MERCATUS CENTER
George Mason University
Bridging the gap between academic ideas and real-world problems

RESEARCH SUMMARY

OPTIONS FOR CORPORATE CAPITAL COST RECOVERY
Tax Rates and Depreciation

The US tax code is excessively complex and riddled with special-interest loopholes. Tax rates that treat similar activities unequally can distort consumer and investor decisions, which damages the economy. The current tax system's treatment of corporate capital investments is emblematic of these problems.

A new study for the Mercatus Center at George Mason University reviews the tax code's requirement that businesses use "depreciation"—the process of writing off a capital purchase over time—and explains how this treatment leads to unequal tax rates across industries.

Shifting to "full expensing"—allowing business to write off all expenditures in the year they are purchased—would offer an even ground for capital investments. It would also simplify the tax code, increase investment, and reduce the ability of politically favored industries to gain targeted tax benefits. While expensing would likely reduce related government revenue in the short run, over the longer run it would likely be revenue-neutral or even growth- and revenue-enhancing.

Using IRS Statistics of Income data for active corporations from 1998 to 2010, the study estimates which industries would be most sensitive to changes in depreciation and how the removal of existing depreciation policies would affect the tax rates of 11 industries. Industries more sensitive to changes in capital cost recovery would likely benefit the most from full expensing, but all industries would receive some benefit.

To read the study in its entirety and learn more about its authors, Mercatus senior research fellow Jason J. Fichtner and MA fellow Adam N. Michel, please see "Options for Corporate Capital Cost Recovery: Tax Rates and Depreciation."

For more information, contact
Angela Kuck, 703-993-9338, akuck@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Boulevard, 4th Floor, Arlington, VA 22201

SUMMARY

The US tax code requires most new purchases of capital, such as machines and buildings, to be deducted from total revenue over the course of many years. This is called "depreciation" or "capital cost recovery."

The Advent of Depreciation
Depreciation was first instituted as an accounting practice when businesses reported earnings to shareholders. Without depreciation, years with large investment purchases could show negative profits while years with no investments showed high profits, all else being equal. To reduce these swings in reported earnings and convey a company's true position, accountants now distribute the cost of each investment over the number of years it will be in service.

Problems with Depreciation
While depreciation helps communicate profitability to shareholders, it distorts the profitability of capital investments when applied to the tax code. This is because businesses make investment decisions based on after-tax profitability, which is directly impacted by how an asset is depreciated.

Determining how a capital asset is to be depreciated depends on its estimated "useful life." Estimating useful lives for all possible assets is nearly impossible, which allows current depreciation rules to be arbitrarily set and manipulated.

Accelerated Depreciation
One way depreciation rules can be manipulated is through "accelerated depreciation." Accelerated depreciation allows more of the cost of the asset to be deducted closer to the time of purchase.

- One specific type of accelerated depreciation is "bonus depreciation," which allows a one-time deduction of 30–100 percent of the initial cost in the year of purchase. This has become a favored policy tool in recent years to stimulate investment and the economy.

- Accelerated depreciation, including bonus depreciation, has also received attention because it is the largest corporate tax expenditure. As a result, depreciation is a much-discussed candidate for tax reform, with various advocates arguing for manipulating the timeline in order to lower the statutory corporate tax rate, increase federal revenue, or further stimulate investment.

KEY FINDINGS

Expensing is a better alternative than depreciation for the following reasons:

- *Zero effective tax rate*. Expensing lowers the effective corporate tax rate on new equity financed capital assets to zero, while leaving the statutory rate unchanged. A zero effective rate on capital increases the after-tax rate of return on new investments, making new investments more attractive under expensing.

- *Greater asset profitability*. Tax depreciation decreases asset profitability by diminishing the value of the tax write-off. The decrease in value is felt disproportionately on investments that have long useful lives, such as buildings and other infrastructure. This problem is compounded by uncertainty stemming from unknown long-run expectations about inflation.

- *Less bias against equity-financed capital.* The current tax code is biased in favor of debt-financed investment. Although expensing will not fix this disparity, it will move the effective tax rate on equity-financed capital to zero.

- *Equal treatment of all investments.* Expensing treats all investments similarly. Depreciation will always favor certain investments over others. Even within the same industry, tangible investments can be treated differently from intangible investments and investments in equipment from investments in structures. Expensing removes these inequities. The ability to manipulate depreciation for special tax breaks also opens the door to corporate lobbying and special treatment.

- *Long-term economic growth.* If an expensing policy were enacted today, there would likely be small revenue losses in the short run and modest revenue increases in the long run. Moreover, because expensing makes investment relatively more attractive, it can be reasonably assumed that there would be some economic growth effects from the tax change.

CONCLUSION

Expensing would be a more efficient tax rule than depreciation. Switching from depreciation to expensing could lower public and private administrative costs by simplifying the tax code. Because expensing makes investment relatively more attractive, switching to expensing would promote positive economic growth.