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The Section 179 and Bonus Depreciation Expensing Allowances: Current Law and Issues for the 114th Congress

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Summary

Expensing is the most accelerated form of depreciation for tax purposes. Section 179 of the Internal Revenue Code allows a taxpayer to expense (or deduct as a current expense rather than as a capital expense) up to $25,000 of the total cost of new and used qualified depreciable assets it buys and places in service in 2015, within certain limits. Firms unable to take advantage of this allowance may recover the cost of qualified assets over longer periods, using the appropriate depreciation schedules from Sections 167 or 168. While the Section 179 expensing allowance is not targeted at small firms, the limits on its use effectively confine its benefits to such firms.

In addition, Section 168(k), which provides a so-called bonus depreciation allowance, has allowed taxpayers to expense a portion of the cost of qualified assets bought and placed in service in recent tax years. Taxpayers that could claim the allowance had the option of monetizing any unused alternative minimum tax credits left over from tax years before 2006, within certain limits, and recovering the cost of the assets that qualified for the allowance over longer periods. The allowance expired at the end of 2014.

Since 2002, the two allowances have been used primarily as tax incentives for stimulating the U.S. economy. Though there appear to be no studies that address the economic effects of the enhanced Section 179 allowances that were available from 2003 to 2014, several studies have examined the economic effects of the 30% and 50% bonus depreciation allowances from 2002 to 2004. Their findings indicated that accelerated depreciation is a relatively ineffective tool for stimulating the overall economy during periods of weak or negative growth.

Available evidence also suggests that the expensing allowances may have a minor effect at best on the level and composition of business investment and its allocation among industries, the distribution of the federal tax burden among different income groups, and the cost of tax compliance for smaller firms. The allowances have advantages and disadvantages. On the one hand, an expensing allowance simplifies tax accounting, and a temporary allowance has the potential to stimulate 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. On the other hand, depending on its design, an expensing allowance may interfere with the efficient allocation of capital among investment opportunities by diverting capital away from more productive uses.

The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended through 2014 the Section 179 expensing allowance and the Section 168(k) bonus depreciation allowance that were available in 2013.

On February 13, 2015, the House passed a bill (H.R. 636) that would permanently set the maximum Section 179 allowance at $500,000 and the phaseout threshold at $2 million and index both amounts for inflation starting in 2016. It also would make qualified computer software, heating and air conditioning equipment, and qualified real property (e.g., improvements to lease hold property and restaurants) permanently eligible for the Section 179 allowance. Under H.R. 636, a taxpayer would have the permanent right to revoke an election made under Section 179 without the consent of the Internal Revenue Service. The estimated revenue loss of $77.1 billion from FY2015 to FY2025 resulting from the bill would not be offset. It is unclear whether the Senate will consider the bill, or something similar.

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Introduction

Under current tax law, firms may expense (or deduct as a current rather than a capital expense) up to $25,000 of the total cost of new and used qualified assets they purchase and place in service in 2015 under Section 179 of the federal tax code. But they no longer have the option under Section 168(k) of expensing any portion of the cost of qualified assets they buy and place in service the same year (or the following year in the case of assets with relatively long production schedules). Many of the assets that qualify for the Section 179 allowance also qualified for the Section 168(k) allowance, which was available from 2002 to 2005 and from 2008 to 2014.

Expensing is the most accelerated form of depreciation. It has the potential to stimulate business investment by reducing the cost of capital for favored investments and increasing the cash flow of firms undertaking such investments. As a result, economists see the two allowances as a significant investment tax subsidy, especially since some firms were able to take advantage of both allowances in the same tax year.

The American Taxpayer Relief Act of 2012 (ATRA, P.L. 112-240) increased the maximum Section 179 allowance to $500,000 and the phaseout threshold to $2 million for qualified assets acquired and placed in service in 2012 and 2013. ATRA also extended the 50% bonus depreciation allowance from 2011 through 2013. Congress extended both allowances through 2014 by passing the Tax Increase Prevention Act of 2014 (P.L. 113-295). In the 114th Congress, the House is considering a measure (H.R. 636) to permanently set the maximum Section 179 allowance at $500,000 and the phaseout threshold at $2 million and index both amounts for inflation beginning in 2016.

