TAX FOUNDATION

Tax Reform Isn't Done, June 8

When it comes to reforming the federal tax code, there is still more work to be done. A number of major provisions in the Tax Cuts and Jobs Act are scheduled to expire over the next eight years. Many of the expiring provisions should instead be made permanent. At the same time, lawmakers should evaluate which portions of the Tax Cuts and Jobs Act ought to be improved. More broadly, the Tax Cuts and Jobs Act did not address every area of the federal tax code in need of reform. Specifically, lawmakers should provide greater cost recovery for structures and reform the tax treatment of household saving.

1. Many provisions in TCJA are scheduled to expire

   There are several scheduled tax changes over the next few years that would create new tax barriers to business investment, including the phaseout of 100 percent expensing for equipment and machinery, as well as the requirement that businesses deduct their research and development costs over five years. There are also a number of individual tax changes that will expire in 2025, including across-the-board rate cuts, the increased standard deduction, the new deduction for pass-through businesses, and new limits on itemized deductions.

2. The TCJA did not significantly improve the ability of businesses to deduct their investments in long-life assets

   One of the most significant distortions remaining in the federal tax code is the rule that businesses that invest in structures (that is, buildings) are required to deduct the cost of these investments over very long periods of time. There are a number of ways that lawmakers could increase cost recovery for structures in the future, in order to lessen the bias against investing in buildings.

3. The federal tax code is not neutral between present consumption and future consumption

   Currently, there are almost a dozen tax-advantaged savings accounts, including traditional and Roth IRAs, 401(k)s, HSAs, and 529s—each with different rules and restrictions. This is an extremely complicated and confusing system, and is a prime target for simplification, which could be achieved through allowing universal tax-deferred savings accounts.

Further Reading:

"Tax Reform Isn't Done" – Scott Greenberg, https://taxfoundation.org/tax-reform-isnt-done/

"The Complicated Taxation of America's Retirement Accounts" – Erica York, https://taxfoundation.org/retirement-accounts-taxation/

"Tax Treatment of Structures Under Expensing" – Stephen J. Entin, https://taxfoundation.org/tax-treatment-structures-expensing/

Tax Treatment of Capital Assets:

Expensing vs. Depreciation
Tax Cuts and Jobs Act Provisions

Tax Foundation University
June 8, 2018

Ways to Improve Capital Cost Recovery

Make expensing (immediate write-off of 100% of cost) permanent

The TCJA allows expensing for short-lived assets through 2022, but phases out, 20% a year, over 2023-2026. The temporary revenue loss of full expensing becomes revenue gains after growth of wages and GDP. If income is not high enough to use the full write-off, adjust NOLs for the time value of money.

