TAX FOUNDATION

Reviewing the Benefits of Full Expensing for the Post-Pandemic Economic Recovery

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Rather than relying on new tax subsidies or policies to address the economic issues resulting from the COVID-19 pandemic, lawmakers can look to reforms within the existing tax system to clear the path for businesses and individuals to invest and create jobs in the new economy.

One of the most cost-effective policy changes would be to make full expensing of machinery and equipment permanent and extend this important tax treatment to structures as well as for firms in a net operating loss position.

What is full expensing and why does it matter?

When a business pays taxes, it is permitted to deduct ordinary business costs from its revenue to determine taxable income and tax owed. These costs include wages and salaries paid and bills paid to keep operations running. However, when a business makes a capital investment, such as building a new facility, instead of deducting that cost immediately as it does for other costs, the business is required to only deduct a share of the cost, with the rest deducted over future years on future tax returns. Denying a full deduction for the costs of capital investments makes a firm's taxable income greater than its actual income on a cash-flow basis.

Denying a full deduction for investment upfront increases the cost of making investments, even though the business will eventually take the deductions in the future. How? Because a dollar in the future is worth less than a dollar today due to inflation and the time value of money. Stretching depreciation deductions for capital investment over time means a business can't fully recover the cost of making the investment. This discourages businesses from making productive investments that would otherwise be worthwhile to pursue.

The Tax Cuts and Jobs Act (TCJA) of 2017 permitted full expensing for investments in short-lived assets such as machinery and equipment, but only on a temporary basis. The policy will begin phasing out in 2022 and will be eliminated by 2026—meaning the tax burden on investment is scheduled to increase.

How can full expensing help with the economic recovery?

First, lawmakers can prevent the upcoming tax increase on investment in machinery and equipment by making full expensing a permanent part of the tax code, giving businesses the certainty they need that their expanded capacity will be financially viable in future years.

We have estimated that making full expensing of machinery and equipment permanent is one of the most cost-effective reforms lawmakers could enact. The provision is entirely aimed at lowering the cost of capital for new investments, and a higher level of capital investment leads to increased productivity, wage gains, and economic output—all well-suited to help with the recovery.

Second, lawmakers can improve the cost recovery treatment of capital investments that are currently ineligible for the TCJA provision and must be deducted over long periods of time, namely, buildings and structures. Currently, businesses must depreciate

investments such as new factories or buildings over 39 years, which creates a substantial tax bias against these investments. Structures comprise more than three-fourths of the private capital stock, meaning that an improvement to the tax treatment of this asset class would likely have a large economic impact. Improvements would include shortening asset lives for new and existing structures, implementing neutral cost recovery, or phasing in full expensing treatment over time.

But what about businesses that don't have enough liquidity?

To take advantage of full expensing deductions, firms need funds to make investments and revenues against which to claim deductions. But many firms in the current crisis are in or will be in net operating loss positions. To help, lawmakers can consider two policies.

First, lawmakers could allow firms with remaining depreciation deductions on their books, such as those for investments made before the TCJA's full expensing policy, to use them now against any taxable income or cash them out at the firm's statutory tax rate. This could be paired with allowing firms to cash out net operating losses. These options would be an acceleration of tax assets that firms would otherwise claim at some point, providing an infusion of cash flow today without requiring Congress to enact new tax or spending programs.

A second policy is safe-harbor leasing, which was included in the Economic Recovery Tax Act of 1981. As explained here, safe harbor leasing allows struggling companies, such as manufacturers and airlines, to acquire the capital equipment they need while giving the tax benefits of the investment to more profitable companies.

For example, this can take the form of a sale-leaseback, in which Business A makes an investment in a piece of machinery but cannot use the tax benefits of full expensing because it lacks profits against which to take the deductions. Business A can agree to sell the property to Business B, which has taxable income, and will pay a flat amount to Business A for the machine, take the depreciation deduction against its taxable income, and lease the machine back to Business A. Business A is better off by receiving revenue from the sale, which reduces the cost of the investment, and Business B is better off because the tax benefits of the deduction exceed the tax cost associated with receiving rental income from Business A. Safe-harbor leasing extends the neutral tax treatment of full expensing to businesses that would otherwise be unable to access the policy and thus face higher investment costs.

Are there other concerns with expensing?

Some will argue that under current law, the combination of full expensing with other provisions in the tax code, namely, the deduction for interest expenses, will lead to a negative marginal tax rate (or a subsidy) for some investments. However, there are at least two reasons why this is not the case.

The normal return to capital is the amount required for an investor to break-even on an investment, enough to cover the cost of her investment without being any better off. The supernormal return to capital, on the other hand, is the amount above and beyond the normal return and represents an increase in the investor's welfare. Supernormal returns to capital may arise due to monopoly power, economic rents, innovations, or the return to risk—and firms often earn at least some above the normal return to capital when they make an investment. Under a neutral tax code, the normal return to capital would be exempt from tax (as it does not represent an increase in welfare), while the supernormal return to capital would be subject to tax.

Some argue that a full deduction for the cost of investment results in a company having zero reportable taxable income over the life of the asset, resulting in zero tax, and that by borrowing the funds to invest in the asset and deducting the associated interest costs, the firm's tax rate on that investment becomes negative.

But as a full deduction for the cost of an investment, full expensing exempts the normal return to capital from taxation but not the supernormal return. A firm earning supernormal returns will still be subject to tax even though the normal return is exempt.

This argument also ignores that the income earned by the marginal lender is taxable. The lender providing funds to the business will be required to pay taxes on the income associated with lending and will require a sufficient interest rate to cover the tax on the income. As colleague Stephen Entin explains here, "The claim that the deduction of the interest payment by the borrowing business (in addition to the cost of the asset) creates too much of a deduction and creates a negative tax is wrong. It ignores the tax paid by the lender. The lender receives some of the return on the asset in the form of interest and pays tax on that portion. The borrower pays tax on the rest."

Further, the current tax advantage of debt financing over equity financing due to the deductibility of interest expenses is a reason to reform the taxation of interest, not a reason to prevent neutral treatment of investments that full expensing provides.

Conclusion

Lawmakers face the challenge of choosing the right policies for the post-pandemic economic recovery. Rather than turn to subsidies that may produce a short-term sugar high and require the government to choose who benefits, broad improvements to the tax code can help businesses and individuals invest, create jobs, and reach higher rates of growth. Permanent full expensing, expanded to additional assets like structures, offers a cost-effective solution to encourage additional investment over the long run. Accelerating tax assets and exploring safe-harbor leasing can help firms that lack cash flow and taxable income make additional investments, accelerating an economic recovery.