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.

Current Expensing Allowances

Section 179

Section 179 of the Internal Revenue Code (IRC) gives firms in all lines of business and all sizes the option, within certain limits, of expensing part or all of the cost of new and used qualified property 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 and at slower rates by claiming the appropriate depreciation deductions under the Modified Accelerated Cost Recovery System (MACRS) or Alternative Depreciation System (ADS).

Maximum Expensing Allowance

The maximum Section 179 expensing allowance is set at $25,000 for qualified assets bought and placed in service in 2015. Assuming no change in current law, the allowance will remain at $25,000 in each year after 2015 as well. (**Table 1** shows the maximum allowances going back to 1987.)

Qualified Property

Under current law, new and used tangible property—as specified in IRC Section 1245(a)(3)—qualifies for the allowance if it is depreciable under IRC Section 168 (which contains the MACRS) and acquired for use in the active conduct of a trade or business. With a few minor exceptions, this property consists of machinery 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) do not qualify for the allowance. But an exception to this rule was made for the 2010 to 2014 tax years: taxpayers were allowed to expense up to $250,000 in each tax year of the cost of qualified leasehold improvements, qualified retail improvement property, and qualified restaurant improvement property they incurred; this treatment expired at the end of 2014. 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 acquired and placed in service from 2003 to 2014 could be expensed under Section 179; this treatment also expired at the end of 2014.

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 a taxpayer can take in a tax year 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 that year exceeds a phaseout threshold. The threshold is set at $200,000 in 2015 and thereafter. (**Table 1** shows the thresholds going back to 1987.) As a result, a taxpayer may claim no Section 179 expensing allowance in 2015 when the total cost of qualified property it acquires and places in service that year reaches or exceeds $225,000.

The income limitation bars a taxpayer from claiming a Section 179 allowance greater than its taxable income (including wages and salaries) from the active conduct of his or her trade or business. The limitation is determined after the application of the investment limitation. For example, if a company has $20,000 in taxable income in 2015 from its business but may claim a Section 179 allowance of $25,000 under the investment limitation, it could expense up to $20,000 of the cost of qualified property and recover the remaining $5,000 under the MACRS or carry it forward to a future tax year. Taxpayers are not allowed to carry forward any allowance from the current tax year that cannot be used because of the investment limitation, but they may carry forward indefinitely allowances that cannot be used because of the income limitation.

Claiming the Allowance

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. 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 was suspended for the tax years from 2002 to 2013, and Congress extended it to cover elections made in 2014. During the period of suspension, a taxpayer was allowed to 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 amended return (IRS regulation 1.179-5). To revoke an election, a taxpayer had to submit an amended tax return for the tax year in question.

Table 1. Maximum Expensing Allowance and Investment Limitation from 1987 to 2015

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 to 2014	$500,000	$2,000,000
2015 and thereafter	$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 had the option of claiming an additional first-year (or bonus) depreciation allowance (under Section 168(k)) for eligible property acquired and placed in service from 2002 and 2014. This added allowance accelerated the depreciation of qualified property, lowering the cost of capital for investment in those assets and increasing the cash flow of companies making such investments. Congress created the bonus depreciation allowance in part to spur increased business investment during periods of negative or sluggish economic growth, such as the severe recession that lasted from late 2007 to mid-2009 and the weak rebound that persisted into early 2014.

The initial bonus depreciation allowance was enacted in 2002 and was equal to 30% of the cost of property eligible for depreciation under the MACRS with recovery periods of 20 or fewer years, water utility property, off-the-shelf computer software, and qualified leasehold property. The property had to be acquired and placed in service between September 12, 2001, and December 31, 2004. (Eligible property with relatively long production times and certain non-commercial aircraft could be placed in service in 2005 and still qualify for the allowance.) Taxpayers claiming

the allowance had to be the original user of the property. In addition, the allowance could be applied against the regular income tax and the AMT with no adjustments.