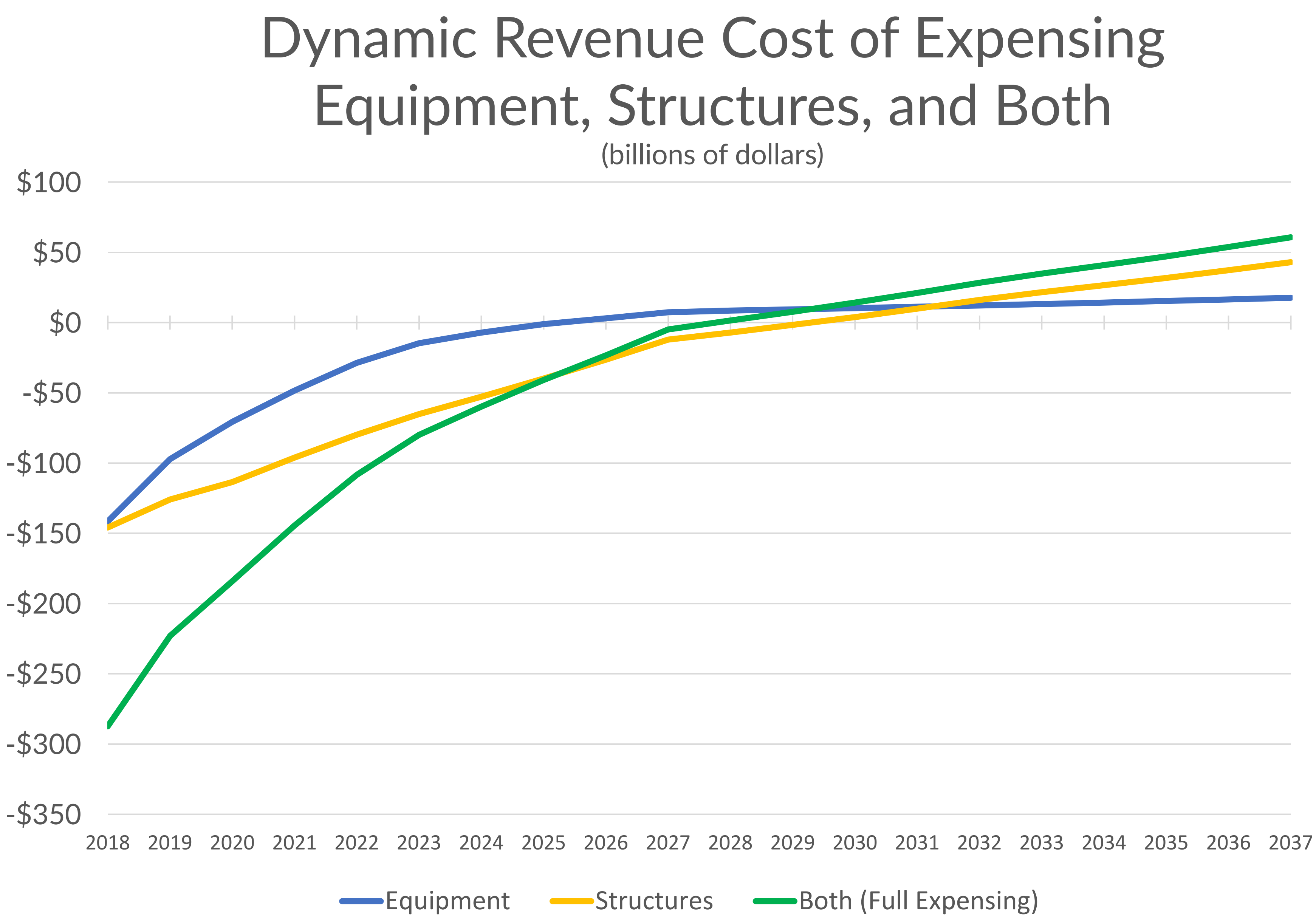
Include Structures

The TCJA did not give expensing to long-lived buildings. They are 2/3 of the capital stock, and currently treated the worst, with a 39-year cost recovery period. Three ways to give them relief:

1) Expense them immediately. Current property owners would complain about competition from new buildings, but renters, consumers, national economy would benefit greatly.

2) Shorten lives gradually. For example, shorten lives to 30 years in 2019, falling one year per year until 2049. Extend 30-year life option to recently-built assets. Slower benefits, but less special interest opposition.

3) Neutral Cost Recovery (NCRS). Increase unused basis each year by inflation plus 3% real return. Equals expensing in present value. Perhaps allow adjustment for old assets too if owners are willing to restart cost recovery beginning at 39 years. Temporary revenue loss, reverses to gains longer term.



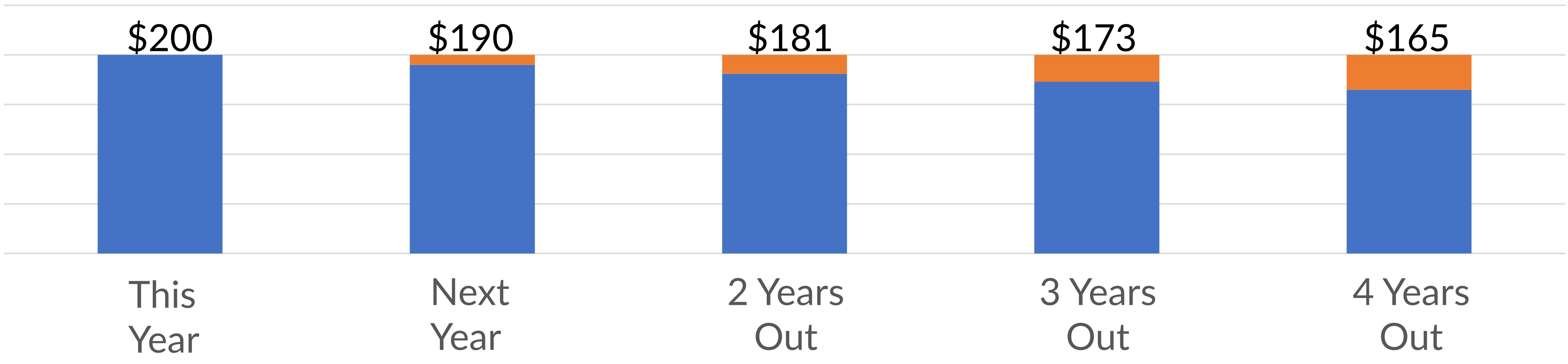
Dynamic Revenue Cost of Expensing Equipment, Structures, and Both
(billions of dollars)
$100
$50
$0
-$50
-$100
-$150
-$200
-$250
-$300
-$350
2018
2019
2020
2021
2022
2023
2024
2025
2026
2027
2028
2029
2030
2031
2032
2033
2034
2035
2036
2037
Equipment
Structures
Both (Full Expensing)

