[JOINT COMMITTEE PRINT]

PROPOSED DEPRECIATION AND INVESTMENT TAX CREDIT REVISIONS

PART III: ANALYSIS OF SPECIFIC ISSUES

PREPARED BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet is Part III of a series of pamphlets prepared by the staff of the Joint Committee on Taxation for the use of the Congress during its consideration of the Administration's proposed depreciation and investment tax credit revisions (Accelerated Cost Recovery System) and other related capital cost recovery proposals. The Administration's original proposal is embodied in H.R. 2400 (introduced by Mr. Conable and others). The Administration has recently endorsed H.R. 3849 (introduced by Mr. Conable and Mr. Hance).

The first part of this pamphlet is a summary of the principal capital cost recovery proposals. The second part is a detailed analysis of specific issues raised by these proposals.

There are two previous staff pamphlets relating to proposed depreciation and investment tax credit revisions. Part I (JCS–18–81) presents an economic analysis of present law capital cost recovery and of various alternative capital cost recovery proposals, as well as a comparison of capital cost recovery systems in certain foreign countries. Part II (JCS–20–81) provides a detailed description of present law capital cost recovery provisions, the Administration's original capital cost recovery proposal and other alternative capital cost recovery proposals, and a comparison of estimated tax changes by industry under the various proposals.

In addition, a staff comparison document (JCS–28–81) has been prepared, which provides an item-by-item comparison of present law with the principal capital cost recovery proposals. (This document also shows a comparison of the estimated revenue effects of the alternative proposals.)

I. SUMMARY OF PRINCIPAL ALTERNATIVE CAPITAL COST RECOVERY PROPOSALS

A. "10–5–3" Proposals

1. Original Administration Bill (H.R. 2400)

The Administration has proposed the Accelerated Cost Recovery System (ACRS) as a complete revision of present depreciation and investment tax credit rules. These proposals are embodied in H.R. 2400 (sponsored by Mr. Conable and others).

The proposed depreciation revisions in H.R. 2400 would be phased in over five years.

Depreciation

Personal property

Recovery period.—The cost of tangible personal property generally would be recovered over a 10-year, 5-year, or 3-year period.

Method.—Taxpayers would use a prescribed accelerated method approximating the benefits of using the 200 percent declining balance method with a switch to the sum of the years digits (SYD) method.

3-year class.—Automobiles, light-duty trucks, and machinery and equipment used in connection with research and development.

5-year class.—All tangible personal property other than property included in the 3-year or 10-year class.

10-year class.—Public utility property with an ADR midpoint life as of January 1, 1981, of more than 18 years.

Real property

In place of the present accelerated methods of depreciation and the "facts and circumstances" approach to determining the useful lives of real proeprty, the Administration proposed to establish three classes of real property, corresponding to recovery periods of 18, 15 and 10 years.

Housing generally would be depreciated over 18 years using the straight-line method. However, low-income housing would be depreciated over 15 years using the straight-line method. The 15-year class also would include nonresidential real estate not in the 10-year class. The 10-year class would include owner-user industrial structures and retail, research, or distribution facilities. Unlike the 18- and 15-year classes, property in the 10-year class would be depreciated using an accelerated method of depreciation—the same method used for the 10-year class of personal property.

For property in the 18-and 15-year classes, the entire gain upon sale would be treated as capital gain. However, for property in the 10-year class, all depreciation allowed prior to the sale would be recaptured as ordinary income (the same rule which applies to personal property).

Investment tax credit

Eligible 5-year and 10-year property would receive a full 10-percent investment credit. Eligible 3-year property would receive a 6-percent credit.

The bill would impose an at-risk limitation on the investment credit similar to the at-risk limitation on losses under present law.

2. Revised Administration Bill (H.R. 3849)

The Administration has recently proposed a revision of ACRS embodied in H.R. 3849, which is sponsored by Mr. Conable and Mr. Hance (Administration's revised bill). The Administration's revised bill would not have a phase-in of recovery periods, but, unlike the Administration's original bill, there would be a phase-in of the prescribed accelerated method.

Depreciation

Personal property

Recovery period.—The cost of tangible personal property generally would be recovered over a 10-year, 5-year, or 3-year period, depending on the type of property. However, the taxpayer could elect to use a 25-year recovery period for 10-year property, a 12-year recovery period for 5-year property, or a 5-year recovery period for 3-year property. Theme park structures and other real property for which the taxpayer under present law may use an ADR useful life of 10 years or less would have a 10-year recovery period and would be treated in the same manner as personal property in that class for depreciation.

Method.—Taxpayers would use a prescribed accelerated method, but only if the regular recovery period is used. The straight-line method may be elected if either the regular or optional longer recovery period is used. For the years 1981–1984, the prescribed accelerated method would approximate the benefit of using the 150-percent declining balance method for the early years with a switch to the straight-line method in later years. For 1985, the prescribed accelerated method would approximate the benefit of using the 175-percent declining balance method with a switch to the SYD method. In 1986 and thereafter, the prescribed accelerated method would approximate the benefit of using the 200-percent declining balance method with a switch to SYD. The retirement-replacement-betterment method for railroads would be repealed.

3-year class.—The 3-year class under the Administration's original bill would be expanded to include all other machinery and equipment with an ADR mid-point life of 4-years or less as of January 1, 1981.

5-year class.—The 5-year class would remain the same as under the Administration's original bill, except some property that was in the 5-year class under the original bill would be placed in the 3-year class.

10-year class.—The 10-year class would be expanded to include theme park structures and other real property for which the taxpayer may use and ADR lower limit life of 10 years or less.

Equipment leasing.—The bill would provide liberalized rules for determining if a transaction involving new personal property owned by corporations is a lease. In general, the present requirement that the lessor must have a minimum at-risk investment of 20 percent of cost would be lowered to 10 percent. In addition, a transaction would not be denied treatment as a lease merely because the lessor can show a profit and a positive cash flow from the lease only if tax benefits are taken into account.

Real property

Recovery period.—Under the Administration's revised bill, real property (other than real property included in the 10-year class) would have a 15-year recovery period. A taxpayer would have the option to use a 35-year recovery period instead of the 15-year recovery period.

Method.—The cost of real property would be recovered using a prescribed accelerated method, but only if the regular 15-year recovery period is used. The straight-line method could be elected if the taxpayer used either the regular recovery period or the optional longer recovery period. The prescribed accelerated method would approximate the benefit of using the 200-percent declining balance method with a switch to the straight-line method.

Gain on disposition.—If nonresidential property in the 15-year class is depreciated under the prescribed accelerated method, all gain would be ordinary income to the extent of all depreciation previously taken. However, if the straight-line method were elected, all gain would be capital gain.

For all residential real property, gain would be ordinary income only to the extent the depreciation allowed exceeds the depreciation that would have been allowable if the straight-line method had been used. Therefore, if the straight-line method were elected, all gain would be capital gain.

Other matters

There are additional changes in the rules relating to the following issues:

(1) Depreciation of property used predominantly outside the U.S.;
(2) Computation of earnings and profits;
(3) Computation of minimum tax preference items;
(4) Public utility property;
(5) Certain railroad property; and
(6) Property used before, and purchased after, the effective date.

Investment tax credit

The investment credit rules would remain the same as under the Administration's original bill except a safe harbor from the at-risk limitation on the investment credit has been added. Under the safe harbor, the taxpayer would be considered at risk with respect to amounts borrowed from banks, insurance companies, and savings and loan associations even if the taxpayer were not personally liable to repay the debt.

Capital Cost Recovery Act of 1981 (H.R. 1053)

For most depreciable assets, the Capital Cost Recovery Act of 1981 (H.R. 1053) would replace existing depreciation and investment credit rules with a system very similar to the original Administration proposal. Unlike the Administration proposal, this bill would place all real property, except for residential real property, in the 10-year class.

Also, the 3-year class would be limited to up to $100,000 of investment in cars and light trucks.

B. Simplified Cost Recovery Systems

1. 1980 Senate Finance Committee's Bill ("2–4–7–10")

The Simplified Cost Recovery System (also called "2–4–7–10") was approved by the Senate Finance Committee last year and was embodied in the Finance Committee amendment to H.R. 5829 in the 96th Congress.

Personal property

Overview.—The bill would establish an open account system in lieu of present methods for the depreciation of most tangible personal property. Public utility property, however, would continue to be depreciated under present rules, except that the ADR useful life variance for it would be increased from 20 to 30 percent. The system would have been fully effective on January 1, 1981.

Open accounts.—Unlike present law, which generally requires separate accounting for assets placed in service in different years (vintage accounting), the bill would establish a system in which a single recovery account is provided for all property with the same recovery period. When an asset is placed in service, a taxpayer would add its costs to the account with the appropriate recovery period. When an asset is sold, no gain or loss would generally be recognized. Instead, the balance of the appropriate open account would be reduced by the amount realized from the sale, and future years' depreciation deductions would be reduced correspondingly.

Recovery period.—Tangible personal property would be assigned to one of four recovery accounts representing periods of 2, 4, 7, and 10 years. In general, property would be assigned to an account with a recovery period at least 40 percent shorter than the present ADR guideline period for the property.

Method.—A declining-balance method would be used to compute each year's depreciation deduction for all assets within a particular open account. Each year's deduction would be computed by multiplying the balance (unrecovered costs) in the account by either 200 percent, 150 percent, or 100 percent of the straight-line rate for the recovery period at the taxpayer's election. For example, for an asset in the 10-year class with a straight-line rate of 10 percent, the annual recovery percentage could be either 20 percent, 15 percent or 10 percent. The amount of the allowable deduction would then be subtracted from the account to determine the opening balance for the following year.

Investment credit.—The regular investment tax credit would be 2.5 percent for assets in a 2-year account, 6 percent for assets in a 4-year account and 10 percent for assets in a 7-year or 10-year account.

$25,000 expensing.—A taxpayer would be allowed to take an immediate deduction for the first $25,000 of expenditures each year for tangible personal property, but no investment tax credit would be allowed for such property.

Real property

The Finance Committee's bill would provide several new approaches to the depreciation of real property, as elective alternatives to present methods. First, a taxpayer could elect to depreciate any structure over a 20-year period using the straight-line method. Second, a taxpayer could elect to depreciate low-income rental housing over a 15-year period using the straight-line method. Third, certain owner-occupied business structures could be depreciated over a 15-year period using the 150-percent declining balance method, in which case the recapture rules currently applicable to depreciable personal property would apply. These 15-year and 20-year lives would be audit-proof.

2. *Modifications of "2-4-7-10"*

A capital cost recovery system using open accounts could be structured to lead to different results than the Finance Committee bill by altering the number of recovery accounts, the length of the recovery periods, the assignment of assets to recovery accounts and the investment tax credit percentage which applies to property in an account.

For example, an open accounts system could be devised which would operate like 2-4-7-10, but which would have fewer asset classes and more accelerated cost recovery, and would be more nearly neutral across different classes of assets. The system could be devised to achieve any desired effective tax rate for assets covered—the 46-percent statutory rate, a zero effective tax rate (i.e., the present value of the depreciation deductions and the allowable investment credit for each recovery class would equal expensing), or any rate in between.

C. First-Year Capital Cost Recovery System (H.R. 3443 and H.R. 3500)

Two bills, H.R. 3443 (Messrs. Shannon, Gibbons, Matsui, Stark, Ford and Downey) and H.R. 3500 (Mr. Heftel), have been introduced based on the Jorgenson-Auerbach first-year capital cost recovery system. Under these capital cost recovery systems, the capital costs of personal property would be recovered through a single deduction allowable for the taxable year in which the asset is placed in service rather than being recovered through a series of deductions spread over the useful life of the property. This first-year allowance would replace both the future depreciation deductions and the regular investment credit and ESOP credit that otherwise would be allowable for the asset.

Under both bills, energy credits would be allowed, as under present law. Long-lived public utility property would not be included under the first-year system, but would be depreciated under present rules with the ADR variance increased from 20 percent to 30 percent.

When an asset is resold, the buyer would be allowed a first-year deduction based on the resale price and the seller's ordinary income would be increased by the amount of this deduction.

Under H.R. 3443, there would be mandatory expensing for the first $25,000 of investment, beginning with investments in assets with the shortest useful lives. Under H.R. 3500, there would be mandatory expensing for the costs of short-lived assets only, without any dollar limitation.

Both bills would limit the amount of used property eligible for the first-year allowance for taxable years beginning before 1984. In addition, both bills provide phase-in rules that would defer the allowance of deductions for personal property placed in service during the first years of the proposed plan.

Real property, other than low-income housing, generally would be depreciated on a composite basis without reduction for salvage value over a 20-year period using the straight-line method. Under H.R. 3500, a 15-year recovery period could be elected for property other than low-income housing, but all previously allowed depreciation would be recaptured as ordinary income upon sale or other disposition of the property. Under both bills, low-income housing would be depreciated on a composite basis without reduction for salvage value using the straight-line method over a 15-year period.

D. Expensing

Under a system of immediate expensing, a taxpayer would be allowed to deduct the entire cost of depreciable property, whatever its useful life, in the year in which the property is placed in service. There would be no regular investment tax credit. This is the method of capital cost recovery now allowed for intangible drilling costs and research and experimentation expenditures. Expensing generally has been discussed as a possible capital cost recovery method for tangible personal property only.

A result approximately equivalent to immediate expensing could be reached in certain circumstances under a capital cost recovery system which is not organized on the principle of expensing but which does include an investment tax credit. A 10-percent investment credit can be viewed as a deduction of 21.7 cents per $1 of investment for a taxpayer whose statutory tax rate is 46 percent, because both a 10-cent credit and a 21.7-cent deduction reduce tax liability by 10 cents (46 percent of 21.7 equals 10). If the taxpayer's investment qualifies for this credit and the present value of depreciation deductions amounts to 78.3 cents per dollar invested, then the present value of the aggregate of the capital cost allowances available with respect to the asset would be one dollar—equivalent to expensing.