The following year, Congress established a 50% bonus depreciation allowance for the same property acquired and placed in service from 2003 through 2005. It expired at the end of 2005, but Congress reinstated it in 2007 for property acquired and placed in service in 2008 (or 2009 for property with long production times and certain aircraft). As a result of several other extensions and enhancements, a bonus depreciation allowance of 50% or 100% was available for eligible property acquired and placed in service from 2009 through 2014 (or 2015 for property with relatively long production times).

For tax years beginning between April 1, 2008, and December 31, 2014, C corporations had the option under Section 168(k)(4) of using a portion of their alternative minimum tax (AMT) credits carried over from tax years before 2006, in lieu of taking a bonus depreciation allowance. The accelerated credit was refundable and limited to a corporation's "bonus depreciation amount" (BDA) for the tax year. This amount was equal to 20% of the difference between the total bonus and regular depreciation that would be allowed on eligible property placed in service during a tax year if bonus depreciation were claimed, on the one hand, and the total depreciation that would be allowed if no bonus depreciation were claimed, on the other hand. But a taxpayer's BDA could not exceed a corporation's "maximum increase amount," which was the lesser of 6% of the sum of its unused AMT credits from tax years before 2006 or $30 million. For the 2008, 2009, and 2010 tax years, corporations were also allowed to claim research tax credits carried over from tax years before 2006, in lieu of a bonus depreciation allowance. Corporations choosing the accelerated, refundable credit had to use the straight-line method over the appropriate period to depreciate the property eligible for bonus depreciation they acquired and placed in service in the current tax year.

Interaction with Other Depreciation Allowances, Including the Section 179 Allowance

In the case of assets that were eligible for both expensing allowances, a taxpayer was required to recover their cost in a prescribed order. The Section 179 expensing allowance had to be taken first, lowering the taxpayer's basis in the asset by that amount. The taxpayer then could apply the bonus depreciation allowance to the remaining basis amount, further reducing her basis in the property. Finally, the taxpayer was allowed to claim a depreciation allowance under the MACRS for any remaining basis, using the double declining balance method.

A simple example illustrates how this procedure was supposed to work. Assume that the only investment a company made in 2014 was the acquisition of 10 new machine tools at a total cost of $700,000. Such a purchase qualified for both the Section 179 expensing and bonus depreciation allowances for that year. Therefore, it was permitted to recover that cost for federal tax purposes as follows:

- First, the company could take a Section 179 expensing allowance of $500,000 on its federal tax return for that year, lowering its basis in the property to $200,000 ($700,000 - $500,000).
- Then it could claim a bonus depreciation allowance of $100,000 ($200,000 x 0.5), further lowering its basis to $100,000 ($200,000 - $100,000).

- Next, the company was allowed a deduction for depreciation under the MACRS on the remaining $100,000. Given that the MACRS recovery period for machine tools is five years and five-year property is depreciated using the double-declining-balance method, the company could claim an additional depreciation allowance equal to 20% of $100,000, or $20,000, using the half-year convention.
- The company could recover the remaining basis of $80,000 ($100,000 - $20,000) by 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 was able to write off nearly 89% of the cost of the machine tools in the same year they were bought and placed in service.

Legislative History of the Two Expensing Allowances

Section 179

The Section 179 expensing allowance began as a permanent first-year depreciation allowance that Congress included in the Small Business Tax Revision Act of 1958 (P.L. 85-866). Its purpose was no different from its purpose today: to 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 ($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 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 a gradual increase in the allowance to $10,000 by 1986. In spite of the substantial increase in the allowance, few firms took advantage of it. Some analysts attributed the tepid response to the limitations on the use of an investment tax credit that ERTA established. A business taxpayer could claim that 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 outweighed the tax savings from a combination of the credit and the allowance.

In an effort to counter the rise 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. Still, use of the allowance rose markedly following the repeal of the investment tax credit by the Tax Reform Act of 1986.

The allowance rose to $10,000 in 1990, as scheduled, and remained at that level until Congress passed 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

[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 (continued...)

designated as an EZ, an area had to meet certain eligibility criteria relating to population, poverty rate, and geographic size.

