreciation would have been made without it. Another study found that although the impact of bonus depreciation on gross domestic product and employment may have been modest, it might have had a substantial impact on the composition of business investment, boosting demand for qualified assets. The researchers, Christopher House and Matthew Shapiro, estimated that bonus depreciation may have resulted in a cumulative increase in GDP between 0.07% and 0.14%, and in overall employment between 100,000 and 200,000, in 2002 and 2003.[10]

There is anecdotal evidence that the current bonus depreciation allowance has made little or no difference in the investment plans of some companies, while moving forward the timing of planned investments for other companies to take advantage of the tax savings.[11] In either case, it can be argued that the tax subsidy is not laying the groundwork for sustained increases in business investment in software and equipment, the vast share of the assets that are eligible for the bonus depreciation allowance. Some experts worry that the subsidy will be made permanent.

The forces constraining the stimulative potential of accelerated depreciation, particularly in a weak economy, suggest that the two expensing allowances examined here would have relatively little bang for the buck as a means of boosting economic activity. Other approaches may produce better results, especially those that would quickly put more money in the hands of the unemployed. A recent analysis by the Congressional Budget Office (CBO) lends some credence to this notion. It estimated that increasing financial aid to the unemployed would increase GDP from $0.70 to $1.90 for each $1.00 of budgetary cost from 2010 to 2015; by contrast, allowing full or partial expensing of investment costs would raise GDP from $0.20 to $1.00 for each $1.00 of budgetary cost.[12]

Efficiency Effects

Efficiency lies at the core of economic theory and analysis. In essence, it refers to the allocation of resources in an economy and how that allocation simultaneously affects the welfare of consumers and producers. When the allocation of resources yields the greatest possible economic surplus—which is defined as the total value to consumers of the goods and services they purchase minus the total cost to sellers of providing the goods and services—the allocation is said to be efficient. But when the allocation is inefficient, some of the possible gains from exchanges 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 permitted by current technology. In this case, a shift in supply from high-cost producers to low-cost producers, driven by consumers seeking greater value, would lower the economic cost of providing the good, perhaps increasing the economic surplus.

(...continued)

Federal Reserve Board, Finance and Economics Discussion Series, Working Paper No. 2006-19 (Washington: April 2006), http://www.federalreserve.gov/pubs/feds/2006/200619/200619pap.pdf.

[10] Christopher House and Matthew D. Shapiro, *Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation*, National Bureau of Economic Research, working paper no. 12514 (Cambridge, MA: September 2006), p. 2. http://www.nber.org/papers/w12514.

[11] Binyamin Applebaum, "Tax Break Increases Deficit, but May Have a Silver Lining," *New York Times*, February 3, 2012.

[12] Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in the Short Term*, Statement of Douglas W. Elmendorf, Director, before the Joint Economic Committee, February 9, 2010, table 1, p. 11.

Expensing is equivalent to exempting from taxation the normal returns on investment. As such, it would be the preferred option for capital cost recovery under some kind of consumption tax, such as a flat tax or a value-added tax. But under an income tax, expensing becomes a tax preference or benefit because it allows the normal returns on investment to go untaxed. When this happens, new opportunities for tax arbitrage open up. Expensing allows taxpayers to borrow funds to purchase new depreciable assets, deduct the full cost of those assets in the year they are placed in service, and deduct interest payments on the debt incurred to acquire the assets.

How does the expensing allowance affect the allocation of capital within an economy? In theory, all taxes, except lump-sum taxes, generate inefficient economic 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 distort the economic choices facing individual and business taxpayers, leading them to allocate resources on the basis of how taxes affect the costs and benefits 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: a condition where the amount of revenue raised by a tax is less than the loss of economic welfare associated with it.

The Section 179 and bonus depreciation expensing allowances have the potential to distort the allocation of resources in an economy by driving a wedge between favored assets and all other assets regarding their profitability. In theory, expensing increases the after-tax rates of return for favored assets, relative to the after-tax rates of return for all other assets. Thus, it could encourage inefficient levels of investment in favored assets, at least in the short run, depriving more productive investments with lower after-tax rates of return of needed capital.

In general, how beneficial is expensing? One way to illustrate its potential tax benefit is to show how expensing affects the marginal effective tax rate on the returns to an investment. This rate encapsulates the tax provisions that affect the returns on an investment and is calculated by subtracting the expected after-tax rate of return on a new investment from the expected pre-tax rate of return and dividing by the pre-tax rate of return. Under expensing, it can be shown that the pre-tax and after-tax rates of return are the same for the investment, which means that full expensing produces a marginal effective tax rate of 0%.