It would be possible to allow or require expensing for a percentage of the taxpayer's investment or for a limited amount (e.g., $25,000) of investment each year. Expensing of investments up to $25,000 per year has been recommended as a way to enable many small businesses to avoid depreciation computations altogether for tax purposes.

II. ANALYSIS OF SPECIFIC ISSUES RAISED BY CAPITAL COST RECOVERY PROPOSALS

A. Property Eligible For Investment Incentives

Present Law

Depreciation

Depreciation is based on the concept that the cost of an asset should be allocated to the period the property is used to produce income. Depreciation, therefore, is intended to permit a proper determination of net income from use of a wasting asset. Congress adopted accelerated methods of depreciation in 1954 so that the timing of depreciation deductions would be more in accord with the actual pattern of loss of economic usefulness. Congress felt that machinery and equipment typically depreciate faster and contribute more to income in the early years of use rather than the years immediately preceding retirement.

In general, property is depreciable if it is (1) used in a trade or business or for the production of income, and (2) subject to wear and tear, decay or decline from natural causes, exhaustion, or obsolescence. Land, goodwill, stock, and other assets that do not have a determinable useful life and that do not have a predictable decline in value are not depreciable.

Investment tax credit

The purpose of the investment credit is unrelated to a determination of net income. The reasons given by Congress in 1962 for allowing the credit were to (1) encourage modernization and expansion of the nation's productive facilities, (2) increase job opportunities, and (3) improve the competitive position of the United States in the world economy.

To be eligible for the investment credit, property must be depreciable and have a useful life of three years or more. Several types of depreciable property, however, are specifically excluded from eligibility for the investment credit. Eligible property does not include (1) intangible property, (2) most buildings and their structural components, (3) property used by tax-exempt organizations or governmental units or leased to one of those entities, (4) property used predominantly outside the United States, (5) property used for lodging or residential use, (6) certain oil or gas fired boilers, (7) air conditioning or heating units, (8) horses, and (9) property amortized under certain special provisions (e.g., amortization of certified historic rehabilitation expenditures under sec. 191). Also, no credit is allowed to most noncorporate lessors.

These exclusions generally reflect the desire to target the investment stimulus for the purposes outlined by the Congress. For example, assets used predominantly outside the United States were excluded because of the desire to increase job opportunities in the United States and to improve the competitive position of businesses located in the United States. Denying the credit for property leased to tax-exempt organizations for use in an exempt function ensures that the credit does not provide an indirect subsidy for tax-exempt organizations as the result of the lessor passing through the credit in the form of lower rents. The exclusion of oil or gas fired boilers and air conditioning or heating units was intended to aid in reducing the United States' dependence on oil and gas.

Issues

(1) Should property ineligible for the investment tax credit:

(a) be included in any new cost recovery system intended as an investment stimulus,

(b) be included in any new system under rules less generous than the rules applicable to property now eligible for the investment credit, or

(c) continue to be depreciated under present law rules?

(2) Should property be excluded from any new cost recovery system that is less generous than the present law rules for depreciation of that property?

Description of Proposals

Overview.—Each of the alternative cost recovery proposals would replace the existing investment credit and depreciation system with a new cost recovery system. In general, the proposed cost recovery systems would provide faster depreciation and increased investment credits to stimulate investment in productive assets.

Most depreciable property would be eligible for the new systems of depreciation. Although the useful life limitation on the amount of the investment credit would change, the eligibility requirements for the credit would remain the same as present law.

In general, any property excluded from the new systems would be subject to present law rules.

Administration bill and H.R. 1053.—Under the Administration's original (and revised) bill, property amortized and most property depreciated in terms other than years (e.g., movies depreciated under the income forecast method) would remain subject to present law. However, railroad property depreciated in terms other than years under the retirement-replacement-betterment system would be included in the cost recovery system.

H.R. 1053 differs from the Administration's bill in that railroad property depreciated under the retirement-replacement-betterment system and residential rental property would remain subject to present law rules.

Simplified cost recovery.—The 1980 Senate Finance Committee bill would exclude: (1) property amortized, (2) property depreciated in terms other than years (e.g., movies depreciated under the income forecast method and railroad property depreciated under the retirement-replacement-betterment system), (3) public utility property, (4) oil or gas fired boilers and (5) property used predominantly outside the United States. Also, the taxpayer could elect to depreciate livestock under present law.

First-year capital cost recovery.—The first-year capital cost recovery systems would exclude the same property excluded under the Finance Committee's bill, except that short-lived utility property would not be included. In addition, the first-year cost recovery system would exclude: (1) regulated oil pipelines, (2) property owned by certain noncorporate lessors, (3) real property for which an ADR life is currently prescribed, and (4) property disposed of within one year after the date the property is placed in service.

General Analysis

Overview.—The proposed cost recovery systems would deviate from the notion that depreciation is a means of recovering costs and determining income from the use of a wasting asset. Rather, the proposals for depreciation are intended to provide the same type of investment stimulus as the investment credit. However, while most property would receive faster depreciation and increased investment credits under the proposals, the combination of depreciation and investment credits for some types of property under some of the cost recovery proposals would be less generous than present law.

Exclusion of property ineligible for investment credit.—As discussed in the earlier staff pamphlet on the economic issues related to depreciation reform (JCS–18–81), the investment tax credit and accelerated depreciation are, to a large extent, interchangeable as components of a capital cost recovery system; that is, additional depreciation is a substitute for a larger investment credit and vice versa. Expending and the first-year capital cost recovery systems represent ways of allowing increased depreciation deductions in lieu of an investment credit. Since depreciation under any of the proposed cost recovery systems is intended to provide the same type of investment stimulus as the investment credit, the Committee may wish to exclude property ineligible for the credit from faster depreciation under any new cost recovery system. The cost for such property could be recovered under present law, perhaps with certain changes (e.g., an increased ADR variance). Alternatively, a new system could be established for such property but with less generous cost recovery provisions.

Present law more generous for some property.—Under present law, movies depreciated under the income forecast method and railroad property depreciated under the retirement-replacement-betterment system may receive benefits more generous than expensing because of the combination of depreciation and the investment credit. Thus, there may be a tax increase for that property if they were included in any new capital cost recovery proposal less generous than expensing.

B. Recovery Periods (or Useful Lives) for Personal Property

Present Law

Under present law, the capital cost of a depreciable asset used in a trade or business or held for the production of income generally must be recovered over the period it is used by the taxpayer, rather than in the year of its acquisition. Allowing the cost of a depreciable asset to be recovered over its useful life generally accomplishes the objective of matching the deductions for the cost of the asset with the income produced by its use, thereby permitting a proper determination of net income from use of the asset.

Under the "facts and circumstances" method, the "useful life" of the asset—the period of time in which the asset may reasonably be expected to be used by the taxpayer in a trade or business or in the production of income—is determined by the taxpayer by taking into account its experience with similar property and considering present conditions and probable future developments. The useful life for identical assets may be different for two taxpayers. For example, one taxpayer may routinely retire a particular piece of equipment after using it for 3 years, whereas, under another taxpayer's usual business practice, an identical piece of equipment may be used for 5 years.

The determination of useful life by facts and circumstances has led to many controversies between taxpayers and the Internal Revenue Service. In an effort to reduce these and other controversies, the Asset Depreciation Range ("ADR") system was enacted. Under ADR, the Treasury, through its Office of Industrial Economics, establishes and publishes estimated useful lives (guideline periods or midpoint lives) for categories of assets that have common characteristics or that are utilized in the same or related activities. These lives are supposed to be based on actual asset replacement practices being employed by taxpayers and also reflect other factors such as obsolescence. A taxpayer may generally select a useful life within a range of 20 percent less than or greater than the midpoint life for the asset.

Table 1 illustrates the useful lives of a limited number of asset classes under ADR. The useful lives for all ADR classes are set forth in Appendix A (pp. 40–47) of the preceding depreciation pamphlet (Part II: JCS–20–81).

TABLE 1.—ADR USEFUL LIVES OF VARIOUS ASSETS

Description of assets in guideline class	Asset depreciation range (in years)		
	Lower limit	Asset guideline period	Upper limit
Certain short-lived assets:			
Manufacture of glass products—special tools	2.0	2.5	3.0
Manufacture of motor vehicles—Special tools	2.5	3.0	3.5
Breeding hogs	2.5	3.0	3.5
Certain intermediate-lived assets:			
Data handling equipment except computers	5.0	6.0	7.0
Assets used in drilling of oil and gas wells	5.0	6.0	7.0
Manufacture of apparel and other finished products	7.0	9.0	11.0
Certain long-lived assets:			
Vessels, barges, tugs, and similar water transportation equipment, except those used in marine contract construction	14.5	18.0	21.5
Telephone central office equipment	16.0	20.0	24.0
Railroad hydraulic electric generating equipment	40.0	50.0	60.0

Source: Revenue Procedure 77-10, 1977-1 C.B. 548, as amended.

Issues

The accelerated capital cost recovery proposals raise the issue of whether capital costs should be recovered over periods which are established with reference to (but possibly significantly shorter than) the actual useful lives of the assets being depreciated (as is the case under present law, the Simplified Cost Recovery System and the First-Year Capital Cost Recovery System) or whether the recovery periods should be established and assigned without reference to actual useful lives (as is the case under the Administration's proposed ACRS and H.R. 1053). A related issue is whether the recovery periods should be established by the Congress in the legislation, by the Treasury on the basis of industry experience, or by taxpayers on the basis of facts and circumstances.

Description of Proposals

Original Administration bill.—Under the Administration's original bill, the capital costs of most assets would be recovered over periods unrelated to their useful lives. For example, most machinery and equipment would be in the 5-year class. Such property, under ADR, presently has midpoint lives ranging from 2.5 to 20 years. Public utility property with midpoint lives ranging from 19 to 50 years would be in the 10-year class. Autos, light-duty trucks, and machinery and equipment used in research and experimentation would be placed in the 3-year class. ADR midpoint lives for cars and light-duty trucks are 3 and 4 years, respectively. The present lives of machinery and equipment used in research and experimentation vary, depending on its type.

Revised Administration bill.—The 3-year class would be expanded to include all assets with present ADR lives of 4 years or less, e.g. special tools used in the automobile manufacturing.

H.R. 1053.—As in the Administration's original bill, the recovery periods for most assets would be unrelated to their present useful lives under H.R. 1053.

Simplified cost recovery.—Under the open account recovery system of the 1980 Finance Committee bill, the recovery periods would be specified in the legislation and would be substantially shorter than present useful lives. In contrast to the Administration's bills and H.R. 1053, however, the recovery periods for tangible personal property would be determined by reference to their present ADR midpoint lives. Under the Senate Finance Committee's bill, recovery periods for machinery and equipment would be at least 40 percent shorter than present ADR midpoint lives as set forth below:

ADR midpoint life:	*Recovery period (years)*
6.5 years or less	2
7.0 years to 11.5 years	4
12.0 years to 16.5 years	7
More than 16.5 years	10

The Treasury would have the authority to reclassify property into a shorter recovery period and to classify property not currently covered under the ADR system.

Public utility property was not included in the simplified cost recovery system and would remain under ADR. However, public utilities would be permitted to select a useful life within a range of 30 percent greater or less than the midpoint life (as contrasted with 20 percent under the present law).

First-year capital cost recovery.—Under the first-year capital cost recovery (FYCR) proposals (H.R. 3443; H.R. 3500), capital costs would not be recovered over a period of time. Rather, a first-year deduction would be allowed for most depreciable assets. The first-year deduction would be computed by multiplying the prescribed percentage for the asset's class by the adjusted basis of the property. The amount of the first-year deduction would be generally correlated with the useful life of an asset; the shorter the useful life of an asset, the greater would be the amount of the first-year deduction.

Under both H.R. 3443 and H.R. 3500, the applicable percentage for each class would be specified by the Congress in the legislation; the taxpayer would not have the option of establishing a recovery deduction based on its own projected use. However, the Treasury would be able to assign property to a different class if it determines that the first-year percentage for a different class would more accurately reflect yearly declines in the value of the property relative to other property. Also, if property does not have a present ADR guideline life, the Treasury would make the initial assignment to a class in a manner consistent with the procedure for reassignment of property to classes.

Analysis of Proposals

Overview.—Eliminating any tie between recovery periods and estimated useful lives or economic depreciation may cause different types of assets with significantly different useful lives to be subject to significantly different effective tax rates. (See discussion of "Bias across assets" in the first of this series of pamphlets on depreciation—Part I at page 18.) If assets are assigned on the basis of their actual useful lives to appropriately designed recovery classes (which may be significantly shorter than the actual useful life but which bear a relationship thereto), then neutrality across assets can be achieved. Under a properly structured system, a relatively high degree of neutrality (in a system with low effective tax rates) can be achieved with only 3 or 4 recovery classes. If, however, the committee decides to design a capital cost recovery system comparable to expensing, neutrality can be achieved with only a single asset class. Under expensing, the effective tax rate would be zero. In general, the closer the effective tax rate is to zero, the fewer are the asset classes needed to achieve neutrality.

The simplified cost recovery proposals (such as the 1980 Finance Committee bill) and the first-year capital cost recovery proposals retain a tie between the estimated useful life of depreciable property and the period used to calculate the depreciation allowances, while the Administration's bills and H.R. 1053 would generally sever that tie. However, the Administration's revised bill would generally retain some tie for assets in the 3-year class because all assets with present ADR midpoint lives of four years or less would be placed in the 3-year class.

Simplification.—An advantage of establishing recovery periods unrelated to the useful lives is that it would permit a reduction in the number of class lives from over 100 to only 3 (10, 5, and 3), substantially simplify the determination of appropriate class life, and minimize possible problems and controversies involved in selecting a class life. This is particularly true under H.R. 1053 and the Administration's bills because almost all machinery and equipment for taxpayers other than public utilities would be in the 5-year class.

