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Consistent and Predictable Business Deductions: State Conformity with Section 179 Deductions

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Key Findings

- Forty-five states and the District of Columbia allow first-year expensing of small business capital investment as permitted under Section 179 of the Internal Revenue Code.
- Twelve states and the District of Columbia are out of conformity with current federal expensing limits, putting small businesses in their states at a competitive disadvantage.
- Now that the federal government has offered six-digit Section 179 allowances for more than a decade, holdout states are increasingly looking at raising state deduction limits or pegging them to federal allowances to remain competitive, less complicated, and growth-oriented.

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Section 179 Expensing Bridges Accounting Practices and Actual Business Expenses

Corporate taxation is ostensibly a tax on net income: corporate revenues less the cost of doing business. In practice, however, rather than the cost of equipment being deducted from gross income the year in which the cost is incurred, businesses are required to deduct the cost of the equipment over time according to a depreciation schedule.

The theory behind this is that companies can only deduct the portion of capital investment consumed in each year as equipment depreciates, although the practical effect is that companies must defer deductions for completed business expenditures into future years, effectively making a zero-interest loan to the government. A better system would permit full expensing, allowing businesses to write off the full cost of capital investment immediately in the year in which the expense was incurred. Full expensing was a historic practice until the need for accelerated revenue during World War II brought about expensing according to depreciation schedules.[1]

Depreciation is an accounting practice, not an economic principle. A bookkeeper records an expense in one column and the value of the acquired asset in another, then depreciates the new equipment over its expected life to better capture the real state of a company's assets, liquid and illiquid. The expense, however, is fully realized in the year of purchase. Spreading out business expenses over many years artificially increases the cost of equipment by overstating business income early, accelerating a business's tax liability long before the value of the investment can be realized.[2]

Section 179 of the Internal Revenue Code serves as an important stopgap for small businesses by somewhat bridging the gap between accounting practices and actual business expenses. Under Section 179, and state provisions linked to Section 179, businesses may deduct up to $500,000 on $2 million of equipment purchases, with the deduction then phasing out before it is completely removed for businesses with more than $2.5 million in annual equipment expenditures.[3]

Section 179 expensing helps to stimulate business investment by reducing the user cost of capital, which is the rate of return an investment must generate to break even.[4] These are funds that can be invested, used to increase wages or buy more equipment, returned to shareholders, or taken as income. Although it is difficult to quantify the effects of such a policy, the Congressional Research Service estimates that a 10 percent decline in the user

1 Stephen Entin, *Washington Post Criticizes Good Tax Policy, Tax Foundation Tax Policy Blog (Dec. 18, 2014)*, http://taxfoundation.org/blog/washington-post-criticizes-good-tax-policy.

2 *Ibid*.

3 This simplified explanation neglects the interplay of bonus depreciation, which is available at the federal level for amounts above the maximum Section 179 write-off.

4 Congressional Research Service, Gary Guenther, *Section 179 and Bonus Depreciation Expensing Allowances (Sept. 10, 2012)* at 11, http://www.fas.org/sgp/crs/misc/RL31852.pdf.

cost of capital should result in a 5 percent increase in business spending on equipment, all things being otherwise equal.[5]

The uncertainty of the current system, in which expensing levels are often set retroactively (businesses did not know the levels for the 2014 tax year until December 2014), undermines the investment incentive Section 179 is intended to provide. While this *ad hoc* approach employs plenty lobbyists, stable, predictable expensing limits would actually employ more people producing goods and services.[6] Ideally, Section 179 deductions should be sufficiently stable to permit informed business decisions and sufficiently large to provide meaningful first year expensing for small businesses.

Federal Maximum Expensing Under Section 179

The federal deduction limit for 2014 was $500,000 and the limit on equipment purchases—the maximum amount that can be spent before the Section 179 deduction is reduced on a dollar-for-dollar basis—was $2 million. At the federal level, bonus depreciation is also available for amounts above the maximum Section 179 write-off.

The current $500,000 allowance was established as part of the economic stimulus and was originally scheduled to decline to $125,000 in 2012 and back to a 2003 baseline of $25,000 in 2013, but has been extended by Congress for tax years 2013 and 2014. Should Congress not act by the end of 2015 to further extend this treatment, the 2015 expensing allowance would revert back to $25,000. It is all but taken for granted, however, that Congress will continue to extend these higher limits in 2015 and beyond.

Table 1. Maximum Expensing Allowances by Year

Tax Year(s)	Expensing Allowance	Investment Limit
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	$24,000	$200,000
2002	$24,000	$200,000
2003	$100,000	$400,000
2004	$102,000	$410,000
2005	$105,000	$420,000
2006	$108,000	$430,000
2007	$125,000	$500,000
2008	$250,000	$800,000
2009	$250,000	$800,000
2010-2014	$500,000	$2,000,000
2015 (current law)	$25,000	$200,000

Source: Congressional Research Service, Gary Guenther, *Section 179 and Bonus Depreciation Expensing Allowances* (Sept. 10, 2012) at 3, http://www.fas.org/sgp/crs/misc/RL31852.pdf.