With the enactment of the Small Business Job Protection Act of 1996 (SBJPA, P.L. 104-188), the regular allowance again was placed on timetable for scheduled increases. Specifically, under the act, the maximum allowance was supposed to rise 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 "renewal communities" (RCs) to the list of special economic development areas and granted businesses located in 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). The benefits were intended to encourage new business investment in the area in lower Manhattan in New York City that bore the brunt of the aerial attacks on the World Trade Center. Owners of firms in the so-called Liberty Zone were allowed to claim the same enhanced expensing allowance for qualified investments that was available to small business owners in the EZs and RCs.

After the SBJPA, no changes were made in the regular allowance until the passage of JGTRRA. Under the act, the allowance rose four-fold to $100,000 (as of May 6, 2003), stayed 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 the recovery of the economies 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 a "Gulf Opportunity Zone," or 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 the phaseout threshold for the regular allowance. It also applied to a wider range of assets than the regular Section 179 allowance.

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

(...continued)

other areas.

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 during 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 a severe economic downturn, Congress increased the allowance to $250,000 and the phaseout threshold to $800,000 for qualified assests bought and placed in service in 2008 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.

Two laws enacted during the 111th Congress included provisions modifying the status of the Section 179 expensing allowance. 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) further extended it through 2010.

Under the Small Business Jobs Act of 2010 (P.L. 111-240), the maximum expensing amount increased to $500,000, and the phaseout threshold to $2 million, for tax years beginning in 2010 and 2011. Starting in 2012 and thereafter, the maximum allowance was scheduled to decrease to $25,000 and the phaseout threshold to $200,000. The act also expanded the definition of qualified property to include certain real property: specifically, qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant property. For the 2010 and 2011 tax years, a taxpayer could elect to expense up to $250,000 of the annual cost of such property.

By passing the Tax Relief, Unemployment Compensation Reauthorization, and Job Creation Act of 2010 (P.L. 111-312), Congress increased the maximum allowance to $125,000 and the phaseout threshold to $500,000 for qualified assets acquired and placed in service in 2012, indexed those amounts for inflation, set the maximum allowance at $25,000 and the phaseout threshold at $200,000 for 2013 and thereafter, and extended the eligibility of off-the-shelf computer software for the allowance through 2012.

The American Taxpayer Tax Relief Act of 2012 retroactively increased the maximum expensing allowance to $500,000 and the phaseout threshold to $2 million for 2012 and 2013. It also made off-the-shelf software eligible for the allowance in 2013 and extended through 2013 the maximum annual $250,000 expensing allowance for qualified real property that first became available in 2010.

Congress extended through 2014 the Section 179 expensing allowance from 2012 and 2013 by passing the Tax Increase Prevention Act of 2014 (P.L. 213-295).

Bonus Depreciation Allowance

The Job Creation and Worker Assistance Act of 2002 (P.L. 107-147) created the 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 by December 31, 2004. A one-year extension of that deadline was available for property with MACRS recovery periods of 10 or more years and lengthy production periods, as well as for transportation equipment.

A year later Congress raised the allowance to 50% of the adjusted basis for qualified property acquired after May 5, 2003 and placed in service before January 1, 2006 through the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27). Once again, a one-year extension of that deadline was available for certain property.

Congress passed the Economic Stimulus Act of 2008, in part, to address the economic effects of the financial crisis that emerged in the late summer and early fall of that year. The act renewed 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 in 2008, Congress passed the Housing Assistance Tax Act of 2008 (P.L. 110-289), which was mainly intended to ease the impact of the financial crisis on the domestic housing market. It included a provision that gave C corporations the option to trade bonus depreciation allowances they could claim for property acquired between April 1 and December 31, 2008 for a refundable, accelerated tax credit equal to the lesser of $30 million or 6% of the sum of any research and AMT credits carried forward from tax years before 2006.

The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) extended the 50% bonus depreciation allowance and the option of monetizing a portion of unused research and AMT credits from tax years before 2006 through 2009.

By passing the Small Business Jobs Act of 2010 (P.L. 111-240), Congress further extended the 50% allowance to qualified property acquired and placed in service in 2010.

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 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.