Nevertheless, other proposals also permit a substantial reduction in the number of asset classes. For example, the 1980 Finance Committee version of Simplified Cost Recovery had only 4 classes (2, 4, 7, and 10 years) for all machinery and equipment other than public utility property and would still provide a greater uniformity of effective tax rates for property depreciated under the system (i.e., greater neutrality) than is provided by present law. A relatively neutral version of the Simplified Cost Recovery System could be structured using only three asset classes. The introduced bills basde on the first-year capital cost recovery system. H.R. 3443 and H.R. 3500, also have only a few classes, four and three classes, respectively. This system achieves relative neutrality, and yet the system also is designed by reference to actual useful lives.

Assigning property to recovery classes based on actual useful lives may cause controversy over appropriate useful lives. Under the present ADR system, taxpayers argue in certain cases that the class lives promulgated by the Treasury Department's Office of Industrial Economics do not (or have ceased to) accurately reflect actual asset replacement practices or obsolescence. If recovery periods are established with reference to useful lives, it would be necessary for Treasury to continue to monitor and analyze actual industry experience with all assets so that changes could be made when appropriate to ensure that an originally designed neutral system maintains its designed level of neutrality across assets. Changes in recovery periods could be left to the administrative process, or the authority to change recovery classes could be reserved by the Congress. The determination of appropriate class lives would involve at least some problems and potential for controversy, although it is not certain that either would be substantial.

Technical issues.—Depreciation over periods assigned without reference to estimated useful life presents certain problems in selecting an appropriate base to use in determining earnings and profits, in determining the tax preference for minimum tax purposes, and in the treatment of foreign assets. Under present law, these items are determined with reference to the actual lives of assets. Use of shortened recovery periods would generally be inappropriate for such determinations. Three possible alternatives are to (1) use recovery periods that are unrelated to actual useful lives but are longer than the regular recovery periods, (2) use the present law system of useful lives or (3) use a system based on the present law ADR system. Alternative number (1) is the approach taken in the Administration's original bill. Both alternatives (1) and (3) would be used in the Administration's revised bill. These issues are separately discussed elsewhere in this pamphlet.

Possible lengthening of lives.—Finally, assigning assets to recovery classes unrelated to actual useful lives creates the possibility that some assets may be assigned to recovery periods which are longer than their actual useful lives. For example, a number of categories of assets with ADR lives of less than 5 years (lower limit) would be assigned to the 5-year class under the Administration's original bill and H.R. 1053.[1] However, this would be less of an issue under the Administration's revised bill because all assets with present ADR midpoint lives of four years or less be placed in the 3-year class.

This lengthening of depreciable lives under the Administration's original bill and H.R. 1053 is, however, for most assets compensated for by the allowance of a more generous investment tax credit than allowed under present law. Under present law, assets depreciated over

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[1] These ADR asset guideline classes and the present ADR lower limits include class 00.26, tractor units for use over the road (3 years); class 01.23, Hogs, Breeding (2.5 years); Class 01.24, Sheep and Goats, Breeding (4 years); class 20.5, manufacture of food and beverage—special handling devices (3 years); class 30.11, manufacture of rubber products—special tools and devices (3 years); class 30.21, manufacture of finished plastic products—special tools and devices (3 years); class 32.11, manufacture of glass products—special tools (2 years); class 34.01, manufacture of fabricated metal products—special tools (2.5 years); class 37.12, manufacture of motor vehicles—special tools (2.5 years); class 49.121, electric utility nuclear fuel assembles (4 years).

3 or 4 years received a 3⅓-percent credit and those using a 5-year or 6-year life receive a 6⅔-percent credit. Under the Administration's bills and H.R. 1053, all assets in the 5-year class initially would receive a 10-percent credit, which would be recaptured on a pro rata basis if the asset is not used by the taxpayer in its business for the full 5 years. (In effect, this would limit the credit to 2 percent for property held for 1 year, 4 percent for property held for 2 years, etc.) However, the lives of a limited number of assets would be lengthened without a compensatory increase in the investment tax credit. For example, taxpayers are claiming useful lives as short as three years for race horses. Under present law, horses are ineligible for the investment tax credit. Under both of the Administration's bills and under H.R. 1053, horses would be placed in the 5-year class and would continue to be ineligible for the credit. The Administration's revised bill would not change this result because horses are not eligible property under the ADR system and, thus, would not be placed in the 3-year class.

C. Depreciation of Real Property

Present Law

Useful lives and methods

Useful lives.—Under present law, depreciation of real property may be determined by estimating useful lives under a facts and circumstances test or by using guideline lives prescribed under Revenue Procedure 62–21, as in effect on December 31, 1970. In general, no guideline lives have been prescribed for real property under the ADR system. However, ADR lives have been established for several types of real property, including gas stations, farm buildings, and theme park structures.

The IRS guideline lives contained in Rev. Proc. 62–21 range from 40 years for apartments to 60 years for warehouses. However, based on a 1975 study by the Treasury Department's Office of Industrial Economics, average lives claimed by taxpayers for new buildings range from 32 years for apartments to 43 years for bank buildings. (See tables 2 and 3 in the earlier staff pamphlet on depreciation proposals: Part I—JCS–18–81). The average figures reflect, in part, the fact that some taxpayers are using component depreciation.

Component depreciation.—Under the component method of depreciation, a taxpayer allocates the cost of a building to its basic component parts and then assigns separate useful lives to each of these components. These components include the basic building shell, wiring, plumbing and heating systems, roof, and other identifiable components. Each of the component parts is then depreciated as a separate item of property. The component depreciation method may be applied to both new and used property.

The use of component depreciation produces the equivalent of a relatively short composite life for the entire building if its short-lived components, such as wiring, comprise a large portion of the building's cost as compared to its long-lived components, such as the shell. However, many taxpayers do not use the component method because it is complex and, for used property, requires a competent appraisal. In addition, there is no assurance that the lives chosen by the taxpayer for the components would be approved by the Internal Revenue Service or the courts.

Methods.—New residential rental buildings may be depreciated under the declining balance method at a rate of up to 200 percent of the straight-line rate, the sum of the years-digits method, or any other method if the total depreciation allowable during the first two-thirds of the property's useful life does not exceed the amount allowable under the 200-percent declining balance method. For this purpose, a building or structure is considered to be residential rental property for any taxable years only if 80 percent or more of the gross rental income is from the rental of dwelling units. New commercial buildings may be depreciated under the declining balance method at 150 percent of the straight-line rate. Used residential property with an estimated useful life of 20 years or more can be depreciated under the declining balance method at a rate of up to 125 percent of the straight-line rate. All other used properties must be depreciated under the straight-line method.

For a discussion of the rules for the treatment of gain or disposition of real property, see "F. Gain upon disposition."

New v. used property

The guideline lives under Rev. Proc. 62–21 measure the useful lives of new buildings and other structures. It is not possible to prescribe guidelines for used buildings and other structures because the useful life of any used asset depends upon its age and condition at the time it is acquired.

Accelerated methods for used property were limited by Congress because it wanted to put greater emphasis on expanding the country's capital stock by encouraging new construction. In addition, requiring less accelerated methods for used property reduces the incentive for rapid turnover of property to maximize tax benefits.

Owner-occupied property v. leased property

Under present law, the useful lives and methods of depreciation for real property are the same, in general, whether the property is leased or owner-occupied.

Low-income housing

The IRS guideline lives for buildings or other structures used to provide living accommodations for families of low or moderate income [1] are the same as other types of residential property. However, a taxpayer may be able to show under the facts and circumstances test that the taxpayer's experience with low-income housing indicates a shorter useful life for that type of property. The taxpayer bears the burden of establishing a pattern of shorter useful lives for comparable assets.

Rehabilitation expenditures for low-income rental housing may be amortized over a 60-month period. Also, for subsidized low-income rental housing, the amount of depreciation subject to recapture as ordinary income when the property is sold is phased out by one percentage point for each month after the property has been held for 100 months.

Issues

(1) What useful lives (recovery periods) and methods should apply for depreciation of real property?

[1] Under current Treasury regulations, occupants of a dwelling unit are considered families and individuals of low or moderate income only if their adjusted income does not exceed 80 percent of the income limits prescribed by the Secretary of Housing and Urban Development (HUD). The level of eligible income varies according to geographical area. The current income limits prescribed by the Secretary of HUD for a family of four are $22,500 in Washington, D.C., $19,875 in Chicago, and $17,375 in Los Angeles. Thus, families whose incomes do not exceed 80 percent of these limits (i.e., $18,000, $15,900, and $13,900), respectively would be considered low-income.

(2) Should the composite method be mandatory for all buildings or should taxpayers be permitted to depreciate building shells and their structural components separately?

(3) Should new property be treated the same as used property?

(4) Should owner-occupied property be treated the same as leased property?

(5) Should low-income housing be treated the same as other residential property?

(6) Should residential property be treated the same as nonresidential property?

Description and Analysis of Proposals

Useful lives (recovery periods) and methods

Original Administration bill.—The Administration's original bill would give real property one of three mandatory recovery periods. Residential property, other than low-income housing, would have an 18-year recovery period. Owner-occupied industrial buildings and research, retail, or distribution facilities would have a 10-year recovery period. A 15-year recovery period would be allowed for (1) low-income housing, (2) leased industrial buildings, and leased research, retail, or distribution facilities, and (3) other nonresidential real property not included in the 10-year class.

In general, real property would be depreciated under the straight-line method. However, the accelerated method available to personal property in the 10-year class would apply to qualifying owner-occupied structures.

For most real property, the Administration's original bill would be more favorable than present law. However, certain real property covered under the present ADR system, such as theme park structures, would have a recovery period longer than present lives and would be required to use straight-line depreciation. For example, theme park structures under present law have an ADR lower limit life of 10 years and, if new, are entitled to use the 150-percent declining balance method of depreciation. However, under the Administration's original bill, those structures would be required to use straight-line depreciation and a 15-year recovery period.[2] Under proposed Treasury regulations, special purpose agricultural structures are treated as section 1250 property (Prop. Treas. Reg. § 1.48–10(h)(2)), and thus would be placed in the 10-year or 15-year class depending on whether the property is owner occupied or leased. Taxpayers have argued that this property should be treated as section 1245 property and thus included in the 5-year class.

Revised Administration bill.—Under the Administration's revised bill, most real property would have a 15-year recovery period. Theme park structures and other section 1250 property with a present ADR lower limit of 10 years or less would have a 10-year recovery period and would be treated the same as personal property in the 10-year class.

There is some question whether special purpose agricultural structures are currently treated as a farm building or other land improve-

[2] Theme park structures would not qualify as owner-occupied buildings because they are not industrial buildings or retail, research, or distribution facilities.

ment with an ADR lower limit of 20 years or as agricultural equipment with an ADR lower limit of 8 years. If the structures do not have an ADR lower limit life of 10 years or less, they would be in the 15-year class under the Administration's revised bill unless they are considered section 1245 property, which would be included in the 5-year class.

For real property (other than real property included in the 10-year class), a taxpayer would have the option to use the recovery period used to compute earnings and profits, i.e., 35 years.

In general, real property would be depreciated using rates based on a 200-percent declining balance method, with a switch to the straight-line method. However, taxpayers would have the option to use the straight-line method over either the 15-year or 35-year recovery period.

H.R. 1053.—Under H.R. 1053, nonresidential property would be placed in the 10-year category. Residential property would remain subject to present law. An accelerated method would apply to property in the 10-year class.

General analysis.—Most taxpayers in the real estate industry support proposals for reducing the period over which real property is depreciated. However, certain real estate developers and their representatives argue against allowing too rapid depreciation for real property. Developers without sources of income other than from real estate activities often will be unable to use the accelerated deductions and, thus, will be at a competitive disadvantage compared to tax shelter operations, which are designed to use all the tax benefits. There have been suggestions by some developers that Congress should adopt a 20-year useful life and a straight-line method for all real property.

Elimination of component depreciation

In general, the proposals would eliminate the component method of depreciation for real property. Thus, the recovery periods would apply to the entire building, including its structural components. However, the recovery periods for real property under the proposals are significantly shorter that the average lives claimed by taxpayers under present law, which reflect use of a component method by some taxpayers. Moreover, the recovery periods could not be challenged on audit. Requiring the composite method would greatly simplify the determination of useful lives for buildings.

Used v. new property

Under each of the proposals, new and used property would have the same recovery periods and methods.

More favorable accelerated methods are given to new construction under present law as an incentive for expanding the stock of buildings. Allowing equivalent write-offs for used buildings, would reduce the relative attractiveness of new construction versus existing buildings.

Depreciation of used real property on a more accelerated basis (either through the use of accelerated methods or shortened recovery periods) also would increase the incentive in an inflationary real estate market for rapid turnover of real estate. The incentives for rapid turnover are also due to present law rules allowing conversion of ordinary income into capital gain under the section 1250 recapture rules. The incentive is particularly great if the seller defers tax on the gain from sale of the property through installment reporting, while the buyer begins depreciating the structure using a stepped-up basis based on the assets purchase price.

Owner-occupied v. leased property

Description of proposals.—Owner-occupied industrial buildings and retail, research, or distribution facilities would receive special benefits under both the Administration's original bill (10-year recovery period and accelerated method) and the 1980 Finance Committee bill (15-year recovery period and 150-percent declining balance method). The Administration's original bill would produce a benefit for owner-occupied property roughly equivalent to using straight-line depreciation over a 6-year period as compared to 15- and 18-year straight-line for other real property.

Under the Administration's revised bill and under H.R. 1053 and the two first-year capital cost recovery proposals (H.R. 3443 and H.R. 3500), there would be no distinction between owner-occupied and leased real property.