5 Congressional Research Service, Gary Guenther, *Section 179 and Bonus Depreciation Expensing Allowances (Sept. 10, 2012) at 12,* http://www.fas.org/sgp/crs/misc/RL31852.pdf.

6 Alan Cole, *Tax Extenders: Take Them or Leave Them, Tax Foundation Tax Policy Blog (Nov. 25, 2014),* http://taxfoundation.org/blog/tax-extenders-take-them-or-leave-them.

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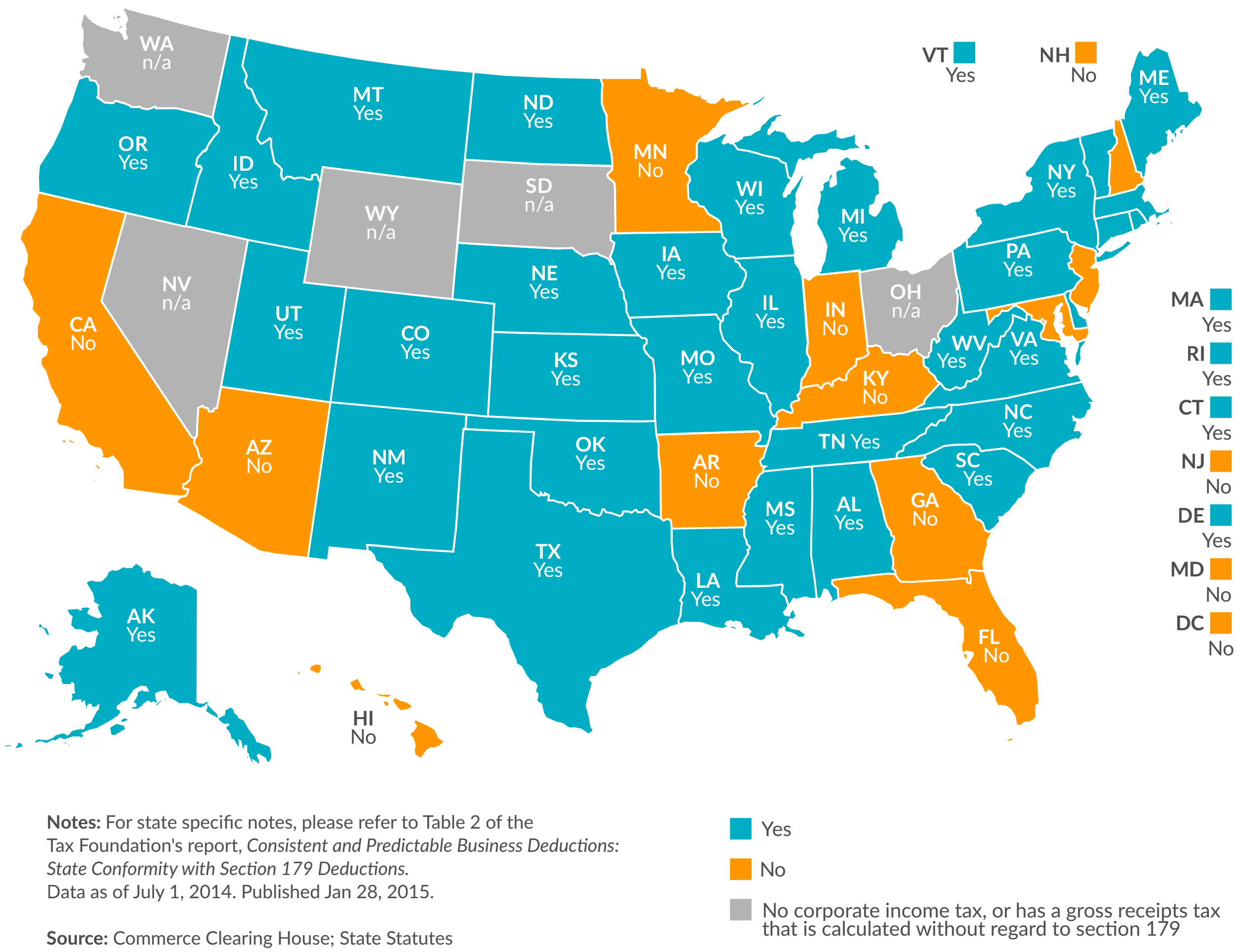
State Conformity with Federal Section 179

Forty-six states allow Section 179 deductions. Of the remaining four, three do not levy corporate income taxes and the fourth (Ohio) does not make allowances for federal expense deductions against its gross receipts tax.

As of last year, 33 of these 46 states with Section 179 deduction pegged to the federal base, with an allowable expense of $500,000. A further four established allowable expenses ranging from $120,000 to $250,000, while nine allowed only $25,000 in expensing—just one twentieth of the current federal limit.

Imagine a small business contemplating $500,000 in equipment expenditures in a state like New Hampshire, which imposes a $25,000 limit. With first year expensing, the business would accelerate $175,000 in deductions at the federal level but only $2,125 at the state level. If New Hampshire joined its neighbors in conforming to federal Section 179, the business would save $42,500 on its state corporate income taxes in the first year rather than waiting over time to claim its deduction.