The American Taxpayer Relief Act of 2012 extended the 50% bonus depreciation allowance through the end of 2013. ATRA also extended through 2013 the option to claim an accelerated, refundable credit for AMT credits carried forward from tax years before 2006 instead of a bonus depreciation allowance for qualified property acquired and placed in service in 2013.

The Tax Increase Prevention Act of 2014 (TIPA) extended through 2014 the bonus depreciation allowance that was available in 2013.

Legislation in the 113th and 114th Congresses to Extend and Modify the Two Expensing Allowances

113th Congress

Section 179 Expensing Allowance

The House has passed two bills (H.R. 4457 on June 12, 2014, and H.R. 4 on September 18, 2014) that would have permanently set the maximum expensing allowance under Section 179 at $500,000 and the phaseout threshold at $2 million. Both amounts would have been indexed for inflation, starting in 2015. And both bills would also have permanently expanded the property eligible for the allowance to include qualified computer software; qualified leasehold improvements for commercial, retail, and restaurant property; and air conditioning and heating units. Neither bill was voted on in the Senate.

The Senate Finance Committee marked up on April 3, 2014 a bill (S. 2260, the Expiring Provisions Improvement, Reform, and Efficiency Act) that would have extended through 2015 all but two of the 57 individual and business tax preferences that expired at the end of 2013. Among the benefits that would have been extended were the Section 179 expensing and the bonus depreciation allowances that were available in 2013. If the bill had been enacted as it was marked up by the committee, the Section 179 allowance would have been set at $500,000 and the phaseout threshold at $2 million for qualified assets acquired and placed in service in 2014 and 2015. In addition, qualified real property (with an annual limit of $250,00 per taxpayer) and off-the-shelf computer software would have qualified for the allowance during the same period. The full Senate did not consider the bill.

In the waning days of the 113th Congress, the House and Senate agreed on a measure (H.R. 5571, P.L. 113-295) that extended the Section 179 allowance from 2013 through 2014.

Bonus Depreciation Allowance

The House passed two bills (H.R. 4718 on July 11, 2014, and H.R. 4 on September 18, 2014) that would have permanently extended the 50% bonus depreciation allowance from 2013 and expanded the list of eligible property to include qualified leasehold and retail improvement property. In addition, the bills would have indexed for inflation the $8,000 increase in the first-year depreciation allowance for luxury cars that qualified for bonus depreciation under Section 280F; expanded and permanently extended the option to exchange a bonus depreciation allowance for unused AMT credits, which would become refundable for this purpose; and allowed growers of fruit- and nut-bearing trees and vines to claim a first-year depreciation allowance under Section 167(a) equal to 50% of the adjusted basis of any such trees and vines they plant or graft in a tax year. The Senate did not consider either bill.

Under S. 2260, as marked up by the Senate Finance Committee, the 50% bonus depreciation allowance from 2013 would have been extended through 2015. It would have made no other changes in the allowance. The full Senate did not consider the measure.

Near the end of the 113th Congress, the House and Senate agreed on a bill (H.R. 5571) to extend through 2014 the 50% bonus depreciation allowance from 2013.

114th Congress

Section 179 Expensing Allowance

On February 13, 2015, the House passed a bill (H.R. 636) that would permanently set the maximum allowance at $500,000 and the phaseout threshold at $2 million and index both amounts for inflation starting in 2016. In addition, the bill would permanently add off-the-shelf computer software, air conditioning and heating equipment, and qualified leasehold, restaurant, and retail improvement property to the list of assets eligible for expensing under Section 179. It would also remove the $250,000 limit on the expensing of this property that was in effect from 2010 to 2014. Under H.R. 636, a taxpayer would have the permanent right to revoke any election made under Section 179 without the consent of the IRS. According to a revenue estimate by the Joint Committee on Taxation, the measure would result in foregone revenue of $77.1 billion from FY2015 to FY2025.[2]

Bonus Depreciation Allowance

The Senate Finance and House Ways and Means Committees have not considered a bill that would extend the bonus depreciation allowance, which expired at the end of 2014. A significant obstacle to an extension of the allowance is its likely revenue effects. According to an estimate by the Joint Committee on Taxation, a permanent extension of the 50% allowance that was available in 2014 and that was included in a bill (Division I of H.R. 4) passed by the House on September 18, 2014, would lead to forgone revenue of $244.7 billion from FY2015 to FY2024.[3]