General analysis.—Investors that own and lease real property to others argue that owner-occupied property should not be treated more favorably than leased property because it would make it much more attractive for their tenants to own their own business premises than continuing to rent. Tenants oppose special treatment for their competitors who own their own business premises because they believe that treatment would put those not in a position to own their buildings at an unfair competitive disadvantage.

Those who favor shorter lives for owner-occupied real property argue that these advantages would be appropriate to offset the advantage received when taxpayers sell real property owing to the section 1250 recapture rules. They argue that taxpayers who do not sell their property frequently, and, thus, who are unable to take advantage of this favorable treatment of gain should be compensated with more rapid depreciation if they are willing to accept the stricter section 1245 recapture rules. Section 1250 allows a relative benefit to real property by treating gain on the sale of real property as ordinary income only to the extent the gain is attributable to the accelerated portion of the depreciation allowable, even though the full amount of the depreciation would offset ordinary income in the year claimed. Thus, in effect, the section 1250 recapture rules permit ordinary income to be converted into capital gain to the extent of that portion of the claimed depreciation that does not exceed straight line.

Low-income housing

Some argue that depreciation for low-income housing should be more generous than for other kinds of real property to provide a tax incentive to invest in low-income housing and to adjust for the fact that low-income housing may have an actual useful life somewhat shorter than other residential real property.

Under the Administration's original bill and the 1980 Finance Committee bill, a 15-year recovery period and straight-line depreciation would apply to low-income housing. The 15-year recovery period would be mandatory under the Administration's original bill and optional under the Finance Committee bill.

Under the Administration's revised bill, low-income housing would have a 15-year recovery period and a 200-percent declining balance method.

Low-income housing would be favored under the 1980 Finance Committee bill because other real property generally would have a 20-year recovery period. Although low-income housing would be favored under the Administration's original bill over other residential property (15-year as compared to 18-year recovery period), it would not be favored over nonresidential property. Under the Administration's revised bill, low-income housing would be treated the same as other real property except for the recapture rules. (See "F. Gain on Disposition.")

H.R. 1053 covers nonresidential structures only and, thus, low-income housing would remain under present law, as would other types of residential property.

Under H.R. 3443 and H.R. 3500, low-income housing would be depreciated using the straight-line method over a 15-year period as compared to a 20-year period for other real property. Under H.R. 3500, taxpayers could elect to use a 15-year recovery period instead of a 20-year period for all real property.

Residential v. nonresidential buildings

A basic issue in determining the appropriate depreciation for structures is whether different types of structures should receive different treatment. Under present law, residential structures receive a preference over nonresidential structures, representing a conscious attempt by Congress to encourage housing investment. The Administration's original bill would reverse this preference in order to encourage construction of industrial and commercial buildings to improve productivity. However, residential property would be given more generous treatment than nonresidential property under the Administration's revised bill because of the recapture rules. (See "F. Gain on Disposition".)

D. Salvage Value

Present Law

Salvage value is the amount (determined at the time of acquisition) that the taxpayer estimates will be realized on the sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of income. Depreciation deductions are not allowed with respect to the cost of property that represents salvage value. This is because the cost of property representing salvage value is not wasted in producing income and is expected to be recovered on its disposition. Disputes between the taxpayer and the Internal Revenue Service have frequently arisen as to the appropriate amount of an asset's salvage value. However, a special rule permits the salvage value of depreciable personal property (other than livestock) with a useful life of three years or more to be reduced by an amount up to, but not more than, 10 percent of the asset's basis. Thus, if the salvage value of this personal property is less than 10 percent, it may be ignored.

Issue

Should the salvage value concept be eliminated?

Analysis

All of the proposed cost recovery systems would eliminate consideration of the projected salvage value of personal property in computing depreciation, even where salvage value may reasonably be expected to exceed 10 percent of the original cost of the asset. Under the Administration's revised bill, the salvage value concept also would be eliminated for real property. Thus, potential disputes as to the appropriateness of the salvage claimed by the taxpayer would be eliminated. Another consequence would be to increase and accelerate depreciation deductions because depreciation would be computed with reference to the full cost of the asset rather than its cost less its projected salvage value.[1]

For personal property subject to recapture, the increase in depreciation deductions resulting from elimination of the salvage value concept generally would not result in a permanent reduction of tax but rather would provide a timing advantage. This is because previously allowed depreciation would be recaptured as ordinary income upon a taxable disposition of the asset to the extent of any gain realized on disposition (sec. 1245). Thus, to the extent there is an increase in allowable depreciation because salvage value is not taken into account, there would generally be an increase in the amount of ordinary income realized on the asset's disposition. Under the 1980 Finance Commit-

[1] The declining balance method of depreciation under present law also permits this acceleration. Unlike the straight-line and SYD methods, the declining balance method is computed using the full cost of the asset. However, unlike the various new capital cost recovery proposals, the declining balance method under present law does not permit the recovery of costs representing the asset's salvage value.

tee's open account system, this recapture would be deferred even further because gain realized generally would not be recognized at the time of the asset's disposition, but would reduce future depreciation deductions allowable with respect to the other assets remaining in the open account.

Real property other than residential property, depreciated at the prescribed accelerated rates under the Administration's revised bill, would receive the same benefit as described above for personal property. However, in the case of residential real property subject to section 1250 recapture, the disregard of salvage value would result in a permanent tax advantage as well as a timing advantage. The depreciation attributable to the salvage value would be used to offset the taxpayer's ordinary income in the year claimed, but on the disposition of the real property, a portion of the gain attributable to these depreciation deductions would be taxed at capital gains rates.

E. Type of Account

Present Law

Under the present ADR system, the taxpayer must use vintage accounts. For assets that are not depreciated under the ADR system, the taxpayer, in general, has a choice of using item accounts or group accounts.

ADR vintage accounts

Grouping of assets.—Under a vintage account system, property is grouped according to the year the property is placed in service. For example, property placed in service in 1981 must be placed in an account separate from assets placed in service in 1982. In addition, all assets with different lives must be grouped in separate accounts. Vintage accounts may contain a single asset or a number of assets. Used property cannot be included in the same account as new property.

Method of computing allowance.—In general, a depreciation reserve must be established for each vintage account. The depreciation reserve records depreciation allowable for the account and certain other adjustments. In general, depreciation allowances must cease when the balance in the reserve equals the account base, i.e., the cost or other basis of the assets in the account less their estimated salvage value.

Gain or loss.—Under ADR, the recognition of gain or loss is postponed for assets retired, in general, for routine causes (ordinary retirements). Instead, the proceeds realized upon ordinary retirements are added to the depreciation reserve, reducing the amount of future depreciation allowances. However, whenever the depreciation reserve for the account exceeds the account base, gain must be recognized to the extent of the excess. Gain resulting from the excess is taxed first as ordinary income under the section 1245 recapture rules. Any remaining gain is treated as gain from the sale or exchange of property used in a trade or business (sec. 1231).

Although gain or loss is not recognized upon ordinary retirements, gain or loss is recognized upon a few dispositions referred to as extraordinary retirements. In general, extraordinary retirements are (1) retirements of any section 1250 real property subject to ADR, such as farm buildings; (2) retirements of section 1245 property resulting from a casualty if the taxpayer consistently treats those retirements as extraordinary; and (3) retirements of section 1245 property resulting from termination of a business or manufacturing operation, but only if the retirement (a) results from termination of a business or manufacturing operation. (b) does not result from a transfer to a supplies or scrap account, and (c) represents more than 20 percent of the basis in all assets of the same vintage and useful life in accounts affected by the retirement.

To determine the vintage, upon an extraordinary retirement, of small items that are too numerous and insignificant in value to account for individually (mass assets), the taxpayer may use a mortality dispersion table based on a statistical "bell" curve.

Group accounts and item accounts

For assets not subject to ADR, the taxpayer may use item or group accounts.[1] The rules for item and group accounts are similar to the rules for vintage accounts. However, group accounts differ from multiple asset vintage accounts in that assets placed in service in different years may be grouped together in the same account. Item and group accounts have rules for normal and abnormal retirements that are similar to the rules for ordinary and extraordinary retirements for ADR assets, in terms of gain on disposition and use of a separate depreciation reserve. However, the term abnormal retirement is somewhat broader than the term extraordinary retirement in that an abnormal retirement includes a retirement occurring for any cause not contemplated in determining useful life.

Issue

Should accounting for depreciation continue to be determined under the existing system, or should that system be replaced by an asset-by-asset account system or, alternatively, an open account system?

Description and Analysis of Proposals

Overview.—None of the proposals would retain the existing system. The Administration's original (and revised) bill and H.R. 1053 would adopt an asset-by-asset account system, and the 1980 Finance Committee bill would adopt an open account system. Depreciation accounts, as such, would not be required under first-year capital cost recovery systems because all deductions allowable with respect to an asset would be taken in the year it is placed in service.

Administration's bill and H.R. 1053.—Under the asset-by-asset system adopted by the Administration's original (and revised) bill and H.R. 1053, separate accounts would be required for each year assets are placed in service and for assets with different recovery periods. For example, 5-year recovery property would be placed in an account separate from 3-year recovery property, and 3-year property placed in service in 1981 would be placed in an account separate from 3-year property placed in service in 1982. However, new and used property could be placed in the same account.

In contrast to the existing system, gain or loss determinations and recapture determinations would be required under the Administration's bill and H.R. 1053 for ordinary or normal retirements, as well as other dispositions. Also, unlike the present accounting system, which generally permits a determination of gain or loss for the account as a whole, the Administration's proposal would require that the adjusted basis of each asset in the account be established for determining gain or loss. The unadjusted basis of each asset in the account would be removed upon its disposition. A special rule would permit the taxpayer to keep the adjusted bases of mass assets in the account if upon disposition the taxpayer elects to include the proceeds in ordinary income for the taxable year of disposition.

Simplified cost recovery.—Under the 1980 Finance Committee bill's open account system, all new or used recovery property with the

[1] In addition to group accounts, present law allows use of "classified" and "composite" accounts under which assets may be grouped in those accounts without regard to useful lives.

same recovery period would be placed in the same open account regardless of the year of acquisition. Thus, for personal property, the taxpayer would maintain only four accounts, i.e., one for each of the four categories of recovery property (2, 4, 7, and 10-year categories). The balance in the account would be decreased by depreciation allowed for a taxable year and by the proceeds from disposition of assets from the account. The account balance would be increased by the addition of assets to the account.

In general, no gain or loss would be recognized under an open account system upon any disposition of an asset. Rather, at the end of each year, the amount realized from dispositions during the year would reduce the balance in the account. If the account balance were reduced below zero, the negative amount would be reported as ordinary income. The amount of income reported would increase the balance in the account back to zero.

Since gain or loss would not be recognized on individual dispositions, a computation of the adjusted basis of each asset normally would be unnecessary, unlike under the Administration's bill and H.R. 1053. Also, unlike the present system, it would be unnecessary to determine whether any particular retirement was ordinary or extraordinary.

The position of the American Institute for Certified Public Accountants (AICPA) regarding types of accounts is represented by the following excerpt from its Statement of Tax Policy No. 7:

> By adopting the pooled-account concept, [an open-ended account system] offers a great deal of simplicity in operation. Not only are the accounting procedures relatively easy to understand and apply, but the handling of dispositions of property is greatly simplified. Of all the alternatives considered, this approach would be the simplest in operation. (Statement of Tax Policy No. 7, "Analysis of Capital Cost Recovery Proposals," pages 24–25.)

The AICPA has specifically recommended open accounts for small businesses because they generally lack adequate resources to administer more complicated systems. The open account system has also been adopted as part of the Canadian system of cost recovery.

F. Gain or Loss Upon Disposition

Present Law

In general, a taxpayer recognizes gain or loss upon each sale or other disposition of depreciable property.

Upon the recognition of gain from the disposition of depreciable personal property (and certain real property—generally property that is eligible for the investment credit), gain is "recaptured" as ordinary income to the extent of the depreciation taken (sec. 1245). Generally, in the case of real property, gain is subject to recapture as ordinary income to the extent of depreciation (or amortization) in excess of straight-line depreciation. If real property is not held for more than 12 months, gain is recaptured to the extent of all depreciation or amortization allowed, including straight-line depreciation. Any gain realized on the disposition of personal or real property in excess of the amount recaptured as ordinary income is treated as long-term capital gain (sec. 1231). A loss, however, would be treated as an ordinary loss.

Issues

property be structured to encourage or discourage property transfers, or should such treatment be neutral?

Description of Proposals

Original Administration bill.—Under the Administration's original bill, gain or loss would be recognized on each disposition of property, including ordinary and normal retirements, unless other provisions of the Code provide for nonrecognition. The Administration's bill also provides a special rule, similar to present law, that permits the deferral of gain recognition on dispositions from mass asset accounts.

Gain recognized on the disposition of personal property and owner-user building would be ordinary income to the extent of prior recovery deductions taken (sec. "1245 recapture").

Upon the disposition of real property with 18-year and 15-year recovery periods, gain or loss would be recognized, but such gain or loss would be capital gain or loss. There would be no recapture of accelerated deductions in excess of straight-line deductions (sec. 1250) because only the straight-line method would be used in computing the depreciation deduction for such property. The use of shortened recovery periods would not be treated as a form of accelerated depreciation.

Revised Administration bill.—Under the Administration's revised bill, the treatment of gain on the sale of personal property would be the same as under present law and the original bill. Owner-user buildings, however, would not be treated as personal property under the revised bill. Real property with an ADR lower limit useful life of 10 years or less, such as theme park structures, would be treated as personal property in the 10-year class under the revised bill, and therefore would be subject to section 1245 recapture.