Expensing Equipment and Structures vs. MACRS with 21 Percent Corporate Tax Rate

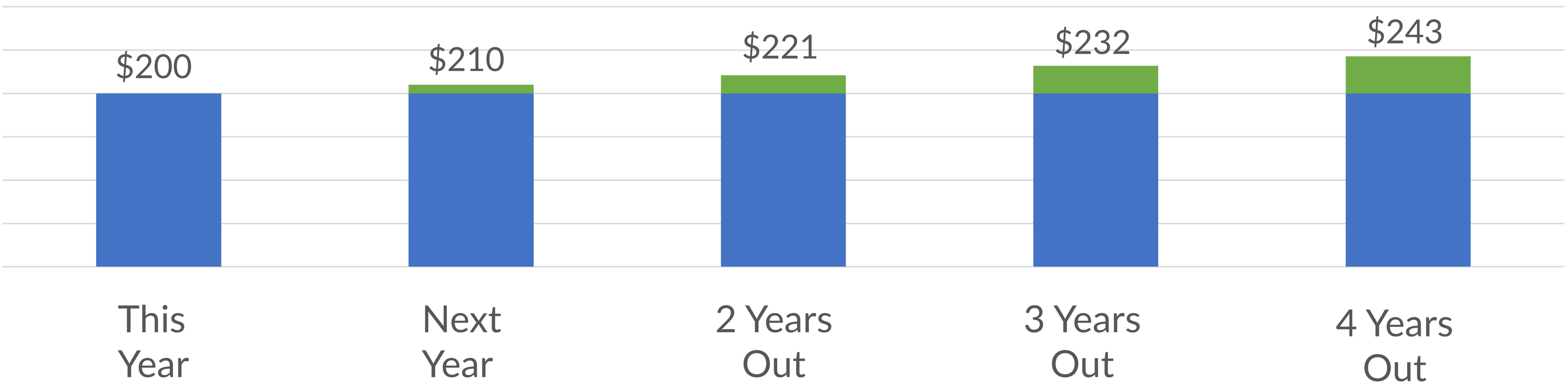
	Expensing Equipment	Expensing Structures	Both (Full Expensing)
GDP change	0.6%	2.3%	2.8%
GDP, long-run change, annual level (billions of 2016 $)	$112	$434	$546
Private business stocks (equipment, structures, buildings)	1.7%	6.6%	8.3%
Wage rate	0.5%	1.9%	2.4%
Full-time Equivalent Jobs (in thousands)	110	414	524

Tax Foundation, Taxes and Growth Model (March 2017 version)

Present Value of $200 Annual Write-off at 5% Discount Rate



Annual Write-off Equaling $200 in Present Value at 5% Discount Rate



Present Value of MACRS Capital Consumption Allowances per Dollar of Investment Compared to Expensing (First-Year Write-Off)

Asset lives:		3 yrs	7 yrs	10 yrs	20 yrs	39 yrs
Present value of first-year write-off of $1 of investment:		$1	$1	$1	$1	$1
Present value of MACRS write-off of $1 if inflation rate is:	0%	$0.96	$0.91	$0.88	$0.74	$0.55
	3%	$0.94	$0.85	$0.79	$0.59	$0.37
	5%	$0.92	$0.81	$0.74	$0.52	$0.30

Assumes a 3.5 percent real discount rate, 3- to 20-year assets placed in service in first quarter of the year, 27.5- to 39-year assets placed in service in January.

Expensing vs. Depreciation: Depreciation Overstates Taxable Income and Depresses Return on Capital

(7-year asset, 3% inflation, 3.5% real discount rate)

Expensing (Full Cost Recovery)	
Revenues from machine, present value	$115
Full cost of machine	$100
Full cost write-off for tax purposes (expensing)	$100
Real profit = Taxable profit	$15
Tax	$4.5
After-tax income	$10.5
Rate of return	10.5%

Depreciation	
Revenues from machine, present value	$115
Full cost of machine	$100
Allowable depreciation write-off, present value	$85
Taxable "profit" (exceeds real profit)	$30
Tax	$9
After-tax income	$6
Rate of return	6%

Expensing vs. Depreciation: Depreciation Overstates Taxable Income and Depresses Return on Capital

(39-year asset, 3% inflation, 3.5% real discount rate)

Expensing (Full Cost Recovery)	
Revenues from machine, present value	$130
Full cost of machine	$100
Full cost write-off for tax purposes (expensing)	$100
Real profit = Taxable profit	$30
Tax	$9
After-tax income	$21
Rate of return	21%

Depreciation	
Revenues from machine, present value	$130
Full cost of machine	$100
Allowable depreciation write-off, present value	$37
Taxable “profit” (exceeds real profit)	$93
Tax	$28
After-tax income	+$2
Rate of return	+2%