President's Budget Request for FY2016

President Obama's FY2016 budget request includes an enhancement of the current Section 179 expensing allowance. The proposal would extend through 2015 the $500,000 maximum allowance and $2 million phaseout threshold from 2014. Then, beginning in 2016, the maximum allowance would permanently rise to $1 million, while the phaseout threshold would permanently remain at $2 million. Both amounts would be indexed for inflation beginning in 2017, as would the current $25, 000 limitation on the expensing of heavy-duty sport utility vehicles. The proposal would also permanently add off-the-shelf computer software to the list of qualified assets but remove improvements to leasehold and retail properties and restaurants. According to a revenue estimate by the Treasury Department, the proposal would lead to foregone revenue of $71.0 billion from FY2015 to FY2025.[4]

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[2] U.S. Congress, Joint Committee on Taxation, *Description of H.R. 636, The "America's Small Business Tax Relief Act of 2015,"* JCX-12-15 (Washington: Feb. 3, 2015), p. 5.

[3] U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of Division I of H.R. 4 ,The "Jobs For America Act,"* JCX-105-14 (Washington: Sept. 17, 2014).

[4] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals* (Washington: Feb. 2015), p. 292.

The President's FY 2016 budget request does not call upon Congress to extend the bonus depreciation allowance that expired at the end of 2014.

Economic Effects of the Section 179 and Bonus Depreciation Allowances

Many lawmakers see the Section 179 expensing allowance as a useful and desirable policy tool for promoting the growth of small firms and stimulating the economy. Many small business owners view the allowance as a valuable and necessary tax benefit in that it increases cash flow and after-tax rates of return on investments in qualified property and simplifies tax accounting.

But in the minds of some analysts, the allowance represents a source of inefficiency in the allocation of resources within the U.S. economy. In their view, the allowance has the potential to distort the allocation of capital among domestic investment opportunities, alter the distribution of the federal tax burden among income classes, and reduce the cost of tax compliance for smaller firms. These effects correspond to three traditional criteria for evaluating tax policy: efficiency, equity, and simplicity. Each is discussed below. The discussion commences with a review of what is known about the effectiveness of expensing allowances in general as a policy tool for economic stimulus.

The Allowances as Tools for Economic Stimulus

Since 2003, seven 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, TRUCA, ATRA, and TIPA. Since 2002, eight bills have been enacted to extend or enhance the bonus depreciation allowance. Each bill was intended, in part, to spark an increase in business investment, as part of a broader government-financed effort to stimulate the economy. At the time of their initial enactment in the early 2000s, it seemed reasonable to expect that these measures would have such an effect, given that expensing lowers the user cost of capital for investment in qualified property and expands the cash flow of companies that make such investments.

The user cost of capital plays a major role in business investment decisions. This cost combines 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 U.S. Treasury bond) with its direct costs, such as depreciation, the actual cost of the asset, and income taxes.[5] In effect, the user cost of capital sets 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 companies

[5] 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.

can profitably undertake, and the lower their desired capital stock. In theory, when a change in tax law decreases the user cost of capital, many businesses can be expected to increase the amount of capital they wish to own, boosting overall business investment in the short run.

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.[6] 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.[7] An elasticity of that magnitude means that a 10% decline in the user cost of capital should result in a 5% rise in business spending on equipment in the short run, all other things being equal.

Cash flow can also affect the investment behavior of firms.[8] A firm's owners or senior managers may prefer to finance new investments from retained earnings in order to limit the firm's exposure to external debt and the risk of default it carries. Or the owners may be forced to rely on retained earnings to finance new investments their business has limited or no access to debt and equity markets. Younger firms investing in the development of new technologies are especially vulnerable to such financing difficulties. This is because the owners know more about their services and products and potential for growth than investors and lenders, including banks. For firms in this bind, the cost of internal funds is lower than the cost of external funds, which means they are better off financing new investments out of retained earnings. Expensing can increase a profitable 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 when they are placed in service, reducing its tax liability.