Nonresidential real property (other than real property in the 10-year class) would be subject to two different recapture rules, depending on the method of depreciation used to compute the capital cost recovery allowance. If the prescribed accelerated method is used, gain would be treated as ordinary income to the extent of all depreciation taken. This is the same recapture rule used for personal property under present law. If the straight-line method is used, none of the gain would be treated as ordinary income. This is the rule for real property under present law.

For residential real property, gain would be treated as ordinary income only to the extent the depreciation allowed exceeds the depreciation that would have been allowable under the straight-line method. For low-income housing, this recapture of excess accelerated depreciation would be phased out so there would be no recapture if the building was held 100 months or more before being sold. The recapture rules for residential buildings under the revised bill are the same rules that apply under present law.

H.R. 1053.—Under H.R. 1053, the recognition of gain or loss upon dispositions would be the same as under the Administration's bill. The recapture rules for personal property would also be the same as under the Administration's bill and present law. The present law recapture rules for personal property would be applied to dispositions of real property so that all previously allowed depreciation would be characterized as ordinary income to the extent of any gain recognized.

Simplified cost recovery.—Under the 1980 Finance Committee bill, there would be no recognition of gain or loss upon disposition of personal property unless the disposition reduces the open account balance below zero. In those cases, the amount of the negative balance would be recaptured as ordinary income. Otherwise, dispositions would reduce the account balance by the amount of the proceeds realized, thereby reducing future depreciation allowances for other assets in the account.

First-year capital cost recovery.—Under the first-year capital cost recovery bills (H.R. 3443 and H.R. 3500), gain would be recognized for each disposition. Upon the disposition of property, a portion of the fair market value of the property or the amount of the proceeds from the sale or exchange would be treated as ordinary income. The portion that would be treated as ordinary income would be the applicable percentage used to determine the first year capital recovery allowance for the property. For example, assume a taxpayer buys an asset for $100 and deducts $80 based on an applicable percentage of 80 percent. If 20 years later the taxpayer sells the asset for $50, $40 would be treated as ordinary income. The purchaser would receive an offsetting first-year deduction of $40 if the asset is eligible property in the hands of the purchaser.

General Analysis

One desirable feature of a tax system is that the tax law not provide incentives either to sell or not to sell depreciable assets. Whether the net effect of the law provides an incentive to sell or not to sell depends on interest rates, rates at which properties increase or decrease in price, installment sales rules, depreciation rules, the tax treatment of interest expenses, and tax rates applied to gains realized on sales.

Incentives under present law.—Present law provides a complex set of incentives and disincentives to sell or exchange depreciable property. A tax on any realized gain discourages sales of assets. Under present law, this disincentive is strongest for personal property, which is subject to recapture rules that treat realized gain as ordinary income to the extent of previously allowed depreciation. The disincentive is not as great for sales of real property, which are subject to a milder form of recapture that treats gain as ordinary income only to the extent of previously allowed depreciation in excess of what would have been allowed using the straight-line method.

However, present law also provides some incentives to sell. Upon the sale of depreciable property, the purchaser's depreciable basis is the amount paid for the property. Therefore, to the extent the seller recognizes gain on the sale (purchase price in excess of the seller's adjusted basis) the purchaser will have a depreciable basis greater than what was available to the seller. The amount of depreciation deductions available to the purchaser will equal the amount of depreciation deductions that would have been available to the seller plus the amount of gain recognized by the seller. However, if the seller is taxed on the gain at capital gains rates or is able to defer recognition of the gain through installment sales treatment, the value of the additional tax benefits to the purchaser can be greater than the burden of the additional tax on the seller, and there will be an incentive to sell the property even if the sale would not have been profitable in a world without any tax system at all.

Personal property.—The character of gain realized on the disposition of personal property would generally be the same as under present law for both Administration bills. The 1980 Finance Committee bill and the first-year capital cost recovery bills would provide that all gain on the sale of personal property would be recaptured as ordinary income. This would provide a stronger disincentive to sell depreciable personal property, but arguably is a more "neutral" rule because both the seller's gain and the buyer's depreciation deduction would be ordinary.

The recapture rules of the 1980 Finance Committee bill and the first-year capital cost recovery bills would also be neutral in terms of the timing of the tax on gain. That is, the timing of the seller's gain and the buyer's depreciation deductions generally would be matched. Under the 1980 Finance Committee bill, the matching would not necessarily be perfect, because the buyer and seller may use different recovery periods for the property and may elect to use different declining balance methods. Both gain and deductions, however, would be spread by operation of the capital cost recovery system. Installment sales treatment would not be available to defer gain on the sale of eligible property. The first-year capital cost recovery bills would match gain and deductions. The amount, the character, and the timing of the seller's gain and the buyer's deductions would be matched because the seller would recognize ordinary income at the same time and in the same amount as the buyer's deduction.

Real property.—The character of gain on the disposition of real property generally would be changed under all the proposed revisions of real property depreciation. In the case of residential real property, gain generally would be treated as ordinary income only to the extent prior depreciation taken exceeds straight-line depreciation. This is the rule under present law. However, because the recovery periods for residential real property generally would be shortened to periods of 10 to 20 years under the proposals, and salvage value limitations would be eliminated under some proposals (the Administration's revised bill and the first-year capital cost recovery bills), the amount of straight-line depreciation that would be taken in the first 15 to 20 years of a building's useful life would be more than the straight-line depreciation available in those years under present law. This additional depreciation would not be recaptured as ordinary income under any of the proposals (except H.R. 3500). Therefore, the potential for converting ordinary income into capital gain would be increased, and the incentive to dispose of residential real property would be increased. Under H.R. 3500, if a 15-year recovery period were used for low-income housing or a 20-year recovery period were used for other residential real property, prior depreciation taken would not be recaptured, and there would be an increased incentive to dispose of such property. However, if a 15-year recovery period were elected for residential real property other than low-income housing, all prior depreciation would be subject to recapture as ordinary income.

In the case of nonresidential real property, the proposals generally provide that all previously taken depreciation would be recaptured as ordinary income if especially short recovery periods or accelerated methods are used. Thus, under H.R. 1053, which provides a 10-year recovery period and a very accelerated method for nonresidential buildings, all depreciation on nonresidential buildings would be subject to recapture as ordinary income. Under the Administration's original bill and the 1980 Finance Committee bill, special shortened recovery periods and accelerated methods would be prescribed or made available for qualified owner-user buildings. Under the Administration's original bill, the special recovery period and accelerated method would be prescribed and there would be recapture of all depreciation taken. Under the 1980 Finance Committee bill, the special recovery period and accelerated method would be elective, but if elected, all depreciation taken would be subject to recapture as ordinary income.

Under the Administration's revised bill, all real property could be depreciated using an accelerated depreciation method over a 15 year recovery period (10 years in the case of certain real property eligible for ADR). For nonresidential real property in the 15-year class, unlike residential real property, all depreciation taken would be subject to recapture as ordinary income if the accelerated method were used. For real property in the 10-year class, all depreciation taken would be subject to recapture regardless of the method used. Similarly, under H.R. 3500, a special shortened recovery period would be available for all real property. If the shortened recovery period were elected for nonresidential real property, all depreciation would be subject to recapture. Thus, to the extent that accelerated capital cost recovery allowances are prescribed or made available for nonresidential real property, the various proposals would neutralize the effect of such allowances that encourage property transactions.

Under the proposals that would make some increased recovery allowances for nonresidential real property elective (the Administration's revised bill, the 1980 Finance Committee bill, and H.R. 3500), none of the depreciation taken would be subject to recapture if the special recovery period or accelerated method is not elected. Similarly, under proposals that would prescribe straight-line depreciation over "normal" recovery periods for some or all nonresidential real property (the Administration's original bill, the 1980 Finance Committee bill and H.R. 3443), none of the "normal" depreciation taken would be subject to recapture as ordinary income. To the extent that the "normal" recovery period (whether elected or prescribed) is shorter than the useful life permitted under present law, the potential for conversion of ordinary income to capital gain would be increased, as in the case of residential real property described above.

G. Earnings and Profits

Present Law

A dividend is defined under present law as a distribution of property (which includes money) by a corporation to its shareholders out of either current or accumulated earnings and profits. If a distribution exceeds the corporation's earnings and profits, the excess is a "tax-free dividend" (not currently taxable to the shareholder) which reduces his cost basis in the stock (increasing capital gain or reducing capital loss if the stock is sold by him). Until 1969, earnings and profits generally were computed by reference to the method of depreciation used in computing the corporation's taxable income and so were reduced by the amount of depreciation deducted by the corporation on its return.

In the Tax Reform Act of 1969, Congress addressed the problem of how accelerated methods of depreciation affected earnings and profits. Accelerated depreciation deductions reduced a company's earnings and profits, thereby often allowing tax-free distributions. Tax-free dividends from accelerated depreciation—in effect resulting in current avoidance of tax at ordinary income rates in exchange for possible postponed tax at long-term capital gains rates—appeared to be increasing in a number of industries, especially among utilities.

Congress decided that corporations should not be allowed to continue to make these types of non-taxable distributions. Therefore, the 1969 Act amended the Code to require that, for purposes of computing its earnings and profits, a United States corporation must compute depreciation on a straight-line method or similar ratable method such as unit-of-production or machine-hours method. The use of the 20-percent ADR variance is not considered an acceleration of depreciation deductions for this purpose and therefore may be used to compute earnings and profits. These rules do not apply to foreign corporations if less than 20 percent of gross income for the taxable year is derived from sources within the United States.[1]

The 1969 Act greatly reduced the number of corporations paying tax-free dividends. However, in recent years, tax-free dividends have reappeared, in part as a result of the low profits of some electric utilities and in part as the result of the use of ADR lower limit lives in computing earnings and profits.

Issues

Should a company's earnings and profits be computed using depreciation allowances greater or less than those used under present law,

[1] To have applied these rules to foreign corporations would have reduced the amount of the deemed paid foreign tax credit and would have raised similar problems under other provisions of the Code relating to the determination of earnings and profits of a foreign corporation. Congress decided that these very substantial changes in the taxation of operations conducted through foreign corporations would not be appropriate.

thereby increasing the potential for changing the character of distributions to shareholders from taxable to tax-free and vice-versa?

If it is desirable that the present law character of distributions to shareholders not be substantially changed, should present law rules be retained for the computation of earnings and profits or is there an alternative method that would be simpler to use in connection with a revised capital cost recovery system?

Description and Analysis of Proposals

Original Administration bill.—Under the Administration's original bill, earnings and profits would be computed using straightline depreciation for both recovery property and real property. The recovery periods used to compute earnings and profits would be longer than the recovery periods used to compute the recovery allowance. The extended recovery periods that would be used to compute earnings and profits are as follows:

Category	*Extended recovery period*
3-year property	5 years
5-year property	10 years
10-year personal property	20 years
Real property	30 years

The Administration's original bill would provide for the use of extended recovery periods and straight-line depreciation in computing earnings and profits because using the accelerated methods and shortened useful lives under ACRS would greatly increase the incidence of corporations paying tax-free dividends, at least for those corporations that currently make large distributions in relation to earnings and profits.

The use of extended recovery period in lieu of present law useful lives has the advantage of achieving the simplicity and certainty of recovery periods that are not subject to dispute. If such recovery periods were not used, one alternative would be to use present law useful lives to compute earnings and profits, although this would offset some of the simplification and elimination of controversy achieved by abandoning a useful life system in computing taxable income. To the extent that the extended recovery period is longer than the present law useful life of the asset (typically, the ADR lower limit), the taxpayer's earnings and profits will be shifted to earlier years as compared to present law; to the extent the extended recovery period is shorter than present law useful life, the taxpayer's earnings and profits will be shifted to later years, relative to present law. In the case of domestic corporations, the shift of earnings to later years or earlier years would have significant impact only when earnings and profits would otherwise have been exhausted under present law. The effect of such a shift would be to convert what would have been dividends to tax-free distributions or vice versa.

Revised Administration bill.—Under the revised bill, the extended recovery periods would be 5, 12, 25, and 35 years. This lengthening of recovery periods used to compute earnings and profits would reduce the instances in which such periods are shorter than present law useful lives, and would thereby reduce the instances in which taxable distributions under present law would be converted to tax-free distributions.

Simplified cost recovery.—Under the 1980 Finance Committee bill, earnings and profits would be computed using the normal recovery periods and a 100-percent declining balance method. The 100-percent declining balance method is slower than the straight-line method in cases where salvage value is negligible. If salvage value is substantial, the 100-percent declining balance method is more accelerated than the straight-line method. Thus, the 1980 Finance Committee bill would require earnings and profits to be computed using a recovery period that is generally at least 40 percent shorter than present law useful lives, but using a method that is slower than straight-line in many cases, thereby attempting to approximate the present law computation of earnings and profits.

H.R. 1053.—Under H.R. 1053, earnings and profits would be computed using the prescribed recovery periods, which are generally but not always shorter than present law useful lives, and the straight-line method. This could have significant effect for taxpayers with long-lived assets, whose recovery periods would be substantially shortened under H.R. 1053. The result could be similar to the situation before the 1969 Act when certain taxpayers could eliminate earnings and profits through depreciation and make tax-free distributions to shareholders.

First-year cost recovery.—Under H.R. 3443 and H.R. 3500, earn-and profits would be computed as under present law.

H. Assets Used Predominantly Outside the United States

Present Law

Property used predominantly outside the United States generally may be depreciated using accelerated methods of depreciation. However, such property is generally not eligible to use the 20 percent variance from the ADR midpoint lives. An investment tax credit is generally not allowed for such foreign assets (sec. 48(a)(2)). When Congress provided for the investment tax credit in the Revenue Act of 1962, the House and Senate committees explained that the primary purpose of the credit was to encourage investment in the United States.

Issues

The issues raised are (1) whether it is appropriate to distinguish between property used in the United States and property used outside the United States, (2) whether this distinction should apply not only to shortened useful lives but also to accelerated methods, and (3) whether depreciation allowances for foreign assets should be significantly different than under present law.