This equivalence between pre- and after-tax rates of return reflects a critical aspect of expensing: it reduces the total after-tax return and total cost for an investment by the same factor: an investor's marginal tax rate.[13] For example, if a small business owner's income is taxed at a rate of 35%, and the entire cost of a depreciable asset is expensed, the federal government effectively becomes a partner in the investment with a 35% interest. 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 use, but it shares in 35% of the income earned by the investment in subsequent years, assuming no change in the owner's tax rate. At the same time, expensing allows the small business owner to receive 65% of the returns from the investment over its lifetime 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 he does before taxes.

[13] 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.

Is there evidence that the expensing allowance has contributed to shifts in the size and composition of the domestic capital stock in recent decades? This question is difficult to answer, largely because no studies have been done that assess the impact of the allowance on capital formation over time. Given that the expensing allowance lowers the cost of capital and boosts the cash flow of 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 domestic investment in those assets to be greater than it otherwise would have been.[14] But it can also be argued that much of this investment would have taken place in any event.[15] Most economists would agree that investment in the assets eligible for the expensing allowance is driven more by expectations for future growth in sales and profits by firms that use these assets, the nature of the assets, and conditions in debt and equity markets than by tax considerations.[16] 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 Section 179 property placed in service was equal to 5% of gross domestic investment in equipment and computer software.[17]

When seen through the lens of economic theory, the expensing allowance has efficiency effects that may worsen the deadweight loss associated with 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 divert some capital away from relatively productive uses and into tax-favored ones. Standard economic theory holds that in an economy devoid 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 a specific set of assets by relatively small firms. As such, it represents a departure from the norm of neutral taxation.

In addition, an expensing allowance, like any subsidy targeted at firms of a certain size, gives smaller firms an incentive to limit their growth by restricting investments to take advantage of the allowance. This unintended effect stems from the steady increase in the marginal effective tax rates on the income earned by qualified assets in the allowance's phaseout range ($500,000 to $2 million 2011).[18] Douglas Holtz-Eakin, a former director of the Congressional Budget Office, has labeled this incentive effect a "tax on growth by small firms."[19]

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[14] 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.

[15] 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.

[16] 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.

[17] 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.

[18] 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.

[19] 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 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 after-tax household incomes among individuals grouped by income. Economists who analyze the equity effects of income taxes tend to focus on two 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 provides the basis 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 may lean more in the direction of vertical equity than horizontal equity. Many individuals with similar incomes before taxes end up in the same tax bracket. But because of the tax preferences (e.g., deductions, preferential rates, deferrals, exclusions, exemptions, and credits) that have been enacted in recent decades, a substantial number of individuals with similar before-tax incomes end up being taxed at different effective rates. At the same time, the income received by those with relatively high pre-tax incomes is generally taxed at higher rates than the incomes of 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 burden. 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 on the returns falls to zero.

Yet the allowance does not change the *actual marginal rates* at which this income is taxed. Accelerated depreciation, such as the Section 179 expensing allowance, does not reduce the federal taxes paid on the stream of income earned by an asset over its useful life. Rather, it allows firms to take a larger share of depreciation deductions for an asset in its first year or two of use than would be possible under the MACRS. This forward shift or acceleration in depreciation allowances raises the present discounted value of the tax savings from depreciation.

Most of the assets eligible for the allowance are held by smaller firms. Therefore, whatever gains in profits can be attributed to the allowance end up in the hands of small business owners. Since the tax benefits associated with capital income tend to concentrate in upper-income households, it might be argued that the expensing allowance tilts the federal income tax away from vertical equity. The allowance lowers the effective tax burden on small business income relative to other sources of income. While this effect makes investment in qualified assets more attractive, it does not change the fact that the allowance has no effect on the taxes paid by small business owners over time on the income that can be attributed to the affected assets. Over the useful life of such an asset, the amount of taxes paid on income from it is the same, regardless of whether its cost is expensed or not. As a result, it seems fair to conclude that the allowance has no discernible effect on the distribution of after-tax incomes.

Tax Administration

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

Most public finance economists would agree that one of the key elements of a desirable income tax system is 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 would also agree that the current federal income tax system fails this test on all counts. 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 depreciation. Less time and paperwork are expended 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 the appropriate depreciation schedules. At the same time, it cannot be denied that the rules governing the use of the allowance add a layer of complexity to the tasks of administering and complying with the tax code.

Tax simplification is a long-standing policy objective for small business owners. A primary motivation for pursuing this goal 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 estimated that the cost per U.S. employee for tax compliance in 2000 was $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.[20] This finding underscores a well-established truth about the costs to firms of tax compliance: namely, these costs are[21] 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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[20] 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.

[21] 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.