

POLICY BRIEF

**RECOMMENDATIONS
FOR THE NEW
ADMINISTRATION**

Extend Investment Tax Incentives for Small Business Recovery

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This brief is part of a series of policy recommendations for the administration of President Joe Biden. Focusing on a range of important issues facing the country, the briefs are intended to provide decision-makers with relevant and effective ideas for addressing domestic and foreign policy priorities. View the entire series at www.bakerinstitute.org/recommendations-2021.

INTRODUCTION

Two federal income tax incentives for business investment are scheduled to end after 2021 and 2022, just as the small business sector will be recovering from the economic downturn of the COVID-19 pandemic. These sunsets were written into the Tax Cuts and Jobs Act (TCJA) of 2017 to satisfy requirements of the budget process.^{1,2} Although the TCJA may never have become law without the sunsets, their palatability is significantly diminished in light of the pandemic.

Small businesses have abandoned or postponed investment plans since the pandemic began. In the second quarter of 2020, total U.S. investment declined by more than \$566 billion (-9.7%),³ and investment in research and development declined by \$20 billion (-3.3%).⁴ A poll by the U.S. Chamber of Commerce found that 36% of small businesses planned to decrease investments in May 2020.⁵ That percentage fell to 18% in July 2020.⁶ Pre-pandemic investment plans may not be resumed if the investments carry a higher after-tax cost than originally planned and

while businesses focus on recovering the fundamentals of customers, cashflow, and profitability. Under President Joe Biden, Congress should extend the expiring tax incentives for business investment and give small businesses more runway to make investments that will bolster their recovery.

EXTEND IMMEDIATE DEDUCTION FOR RESEARCH AND DEVELOPMENT

Evidencing the importance of research and development (R&D) activity in the United States, R&D expenses have been fully deductible in the year incurred since 1954⁷ and/or eligible for a tax credit since 1981.⁸ Under the TCJA, however, R&D expenses after 2021 will no longer be immediately deductible but, instead, will be deductible over a five-year period.⁹ The TCJA also made conforming changes to the R&D tax credit.¹⁰ Consequently, the immediate tax savings associated with R&D expenditures will be significantly reduced after 2021.¹¹ While a \$100,000 R&D expenditure in 2018 yielded an immediate \$26,530 in tax savings for a corporate taxpayer, the same expenditure in 2022 may only yield an immediate \$7,630



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in tax savings, with remaining savings from amortization over the next five years.¹²

The reduction in immediate tax savings will have a greater negative impact for small businesses, which tend to devote a higher share of expenditures to R&D than larger businesses. In 2018, the R&D-to-sales ratio was 21.6% for firms with 10 to 19 employees but only 3.3% for firms with 25,000 or more employees.¹³ In 2018, small businesses with 10 or more employees invested \$66 billion in domestic R&D, comprising 15% of R&D expenditures by all businesses.¹⁴ Small businesses represented 99.6% of all firms in the professional, scientific, and technical services industry in 2017,¹⁵ which participate heavily in research and development. Among microbusinesses (firms with fewer than 10 employees) in 2017, 76% of R&D expenses were incurred by the professional, scientific, and technical services industry,¹⁶ indicating the outsized role that small start-ups play in research and development.

Amortization of R&D expenses will significantly raise the tax burden on companies that conduct R&D, discourage R&D spending, and slow economic growth. According to the Congressional Research Service, the effective tax rate for equity-financed R&D investment was -14% before the TCJA (amounting to a tax subsidy) and is projected to increase to 11% in 2022 under the TCJA's amortization policy.¹⁷ The accounting firm Ernst & Young estimates an annual decline of \$4.1 billion in R&D investment and an annual loss of 23,400 jobs in each of the first five years of amortization, followed by an annual decline of \$10.1 billion in R&D investment and an annual loss of 23,400 R&D jobs thereafter.¹⁸ If the TCJA's amortization provision was shelved in favor of permanent expensing of R&D, however, the Tax Foundation estimates the United States could expect 0.15% more gross domestic product (GDP), 0.26% larger capital stock, 0.12% higher wages, and 30,600 more jobs in the long run.¹⁹

EXTEND FULL EXPENSING FOR CAPITAL EQUIPMENT

Investment in capital equipment is one of the most important drivers of future economic growth. Before the TCJA, businesses could deduct 50% of the cost of qualifying machinery and equipment in the year of purchase (so-called "bonus depreciation").^{20, 21} The TCJA amended section 168 of the Internal Revenue Code (IRC § 168) to allow the deduction of 100% of the cost of qualifying machinery and equipment in the year of purchase and also extended bonus depreciation to more investment property.²² Beginning after 2022, however, 100% bonus depreciation will phase out over a five-year period, with 80% of acquisition costs deductible in 2023, 60% in 2024, and so on.²³

Extending 100% bonus depreciation would substantially aid the recovery of the manufacturing sector, where 98.4% of firms are small businesses.²⁴ According to the Tax Foundation, making 100% bonus depreciation permanent would result in 0.9% more GDP, 2.2% larger capital stock, 0.8% higher wages, and 172,300 more jobs in the long run.²⁵ Research on the impact of comparable bonus depreciation policies from 2002 to 2012 shows similar macroeconomic effects. Researchers Zwick and Mahon found that bonus depreciation increased investment in eligible capital by 10.4%, compared to ineligible capital, between 2001 and 2004 when firms could deduct up to 30% of capital expenses. When bonus depreciation increased to 50%, investment in eligible capital increased 16.9% from 2008 to 2010 compared to ineligible capital. Moreover, small firms responded to increases in bonus depreciation "95% more than big firms," indicating the added importance of the policy for small businesses.²⁶ Finally, Garrett, Ohrn and Suárez Serrato found that local employment increased by 2.1% on average as a result of bonus depreciation from 2002 to 2012.²⁷

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SUMMARY OF PROPOSALS

To incentivize research and development activities and capital investment postponed or abandoned during the pandemic and to boost the recovery of small businesses, Congress, under the leadership of the Biden administration, should:

- Extend the immediate deduction for research and development expenditures under IRC § 174; and
- Extend 100% bonus depreciation for qualified property under IRC § 168(k).

ENDNOTES

1. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115–97, 131 Stat. 2054.
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8. IRC § 41.
9. IRC § 174, as amended by Pub. L. No. 115–97, 131 Stat. 2054 (2017).
10. See Joint Committee on Taxation, *General Explanation of Public Law 115–97*, JCS–1–18, December 2018, 145.
11. A \$100,000 R&D expenditure in 2018 would yield \$26,530 in tax savings for a corporate taxpayer.
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20. IRC § 168(k), as amended by Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (2008).

21. Bonus depreciation under IRC § 168(k) is not the only deduction for purchases of capital equipment. Full expensing under IRC § 179 and otherwise allowable depreciations under the modified accelerated cost recovery system may also apply. See Scott Mackay, Sam Weiler, and Tim Powell, "First-Year Expensing and Additional Depreciation," *Bloomberg Tax and Accounting*, <https://pro.bloombergtax.com/portfolio/first-year-expensing-and-additional-depreciation-portfolio-532/>.

22. Qualifying machinery and equipment refer to property that meets the definition of "qualified property" in IRC § 168(k)(2).

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