Description of Proposals

Original Administration bill.—Under the Administration's original bill, property used predominantly outside the United States would be depreciated using straight-line depreciation and longer recovery periods than the recovery periods for identical assets used predominantly inside the United States. The extended recovery periods for recovery property used predominantly outside the United States are as follows:

Category	*Recovery period*
3-year property	5 years
5-year property	10 years
10-year personal property	20 years
Real property	30 years

The rationale for the denial of ACRS benefits for foreign assets is the same as for the investment credit exclusion and denial of the 20-percent ADR variance, i.e., the purpose of ACRS is to encourage capital investment in the United States, partly to improve the ability of businesses operating in the United States to compete with businesses operating abroad. On the other hand, some would argue that increased U.S. business activity abroad provides an increased market for U.S. goods and creates jobs in the United States.

Although the Administration's bill would deny the benefits of ACRS to most foreign assets, requiring the use of extended recovery periods also could deny taxpayers some of the benefits of present law rules. This is due to the fact that the extended recovery periods were selected without reference to actual useful lives and for many assets are longer than present law useful lives. In addition, foreign assets would not be eligible for accelerated methods of depreciation as they are under present law. It should also be noted, however, that for relatively long-lived assets the extended recovery periods may be substantially shorter than present law lives. Thus, for some businesses operating overseas, ACRS could provide significant benefits, while for others it would cause a tax increase.

Revised Administration bill.—Under the Administration's revised bill, foreign assets that would otherwise be 3-, 5-, or 10-year recovery property would be depreciated using ADR midpoint lives as of January 1, 1981, and an accelerated method based on the 200-percent declining balance method in the first year and the sum of the years-digits method in all later years. To provide flexibility, taxpayers may elect to use the straight-line method over either the ADR midpoint life or, if longer, the extended recovery period used to compute earnings and profits. The revised bill would, therefore, leave the depreciation treatment of foreign personal property essentially as it is under present law. Real property would be depreciated over a 35-year period using either prescribed accelerated method or the straight-line method.

Other proposals.—Under H.R. 1053, foreign assets would be treated the same as assets used in the United States. This treatment would result in a significant acceleration of depreciation deductions with respect to the foreign operations of many United States businesses Under the 1980 Finance Committee bill and also under the first-year capital cost recovery bills (H.R. 3443 and H.R. 3500), foreign assets would not be included as eligible property but would continue to be depreciated under present law rules.

I. Add-on Minimum Tax and Maximum Tax

Present Law

Prior to 1969, there were large variations in the tax burdens of individuals or corporations with similar economic incomes. In general, those individual or corporate taxpayers who received the bulk of their income from personal services or manufacturing were taxed at effectively higher tax rates than others. On the other hand, individuals or corporations that received the bulk of their income from such sources as capital gains or that could benefit from net lease arrangements, accelerated depreciation, percentage depletion, or other tax-preferred activities tended to pay lower rates of tax. In extreme cases, individuals enjoyed large economic incomes without paying any tax. Similarly, a number of large profitable corporations paid either no tax or taxes which represented very low effective rates.

In response, Congress included in the Tax Reform Act of 1969 a provision for a minimum tax on specified tax preference income.

As subsequently modified, a 15-percent minimum tax is imposed on the amount of a taxpayer's tax preferences in excess of the greater of (1) $10,000 ($5,000 in the case of married individuals filing separately), or (2) the amount of the regular income tax in the case of a corporation or one-half of the amount of the regular income tax in the case of an individual.[1]

One of the items of tax preference subject to the minimum tax is accelerated depreciation on leased personal property.[2] The preference is the amount by which the depreciation (or amortization) allowable with respect to an asset for the year exceeds the depreciation deduction which would have been allowable if the property had been depreciated using the straight-line method over its useful life. If the leased property is depreciated under the ADR system and the taxpayer chooses to use a life shorter than the midpoint life, depreciation attributable to the shorter useful life is included in the amount of the preference. Thus, additional ADR depreciation is a preference even if the straight-line method is used rather than an accelerated method. Accelerated depreciation on leased personal property is not a preference item for corporations other than personal holding companies and subchapter S corporations.

Another preference item is accelerated depreciation on real property, i.e., the excess of the depreciation (or amortization) allowable for the year in excess of the depreciation that would have been allowable for the year computed using the straight-line method over the

[1] This minimum tax is sometimes called the 15-percent "add-on" minimum tax (under sec. 56) and is different from the alternative minimum tax (under sec. 55), although it has the same general purposes.

[2] For this purpose, the term "personal property" means property which is subject to depreciation recapture under section 1245.

property's useful life. This item is a tax preference for all taxpayers whether the property is leased or the taxpayer uses the real property in his own business.

Under present law, the maximum marginal tax rate on taxable income from personal services is 50 percent (sec. 1348). However, the amount of personal service income subject to the maximum tax is reduced, dollar-for-dollar, by the amount of a taxpayer's preference items. Thus, a taxpayer's preference items not only are subject to a separate minimum tax but also may cause part of a taxpayer's personal service income to be taxed at a marginal rate greater than 50 percent.

Issue

Which benefits, if any, resulting from accelerated cost recovery should be preferences subject to the minimum tax and how should the preferences be measured?

Description of Proposals

Leased personal property

Original Administration bill.—Under the Administration's original bill, for leased personal property, depreciation allowed for a taxable year in excess of that which would be allowable for the year if the taxpayer had depreciated the property using the straight-line method over its extended recovery period would be a minimum tax preference item. The extended recovery period would be 5 years for 3-year property, 10 years for 5-year property, and 20 years for 10-year property. This minimum tax provision would not apply to corporations other than subchapter S corporations and personal holding companies.

Revised Administration bill.—Under the Administration's revised bill, the recovery periods used as a base to compute the minimum tax preference generally would be shorter than the base periods under the original bill. For noncorporate lessors of machinery and equipment in the 3-year, 5-year, and 10-year classes, the preference would be the excess of the recovery deductions taken over the deduction which would be allowable based on the straight-line method over 5, 8, and 15 years respectively, rather than 5, 10, and 20 years respectively under the original bill.

H.R. 1053.—Under H.R. 1053, accelerated depreciation would be a preference item only for leased personal property in the 5-year class. There would be no preference for accelerated depreciation on cars and light-duty trucks in the 3-year class; there would be no personal property assigned to the 10-year class. The measure of the preference under H.R. 1053 would be the excess of depreciation taken over that which would have been allowable using straight-line depreciation over the regular recovery period (i.e., 5 years). Accelerated depreciation would not be a preference item for corporations other than subchapter S corporations and personal holding companies. However, accelerated depreciation on leased property would not be a preference item if the property is manufactured or produced by the taxpayer.

Simplified cost recovery.—Under the 1980 Finance Committee bill, accelerated depreciation on personal property leased by noncorporate lessors and subchapter S and personal holding company lessors would likewise continue to be treated as a preference item. The amount of the preference would be the amount by which that portion of the recovery deduction attributable to leased property exceeds the deduction which would have been allowable as a recovery deduction for such property if it were computed using the 80-percent declining balance method, rather than the 200, 150 or 100-percent method actually used. This manner of determining the tax preference generally was designed to take into account both the use of accelerated methods and the shortened recovery periods.

First-year capital cost recovery.—Neither of the first-year capital cost recovery bills (H.R. 3443; H.R. 3500) has a provision amending present law minimum tax provisions.

Real property

Of the capital cost recovery bills, only H.R. 1053 and the Administration's revised bill would treat accelerated depreciation on real property as a preference item.

Under H.R. 1053, accelerated depreciation on leased real property in the 10-year class (commercial and industrial buildings) would be an item of preference. The measure of the preference would be the excess of accelerated depreciation allowed over that which would be allowable for the year had the taxpayer depreciated the property using the straight-line method over the 10-year recovery period.

Under the Administration's revised bill, the amount of the preference for accelerated depreciation on 15-year real property would be the amount by which the depreciation deduction for the year exceeds the deduction that would be allowable had the property been depreciated using the straight-line method over the 15-year recovery period.

Neither of the bills would create a preference for the accelerated depreciation allowable for real property attributable to recovery periods shorter than the properties' actual useful lives.

Maximum tax

Under H.R. 1053, the amount of a taxpayer's preference items attributable to accelerated depreciation would reduce, on a dollar-for-dollar basis, the amount of the taxpayer's personal service income eligible for the maximum tax.

Under the Administration's revised bill, there would be no offset of personal service income eligible for the maximum tax because the maximum rate on all income would be 50 percent effective for taxable years beginning in 1982.

Under the Administration's original bill, the 70 percent maximum rate on unearned income would be reduced in stages to 50 percent effective for taxable years beginning in 1984. Thus, the impact of preference income on personal service income eligible for the maximum tax would be reduced each year until 1984 when it would be eliminated entirely.

Although the Senate Finance Committee's bill would not have reduced the 70 percent maximum rate on unearned income to 50 percent, the amount of the taxpayer's personal service income subject to the 50 percent maximum rate would have been unaffected because the accelerated depreciation preference item would not be an offset for maximum tax purposes.

Analysis of Proposals

Mandatory nature of minimum tax.—The first issue raised by the Administration's original bill and H.R. 1053 is that, under these bills, noncorporate lessors would automatically have preference items for recovery deductions on leased personal property. Under present law, a taxpayer can avoid paying the minimum tax by not electing accelerated methods or a useful life shorter than the ADR midpoint. Under these two bills, a taxpayer could not use less accelerated methods or a longer recovery period. Some persons would argue that it would be inequitable to force taxpayers to use accelerated methods and shortened recovery periods and then subject them to what is viewed by some as a penalty tax, i.e. the minimum tax, on the benefits of such acceleration.

The result under the 1980 Finance Committee bill would be substantially lessened because the taxpayer could choose to use the 200-150- or 100-percent declining balance method to calculate the recovery deduction. Thus, taxpayers could reduce the amount of the preference by selecting a declining balance method less than 200-percent. However, the preference could not be eliminated entirely even if the 100-percent method were selected because the method used to compute the preference under the bill would be the 80-percent declining balance method. The 80-percent declining balance method was designated by the Committee to be used in computing the amount of the preference to take into account the shortened recovery periods under the bill.

Under the Administration's revised bill, a taxpayer could elect to use the straight-line method and extended recovery periods to compute the recovery deduction for personal property and the straight-line method over the regular 15-year recovery period for real property, thereby eliminating any possibility of preference items for depreciation.

Relation to useful life concept.—For present minimum tax purposes shelter potential (i.e., a potential that tax deductions will exceed income from the activity and will be able to "shelter" some or all of the taxpayer's income from other activities as well) is viewed as arising when the taxpayer claims depreciation faster than straight-line depreciation over the asset's actual useful life. If this concept were to be continued under a new cost recovery system, the useful life concept (or a variation) would need to be retained. However, if useful lives are abandoned for depreciation purposes, the use of other recovery periods may provide a practical, if less exact, way of determining the minimum tax preference amount.

The present law minimum tax concept applies with much less exactness to the preferences determined under ACRS because recovery periods and extended recovery periods are not related to useful lives. For example, under the Administration's original bill, the preference for an asset in the 5-year class would be the excess of the recovery deduction over that which would be allowable if the depreciation had been calculated using the straight-line method over the 10-year extended recovery period. This would be true even though the 10-year extended recovery period (applicable for assets in the 5-year class) would apply to assets with actual useful lives as short as 2.5 and as long as 28 years. On the other hand, the preference for an asset in the 3-year class would be the excess of the recovery deduction allowed over that which would be allowable if the depreciation had been calculated using the straight-line method over a 5-year extended recovery period. Present ADR mid-point lives for assets in the 3-year class range from 2.5 years to 4 years.

Under the Administration's revised bill, the base periods used to compute the amount of the preference also would be generally unrelated to the actual useful lives of the property. These extended recovery periods would be 5 years for 3-year property, 8 years for 5-year property, and 15 years for 10-year property. Except for property in the 3-year class, these extended recovery periods are shorter than the extended recovery periods under the original bill. Although the extended recovery period would not be changed for the 3-year class, some assets that would be assigned to the 5-year class under the original bill would be placed in the 3-year class under the revised bill. Under the revised bill, all assets with an ADR midpoint of 4 years or less would be placed in the 3-year class. This would mean that the preference for such assets would be calculated using a period longer than the asset's useful life, thereby creating greater preference income than under present law. However, for these assets, with actual useful lives of 4 years or less, this burden would be lessened as compared to the Administration's original bill under which the base period used to compute the preference would have been 10 years.

Nevertheless, given the general policy under ACRS of abandoning useful lives for depreciation purposes, the use of extended recovery periods may provide a practical, if less exact, way of determining the minimum tax preference amount. It would be somewhat inconsistent with the goals of ACRS to maintain useful life criteria solely for the function of determining preferences for the minimum tax.

Impact on maximum tax.—The impact of the amount of a taxpayer's preference item on the amount of the taxpayer's personal service income eligible for the maximum tax will be eliminated to the extent that the 70-percent maximum rate on unearned income is reduced to the 50-percent maximum rate applicable for personal service income.

J. Investment Credit Rate and Recapture

Present Law

Useful life limitation on amount of credit.—The investment tax credit is generally 10 percent of a taxpayer's qualified investment. However, for assets with useful lives of 5 or 6 years, the credit is 6⅔ percent, and it is 3⅓ percent for assets with lives of 3 or 4 years. No credit is allowed for assets with useful lives shorter than 3 years. These limitations on the credit for short-lived assets were enacted to counteract what would otherwise have been a bias in favor of short-lived assets if all assets received the full 10-percent credit.

Recapture.—In order to prevent circumvention of the useful life limitations, the credit must be recomputed if the property is disposed of prior to the end of its estimated useful life ("recapture"). The recomputed credit is based on the amount of credit the property would have received if the credit had been based on the actual time the property was held. The recapture rules are intended to prevent a quick turnover of assets for additional credits.