But what makes sense in theory is sometimes difficult to measure or verify in practice. The impact of increases in cash flow on business investment (especially small business investment) remains unclear. Some studies have found a significant positive correlation between changes in a firm's net worth and its investment spending.[9] This correlation was strongest for firms with very limited access to debt and equity markets. Yet these findings do not demonstrate that firms with

[6] 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.

[7] 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.

[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.

relatively high cash flows invest more than firms with relatively low or negative cash flows. A strong correlation between two factors does not necessarily mean that one is a main cause of the other. In this case, a plausible explanation for the correlation may be 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.[10] The relationship between cash flow and business investment is complicated, and additional research is needed to shed more light on it.

Still, the financial effects among individual businesses of an enhanced Section 179 or generous bonus depreciation allowance suggest that it has the potential to boost business investment above what it otherwise would be. These effects raise the question of how effective expensing has been as a policy tool for economic stimulus, both absolutely and relative to other policy options.

There are several reasons to believe that an enhanced Section 179 allowance or generous bonus depreciation allowance would have no more than a modest impact on the economy during a recession. First, the design of each allowance sharply limits their potential to affect economic activity. Neither allowance applies to investments in inventory, structures, and land. And the Section 179 allowance phases out once a company's total investment in qualified assets in a tax year crosses a certain threshold ($200,000 in 2015).

Second, among qualified assets, the tax benefit of each expensing allowance grows as the depreciation life of qualified property increases. This means that investments in longer-lived items (such as machine tools) generate a larger tax savings in present-value terms than do investments in shorter-lived ones (such as business software). Consequently, spending on assets eligible for the two expensing allowances tends to account for a relatively small slice of business investment. One measure of this relationship is the value of depreciation allowances claimed by businesses in a tax year. According to corporate income tax data made available by the IRS through its website, corporations claimed a total of $609.8 billion in depreciation allowances for the 2009 tax year. Of that amount, Section 179 allowances amounted to $7.8 billion (or 1.3% of the total amount) and bonus depreciation allowances came to $137.4 billion (or 22.5% of the total amount).[11]

In addition, expensing is 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. This is because business investment in general is driven more by the short-to-medium-term outlook for sales and economic expansion than it is by temporary tax incentives. An increase in an expensing allowance when the economy is contracting and many companies, large and small, have excess capacity may affect the timing of planned qualifying investments, but is likely to have less of an effect on the total amount of those investments. Companies may be able to accelerate some planned investments to take advantage of a temporary expensing allowance, but little new investment would be likely to materialize while the sales and profit outlook for most companies remains unpromising or bleak.

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 from 2002 to 2004

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

[11] See http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Depreciation-Data.

ranged from 54% to 61% for C corporations and from 65% to 70% for S corporations.[12] Knittel attributed the surprisingly low rates to an increase in that period in the number of firms that had relatively large stocks of accumulated net operating losses. He also pointed to the many states that elected not to change their tax codes to include bonus depreciation allowances as another contributing factor.

A second study found 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.[13] This suggested that many of the 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.[14]

Furthermore, there is anecdotal evidence that the current bonus depreciation allowance has made little or no difference in the investment plans of some companies, while accelerating the timing of planned investments by other companies to take advantage of the tax savings.[15] These findings hardly back the notion that temporary investment tax subsidies can serve as an effective tool for stimulating the economy.

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 2010 analysis by the Congressional Budget Office (CBO) lent 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.[16]

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[12] 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.

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

[14] 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.

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

[16] 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.

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.

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. All other things being equal, expensing increases the after-tax rates of return for favored assets compared with 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.[17] 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.

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.[18] But it can also be argued that much of this investment would have taken place in any event.[19] 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.[20] 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.[21]

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

[17] 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.

[18] 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.

[19] 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.

[20] 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.

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

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).[22] Douglas Holtz-Eakin, a former director of the Congressional Budget Office, has labeled this incentive effect a "tax on growth by small firms."[23]

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.

[22] 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.

[23] 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.

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, any gains in profits that 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.[24] This finding underscores a well-established truth about the costs to firms of tax compliance: namely, these costs are[25] 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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[24] 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.

[25] 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.