Does Your State Peg 179 Expensing to Federal Law?



Notes: For state specific notes, please refer to Table 2 of the Tax Foundation's report, *Consistent and Predictable Business Deductions: State Conformity with Section 179 Deductions.*
Data as of July 1, 2014. Published Jan 28, 2015.

Source: Commerce Clearing House; State Statutes

Table 2. Section 179 Expensing Allowances By State

State	Allowable Expense	Pegged to Federal Base
Alabama	$500,000	✔
Alaska	$500,000	✔
Arizona (a)	$120,000	
Arkansas	$25,000	
California	$25,000	
Colorado	$500,000	✔
Connecticut	$500,000	✔
Delaware	$500,000	✔
District of Columbia (b)	$25,000	
Florida	$128,000	
Georgia	$250,000	
Hawaii	$25,000	
Idaho	$500,000	✔
Illinois	$500,000	✔
Indiana	$25,000	
Iowa	$500,000	✔
Kansas	$500,000	✔
Kentucky	$25,000	
Louisiana	$500,000	✔
Maine (c)	$500,000	✔
Maryland (d)	$25,000	
Massachusetts	$500,000	✔
Michigan	$500,000	✔
Minnesota (e)	$196,000	
Mississippi	$500,000	✔
Missouri	$500,000	✔
Montana	$500,000	✔
Nebraska	$500,000	✔
Nevada (f)	n/a	
New Hampshire	$25,000	
New Jersey	$25,000	
New Mexico	$500,000	✔
New York (g)	$500,000	✔
North Carolina	$500,000	✔
North Dakota	$500,000	✔
Ohio (h)	n/a	
Oklahoma	$500,000	✔
Oregon	$500,000	✔
Pennsylvania	$500,000	✔
Rhode Island	$500,000	✔
South Carolina	$500,000	✔
South Dakota (f)	n/a	
Tennessee	$500,000	✔
Texas (i)	$500,000	✔
Utah	$500,000	✔
Vermont	$500,000	✔
Virginia	$500,000	✔
Washington (h)	n/a	
West Virginia	$500,000	✔
Wisconsin	$500,000	✔
Wyoming (f)	n/a	

(a) Includes addition for amount of federal deduction exceeding $25,000 and subtraction equal to addback amount in first and subsequent four years.
(b) Or $40,000 for qualified high technology companies.
(c) Allows subtractions for portion of additions required before 2011.
(d) Subtraction allowed to extent amount claimed for federal purposes is less than amount permitted for state purposes.
(e) Addition to federal base required for 80% of amount that exceeds $25,000, and subtraction allowed equal to 1/5th of addback amount in first and succeeding four tax years.
(f) Nevada, South Dakota, and Wyoming do not levy corporate income or comparable taxes.
(g) Addition required for SUVs over 6,000 lbs (excepting eligible farmers).
(h) Ohio's and Washington's gross receipts taxes are computed without regard to federal expense deduction.
(i) Subtraction from total revenue or gross receipts computation for costs of goods sold under the Texas Margin Tax includes Section 179 deductions.

Source: Commerce Clearing House and state statutes.

Coping with Federal Uncertainty

Congress's recent practice of extending higher depreciation allowances through last-minute tax legislation forces small businesses to make decisions on capital investment based, on their best guess of what Congress will do. There is always the possibility that the higher allowances will be permitted to lapse, lowering limits to states who peg to the federal level as well.

While 33 states index to the federal level, there is some variety in the way the issue is handled by the other 13 states permitting Section 179 deductions. Some require an addition to taxable revenue for any amount the federal maximum in excess of the state's statutory expensing allowance, e.g., $25,000. Others allow the excess federal amount to be partially claimed, e.g., $25,000 plus one-third of the additional federal allowance. A few set statutory minimums, though current federal levels exceed these minimum values.

A good solution for a state desiring to maintain conformity with the federal government while not relying on Congress's ability to enact timely tax legislation would be to add a floor below which state expensing limits cannot fall. For instance, the state might adopt the greater of the federal limit and $500,000 (the current federal limit) or even some lower figure. This would provide businesses with the assurance that for state tax purposes, they can expense at least that amount regardless of what the federal government ultimately does.

For the thirteen states below the maximum federal allowance, coupling with the federal rate would enhance competitiveness and promote economic growth. For those states and the thirty-three that already adopt federal allowance levels, establishing a floor would help ensure that state law does not unduly amplify the uncertainty created by the federal government's ad hoc approach to setting Section 179 deduction levels.

Conclusion

The states currently below the federal government's $500,000 expensing allowance—Arizona, Arkansas, California, Florida, Georgia, Hawaii, Indiana, Kentucky, Maryland, Minnesota, New Hampshire, New Jersey, and the District of Columbia, would benefit from addressing this anomaly in their tax codes. Raising the expensing limit is both sound tax policy and economically advantageous, enhancing the state's competitiveness and curtailing a disincentive to economic growth currently embedded in the tax code. By adopting the federal allowance, coupled with a floor at or above current state limits, these states can provide greater certainty for small businesses and help set the stage for additional business expansion and job creation.

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