Issues

(1) Should the amount of the investment credit continue to vary according to the asset's useful life or recovery period?

(2) Should the recapture rules be revised to provide for the allowance of credit on a more ratable basis (e.g., a certain amount of credit for each year the property is held)?

(3) If property is disposed of before the end of a taxable year, should credit for a full year be allowed under the recapture rules?

(4) Should recapture be based on the amount realized on disposition of the property rather than on the period of time the property is held?

Description of Proposals

Administration's bill and H.R. 1053.—Under the Administration's original (and revised) bill and H.R. 1053, the investment credit initially allowable with respect to an asset would not be based on the asset's actual useful life. Rather, the credit would be based on the recovery period of the property used in determining the deduction for depreciation. For eligible 5-year and 10-year recovery property, the Administration's bill would permit a full 10-percent credit. For 3-year recovery property, a 6-percent credit would be allowed.

Upon disposition of eligible property, the Administration's bill, in effect, would permit a 2-percent credit for each full year any recovery property is held. If the property is held for the entire recovery period used to determine the credit earned, no recapture would be required on a subsequent sale of the asset. Even property held less than 3 years would receive a partial credit.

H.R. 1053 is similar to the Administration's bill in terms of recapture, except a recomputed credit would be allowed for property held for any portion of a taxable year. For example, assume 5-year recovery property is placed in service on the last day of the taxable year and sold on the first day of the next taxable year. A 10-percent credit would be allowed for the year the property was placed in service. Under the recapture rules, only 80 percent of the credit would be recaptured in the following year because the property was held for part of the taxable year following the taxable year the property was placed in service. Thus, the taxpayer could hold the property for as little as one day after the property was placed in service to obtain a recomputed credit of 2 percent.

Simplified cost recovery.—Under the 1980 Finance Committee bill, a credit of 2.5 percent would be allowed for property in the 2-year class (property with ADR guideline lives of 2 to 6.5 years), a 6-percent credit would be allowed for property in the 4-year class (property with ADR guideline useful lives of 7 to 11.5 years), and a 10-percent credit would be allowed for 7-year and 10-year property (property with ADR midpoint lives of 12 years or more). Taxpayers would have the option to place property in the next highest class for both investment credit and depreciation. The recapture rules would be similar to those under present law.

First-year capital cost recovery.—Under H.R. 3443 and H.R. 3500, the regular investment credit and the ESOP credit would be repealed for property eligible for the first-year recovery allowance. Present law rules relating to the energy credit would be retained. Present law rules relating to the regular investment credit would be retained for property not subject to the first-year system.

General Analysis

Overview.—The present system of varying the amount of the investment credit according to the useful life of the property and recapturing the credit upon disposition of the asset based on the period of time the property was held presents several problems. First, it adds complexity to the system. Second, the present system causes significant variations in the amount of credit based on small differences in the useful life of the property. Third, the recapture rule creates a "cliff effect" in the sense that taxpayers are encouraged to hold property longer than they otherwise would to avoid recapture of the credit.

"Cliff" effect.—The cliff effect puts pressure on taxpayers in some cases to hold assets longer than they otherwise would. For example, assume that a taxpayer claims the full 10-percent credit for a particular asset and that it would be most efficient from a business standpoint to sell the asset after 6 years and replace it with a new asset. The current recapture rule creates an incentive to hold the property for an additional year to avoid recapture of one-third of the credit originally claimed. (The same cliff exists at the 3-year and 5-year cut-off points.)

This tendency of the useful life limitation and recapture rules to distort business practices is mitigated somewhat under the Administration's bill and H.R. 1053 because the credit, in effect, is allowed ratably, thereby reducing the size of the cliff at any given point from $3\frac{1}{3}$ percent to 2 percent. On the other hand, the potential for distortion might increase somewhat because there would be five 2-percentage-point cliffs. Under the 1980 Finance Committee bill, there would be a $3\frac{1}{2}$-percent cliff at the 4-year holding period and a 4-percent cliff at the 7-year holding period.

Proceeds-based recapture.—Several of the problems created by the useful life and recapture rules could be solved if the recapture system were based on the amount realized on the disposition of the property rather than up the period of time the property is held. Under such a system, analogous to that used for depreciation recapture purposes, the amount of the credit recaptured on the disposition of an asset would be an amount equal to the amount realized on the disposition (if any) times the percentage used in determining the original credit.

For example, assume a taxpayer acquired a $1,500 asset qualifying for a full 10-percent credit and in a subsequent year disposed of it for $500. A credit of $150 would initially be allowed and $50 would be recaptured in the year of disposition. The taxpayer would retain a net credit of $100, equal to 10 percent of the taxpayer's net $1,000 ($1,500 less $500) investment in the asset. In contrast, under present law the amount of the credit recapture would be more or less than $50, depending on how long the taxpayer held the asset; the amount received on the disposition of the asset would be immaterial.

Adoption of a recapture system based on the amount realized on disposition would have several advantages. First, if an open account system were adopted, proceeds-based recapture would be simpler than the present system because there would be no need to determine the length of time property is held for Federal income tax purposes. Second, the amount of credit allowable to the buyer of eligible used property under a proceeds-based recapture system would generally be the same as the amount recaptured from the seller. (In the above example, the buyer would be allowed a 10-percent credit of $50 in its $500 purchase price.) Thus, unlike present law, an asset generally could not earn an aggregate credit greater than the credit allowed to the original purchaser of the asset. This solution to the problem of multiple credits would, in turn, permit repeal of the used property limitation (discussed in the next section), which has been a matter of concern to many taxpayers, particularly small business. Another advantage of the suggested recapture system is that it would eliminate the cliff problem inherent in a recapture rule based on the taxpayer's holding period.

K. Used Property Limitation

Present Law

Under present law, only $100,000 of used property per year qualifies for the regular investment credit. Originally, an annual $50,000 limitation was imposed to encourage increases in the stock of assets. It was felt that small businesses, which depend heavily on used equipment, should still receive some credit, even if purchases of used assets do not increase the overall stock of capital (unless the assets otherwise would have been retired). The limitation was raised to its present level in 1975 as a rough adjustment for inflation.

Issue

What limits, if any, should be imposed on the credit for used property?

Description of Proposals

Administration's bill and H.R. 1053.—Neither the Administration's original (or revised) bill nor H.R. 1053 would change the present used property limitations for the investment credit.

Simplified cost recovery.—The 1980 Finance Committee bill would increase the used property limitation to $150,000.

General Analysis

Another alternative would be to repeal the used property limitation. However, under any proposal that permits a credit based on recovery periods shorter than actual useful lives, there would be potential for allowance of multiple credits for the same asset.

Removal of the used property limitation would be possible if the Committee were to adopt the investment credit recapture alternative (discussed above under "Investment Credit Rate and Recapture") that would recapture investment credit based on a percentage of the amount realized upon disposition of the asset. Under this approach, the potential for a double credit would be eliminated because the amount recaptured generally would equal the amount of credit allowed the purchaser.

L. At-Risk Limitation

Present Law

Present law imposes a limit on the losses from a business or income-producing activity that a taxpayer can currently deduct (sec. 465). This at-risk limitation was added by the Tax Reform Act of 1976 to prevent the taxpayer from deferring tax on income from other sources with losses generated by tax shelter investments, to the extent those losses exceeded the actual investment the taxpayer has placed at risk in the shelter activity.

A taxpayer is not considered at risk to the extent there is non-recourse financing. Non-recourse financing generally means debt the taxpayer is not personally required to repay and for which the taxpayer has not pledged his personal assets. Nonrecourse financing also means debt owed to a creditor who either has an ownership interest in the activity or who is related to the taxpayer (within the meaning of section 267(b)). Amounts invested in an activity are treated as nonrecourse financing if the taxpayer is protected against the loss of such amounts through guarantees, stop-loss agreements or similar arrangements.

The at-risk loss limitation rules apply to most business activities, except real estate, engaged in by individuals, subchapter S corporations, and certain closely held corporations. Certain leasing activities engaged in by closely held corporations are not covered by the at-risk loss limitations.

The present loss limitation rules suspend any losses from an activity to the extent such losses exceed the taxpayer's amount at risk in the activity at the close of the taxable year. These suspended losses can be deducted in later years generally to the extent the activity produces net income, to the extent the taxpayer increases his amount at risk by making future at-risk investments in the activity, and to the extent the taxpayer pays off nonrecourse debt or replaces it with recourse debt.

The loss limitation rules are applied to business activities, as opposed to discrete items of property, although activities with respect to certain items of property may be treated as a separate activity. For example, if an individual has a business activity with respect to several films or video tapes, the activity with respect to each film or video tape is treated as a separate activity. On the other hand, an individual's losses from one film or video tape activity are aggregated with the gains from other film or video tape activities if the activities are engaged in through the partnership form. The different treatment of activities depending on the form of doing business is not related to the purpose of the at-risk limitations, but is based on considerations of administrative feasibility.

Under present law, there is no at-risk limit on the investment credits.

Issues

(1) Should an at-risk limitation be imposed on eligibility for investment credits?

(2) Should a statutory limitation be imposed on eligibility for investment credits and depreciation, focusing solely on the problem of inflated property valuations that do not represent real investment?

(3) If an at-risk limitation is imposed on the regular investment credit, should an at-risk limitation also be imposed on the energy credit?

Description of Proposals

Original Administration bill.—The Administration's original bill would apply an "at-risk" limitation to investment credits. Under the bill, the cost used to compute the investment qualifying for investment credits would not include amounts that are not at-risk. The application of the ACRS at-risk limit on investment credits would apply to the same taxpayers and business activities subject to the present law at-risk rules. The determination of whether amounts are at-risk and the consequences of increasing or decreasing the amounts at-risk would be substantially the same as under the present law at-risk loss limitation rules.

Revised Administration bill.—Under the Administration's revised bill, there would be an at-risk limitation on investment credits. However, amounts borrowed for use in an activity generally would be considered at risk if the amounts are owed to a bank, savings and loan association, or insurance company that does not have an interest in the activity other than an interest as a creditor. The revised bill also contains a revised effective date for the proposed at-risk limitation. Under the revised effective date, certain property placed in service after February 18, 1981, would not be subject to the limitation, even though the taxpayer was not contractually bound to acquire the property. Generally, this property would be property necessary to complete a project that was begun before February 19, 1981.

Other proposals.—None of the other proposals would address the issue of an at-risk limit on the investment credit.

General Analysis

Two distinct issues relating to nonrecourse financing are raised by at-risk rules. They are the issues of tax shelter limitations and overvaluation problems. A third issue, relating to the energy credit, is raised by the at-risk rules in the Administration's bills.

Tax-shelter limit.—The first issue addressed is whether taxpayers should be permitted to shelter income with losses or tax credits from an activity if the taxpayer's basis for the losses and credits is founded on nonrecourse financing. Nonrecourse financing is an issue because there is the concern that the indebtedness will not be repaid if the activity turns out to be unproductive. In that event, the taxpayer will have received tax benefits for an investment that ultimately is never made by the taxpayer. In such situations, the taxpayer is supposed to include an amount in income from the discharge of the indebtedness or realize an amount that reflects the indebtedness upon the abandonment or disposition of the activity. However, it is often difficult to determine from examination of a taxpayer's returns whether the taxpayer has abandoned a "burned-out" tax shelter. The present law loss limitation rule is intended to prevent the allowance of losses for investments that may never be made by suspending the losses attributable to nonrecourse financing, thereby mitigating the problems involved with burned-out tax shelters.

This concern regarding losses based on nonrecourse financing applies with equal force to investment credits based on nonrecourse financing. Under the Administration's original bill, the amount of investment credit allowable with respect to an investment would be based on the amount of the investment that is not based on nonrecourse financing. Under the Administration's revised bill, investment credits generally would be allowed for nonrecourse financing by banks, savings and loan associations, and insurance companies. It is argued by some that the Administration's original and revised bills are overly severe limitations on the investment credit because separate limitations would be applied to losses and investment credits. Some would argue that taxpayers should be able to claim investment credits in lieu of losses when the at-risk amount exceeds losses. This problem might be solved by limiting losses and credits under a single limitation by converting the credit to a deduction equivalent for this purpose.

Overvaluation.—The problem of overvaluation is exemplified by the case of a taxpayer who purchases an asset worth $20 for $20 cash and a nonrecourse note, secured only by the asset, for $80. The purchaser then claims depreciation allowances and tax credits for a $100 investment, even though the $80 indebtedness is meaningless and represents no real investment. The seller, who typically provides the financing, is willing to take the note even though there is no likelihood of the note being paid off. The seller is willing to do this because he has received $20 cash for an asset worth $20 and income from the $80 note does not have to be recognized unless and until payments are actually made.

The Internal Revenue Service has attacked transactions of this type, ruling that the purchaser's basis in the property does not include nonrecourse debt if the value of the property cannot be shown to at least approximate the value of the consideration paid (the total of the cash downpayment and the face amount of any indebtedness). Rev. Rul. 79–432, 1979–2 C.B. 289. While the credit and the depreciation allowable should not be determined with reference to an amount greater than the actual value of the asset in such cases, valuation issues present a number of practical difficulties for the Service. Moreover, since the down-side risk is generally not great, aggressive taxpayers can play the "audit lottery" by claiming inflated values based on nonrecourse debt, gambling that their returns will not be audited and the issue raised.

The problem of inflated values supported by nonrecourse debt would be solved if the basis of property for purposes of both the investment credit and depreciation allowances were limited to the amount of a taxpayer's at-risk investment. However, if the concern is only the overvaluation problem, nonrecourse financing would not have to be excluded from basis if the taxpayer could show that the fair market value of the property approximated the consideration paid for the property. This showing could be made by evidence of cash markets for the same or similar property, evidence of nonrecourse financing available from disinterested third parties, such as banks, evidence of the production cost of the property, or similar reliable evidence of value.

The present loss limitation rules do not adequately address the problem of inflated valuation supported by nonrecourse debt. Although the amount of losses allowed is limited to the amount of investment that is at risk, the inflation of basis by overvaluation has the effect of accelerating the losses of an activity. For example, assume that a $20 at-risk investment in depreciable property would generate deductions of $4 per year for five years. Assuming no other deductions are allowable and no income is produced, a total of $20 in losses would be allowed over a 5-year period. However, if the basis of the property were inflated to $100, deductions of $20 per year for five years would be generated. Even though the loss limitation rule would allow only $20 of losses, the inflation of basis would enable the taxpayer to claim a $20 loss in one year rather than waiting five years.

The Administration's bills would eliminate the problem of investment credits based on inflated valuation supported by nonrecourse debt. The Administration's bills would not address the problem of inflated depreciation allowances attributable to over-valuation.

Energy credits.—Although the availability of investment tax credits for investments that are not at-risk may encourage taxpayers to make unproductive investments, some argue that this concern does not apply with equal force to investments in property eligible for the energy credit. The energy credit is intended to encourage the use of alternative energy sources, conservation, and the development of advanced energy technology. To the extent that energy credits were intended to encourage investment that would not otherwise be economically feasible, it is argued that it is not appropriate to limit the availability of such credits through an at-risk limitation. Investment in new energy technology is often very risky and prudent investors may seek to limit this risk by forming limited partnerships and using nonrecourse financing. Application of an at-risk limitation to investments in property eligible for energy credits could have the result of discouraging some of the investment activity the credit was intended to foster.

M. Qualified Progress Expenditures

Present Law

Overview.—In general, the investment credit is allowed when property is placed in service. However, for property with a long construction period, the credit is allowed at the time when a progress expenditure is made during the construction period. Congress felt it was inequitable for taxpayers making payments over a long construction period to have to wait until the property is placed in service to claim the credit.

Eligible property.—To qualify for progress expenditure treatment, property must have a 7-year useful life and a 2-year normal construction period beginning with the year physical work starts on the property.

Self-constructed property.—For eligible self-constructed property, the credit for progress expenditures is generally allowed when amounts are property chargeable to capital account for the property. Property is self-constructed if more than half of the expenditures for the property are made directly by the taxpayer.

Nonself-constructed property.—For eligible nonself-constructed property, actual payment is required (payment rule). However, amounts borrowed from the manufacturer are not taken into account as progress expenditures (borrowing rule). In addition, payments are taken into account only to the extent they represent progress in construction (progress rule).

Preconstruction expenditures.—Under proposed Treasury regulations interpreting the progress expenditure rules, it appears that progress expenditures do not include amounts paid or incurred prior to commencement of the normal construction period (Prop. Treas. Reg. § 1.46–5).

Election.—Progress expenditure treatment is not mandatory. However, under proposed Treasury regulations interpreting this provision, the election, once made, would apply to all of the taxpayer's eligible property (Prop. Treas. Reg. § 1.46–5(g)).

Issues

(1) Should progress expenditure treatment be extended to depreciation?

(2) Should the 7-year useful life and the 2-year normal construction period requirements, which limit eligibility for progress expenditure treatment, be liberalized or relaxed?

(3) Should the distinction between self-constructed and nonself-constructed property be retained, and if so, what limitations should apply to nonself-constructed property?

(4) Should progress expenditure treatment be made mandatory?

Description of Proposals

Original Administration bill.—The Administration's original bill would extend the progress expenditure rule to depreciation. The progress expenditure rule would be mandatory for depreciation, except for utilities. For the investment credit, the progress expenditure rule would be made mandatory for all taxpayers. The bill would retain the 2-year normal construction period limitation but eliminate the 7-year useful life limitation for progress expenditures for both investment credit and depreciation. The bill also would retain a distinction between self-constructed property and nonself-constructed property and would retain the present law limitations on nonself-constructed property.

Revised Administration bill.—The Administration's revised bill would not extend the progress expenditure rule to depreciation. In addition, the revised bill would restore the elective feature of the progress expenditure rule for the investment credit.

H.R. 1053.—H.R. 1053 would extend progress expenditure treatment to depreciation on a mandatory basis and eliminate both the 2-year normal construction period and 7-year useful life limitations. H.R. 1053 would make progress expenditure treatment for the investment credit mandatory. The bill would eliminate the borrowing and progress rules for non-self-constructed property. Since the normal construction period requirement is eliminated, presumably payments made prior to commencement of construction would be allowed progress expenditure treatment when made.

Simplified cost recovery.—The 1980 Finance Committee bill is similar to the Administration's original bill except that (1) progress expenditure treatment would continue to be elective and (2) the nonself-constructed property limitations (i.e., payment, progress, and borrowing rules) would apply to the nonself-constructed portions of the property, even if the property as a whole would be considered self-constructed under present law.

First-year cost recovery.—Under the first-year cost recovery proposals, progress expenditure treatment would not be extended to depreciation.

General Analysis

Progress expenditures for depreciation.—There are a number of different considerations in determining whether depreciation should be allowed before property is placed in service.

If the intent of the Committee is to draft capital cost recovery rules that attempt to measure the net income of a business, capital cost recovery allowances should be taken into account only as the real value of the property declines. Since property tends to rise, rather than decline, in value during its construction period (and does not generate income), allowing capital cost recovery allowances during this period would be inconsistent with a system based on measuring net income. If instead the intent is to provide an incentive by approximating "expensing", a cash flow approach to capital cost recovery allowances, as in H.R. 1053, would be consistent.

Neutrality.—Another consideration in determining whether to extend progress expenditure treatment to depreciation is how the timing of capital cost recovery allowances affects a taxpayer's decision about when to place property in service. A "placed-in-service" rule encourages taxpayers to place assets in service as soon as possible. The progressive expenditure rules provide no such incentive.

Two-year construction period.—Another issue is the extent to which the 2-year normal construction period requirement creates a "cliff" effect by permitting different treatment based on small differences in the length of the construction period. This effect would be eliminated by deleting the 2-year normal construction period, as in H.R. 1053. However, this change may extend progress expenditure treatment to many tax shelter projects, which typically have short construction periods.

Borrowing limitation for nonself-constructed property.—The borrowing rule complements the payment rule by preventing progress expenditure treatment if the taxpayer does not have an out-of-pocket expense and, thus, a cash flow problem. An accrual basis taxpayer that has incurred a liability on its books of account by borrowing from the supplier may be viewed as suffering economic detriment, but the taxpayer does not have an out of pocket expense. On the other hand, the impact of the liability on the debt-to-equity ratio of the corporation limits the ability of the corporation to borrow additional working capital indirecly affecting the taxpayer's cash flow. In addition, there is an argument that the borrowing rule is ineffective with respect to its role as a "backstop" to the payment rule in that the borrowing rule does not apply to amounts borrowed from a bank or other third party.

Preconstruction expenditures.—The Committee may want to consider at what point in time preconstruction expenditures should be allowed the investment credit. If the credit is allowed prior to the time there is physical evidence of a viable project, a taxpayer conceivably could claim the credit for research expenditures for several years before scrapping the project. On the other hand, a taxpayer that does not believe he has a viable project may elect to expense the research expenditures rather than capitalize them and claim the credit and depreciation. (Unless the combination of investment credits and depreciation exceeds the benefit of expensing).

An alternative to the position in the proposed Treasury regulations requiring taxpayers to wait until property is placed in service to claim the credit for preconstruction expenditures would be to allow the credit for those expenditures in the year physical work on the property commences. At that time, there would be tangible evidence of a viable project. Another alternative would be to prorate the preconstruction expenses over the construction period.

Self-constructed v. nonself-constructed.—The Committee may wish to consider dividing progress expenditure property into its self-constructed and nonself-constructed portions, as in the 1980 Finance Committee bill, rather than considering the property as a whole. Under the present law rules, the progress, payment, and borrowing rules do not apply to self-constructed property even if a portion of the property, treated alone, would not be self-constructed property. In effect, the present rules for self-constructed property represent a safe harbor. Under the 1980 Finance Committee approach, the progress, payment, and borrowing rules could apply to the nonself-constructed portions of the property even if the property as a whole were considered self-constructed under present law. Thus, the 1980 Finance

Committee bill would eliminate what is in effect a safe harbor under present law. However, eliminating the safe harbor would ensure that the progress, payment, and borrowing rules are applied to the perceived problems regardless of the overall character of the property.

N. Public Utility Property

Present Law

Accelerated depreciation

Under present law, public utilities generally are able to use the same depreciation methods as other taxpayers. However, certain utilities (electric, water, sewage, gas, steam, and telephone companies) generally are permitted to use accelerated depreciation methods and the 20 percent ADR useful life variance only if the current tax reductions that result from using these methods are "normalized" in setting the rates charged to utility customers (sec. 167(l)). In theory, the rates charged to customers are set at a level that permits the utility to earn a fair rate of return on its investment and recover its cost (including a ratemaking allowance for Federal income taxes plus a ratemaking allowance for depreciation). The normalization of accelerated depreciation methods generally means that the rates charged to utility customers would not reflect a ratemaking allowance for Federal income taxes based on the use of a depreciation method more accelerated than the depreciation method used to determine the ratemaking allowance for depreciation. The normalization of the 20 percent ADR variance generally means that the rates charged customers would not reflect a ratemaking allowance for Federal income taxes based on useful lives shorter than the ADR midpoint life or the useful life, whichever is shorter, used to determine the ratemaking allowance for depreciation. The straight-line method and relatively long useful lives are generally used to compute the ratemaking allowance for depreciation. Therefore, normalization generally allows the utilities to collect revenues that reflect a tax allowance based on straight-line depreciation and ADR midpoint lives.

The use of accelerated methods and the ADR useful life variance for Federal income tax purposes generally results in an actual Federal income tax expense that is less than the ratemaking tax allowance in the early years of an assets life and more than the ratemaking tax allowance in the later years of an asset's life. These "deferred taxes" can be viewed as an interest-free loan to the utility. The utilities are able to use this money in lieu of capital that otherwise would have to be obtained by borrowing or raising equity capital. The normalization rules do not limit the authority of regulatory bodies to pass through these capital cost savings to utility customers; i.e., the reduced costs of acquiring capital can be reflected in the rates charged to utility customers.

The use of accelerated methods and short useful lives to compute the ratemaking allowance for Federal income tax is known as "flow-through" accounting because current tax reductions are immediately reflected in lower rates to customers, rather than being flowed through over the period of tax deferral. The normalization rules in the Code generally do not apply to property that was subject to flow-through accounting before 1970 or similar property placed in service after 1969.

Investment tax credit

Under present law, public utilities (electric, water, sewage, gas, steam, and telephone companies) are generally allowed the same investment credit for their business property, subject to the same limitations based on tax liability, as other taxpayers. The only exception is that certain energy property eligible for the energy credit does not include public utility property. However, although public utility property is generally eligible for the same investment incentives as other business property, it is also generally subject to a "normalization" requirement, which relates to the treatment of the credit in the allowance of the investment credit is conditioned on the credit setting the rates charged to utility customers (sec. 46(f)). Generally, being treated in ratemaking as a capital subsidy that reduces the utility's capital costs over an asset's life rather than as an immediate reduction in Federal income tax expense that would reduce the utility's current cost of doing business. The benefits of the reduced capital cost generally must be shared between utility shareholders and utility customers in a way that insures that a minimum of roughly half the benefits go to the shareholders. The normalization rules for the investment credit accomplish this sharing by permitting the establishment of rates charged to customers that either do not include an investment return on the capital represented by the credit or do not include any allowance for depreciation on the amount of investment attributable to the credit. Utility rates therefore must include, generally, either a rate of return or a depreciation allowance based on the amount of the investment credit. A special rule for gas pipeline property permits the utility to retain all capital cost savings for utility shareholders. Another special rule for property eligible for accelerated depreciation flow-through treatment permits the benefits of the investment credit to be allocated between customers and shareholders without any limitation.

Utilities generally benefit more from investment credits than from the deferred taxes from accelerated depreciation. This is because the capital cost savings from the investment credit are generally shared between utility investors and utility customers, while the capital cost savings from deferred taxes generally are entirely passed through to customers.

The credit for qualified progress expenditures is subject to the normalization rules under present law. Although this means that the benefits of the credit must be shared between customers and shareholders, the time when customers and shareholders enjoy their share of benefits is not necessarily the same. This is because the customers enjoy their benefits as soon as the credit is earned, but shareholders often do not enjoy their share of the benefits until the eligible property is actually placed in service. This is the case in many ratemaking jurisdictions where the construction work in progress is not included in determining the utility's rate of return on investments or the utility's cost of providing goods and services.

Issues

Should regulated public utilities be eligible for the same investment incentives as unregulated companies?

In determining the eligibility of utilities for investment incentives, should a distinction be made between regulated utilities that are in competition with unregulated companies (e.g., the telephone utilities), and utilities that are not in direct competition with unregulated companies, (e.g., the gas and electric utilities)?

Should regulated oil pipeline property be treated differently than regulated gas pipeline property, even though both types of property are substantially similar and are subject to substantially similar regulation of rates?

Should special normalization rules be applied to tax incentives, such as credits or depreciation for qualified progress expenditures, that are received before the qualified property is placed in service?

Description and Analysis of Proposals

Accelerated depreciation

Original Administration bill.—The Administration's original bill would distinguish between long-lived public utility equipment and other equipment. Long-lived public utility property (property with a midpoint life over 18 years as of December 31, 1980 would be placed in the 10-year recovery class and would be the only type of personal property in that class. This distinction is presumably based on the argument that this type of property is not used in competition with unregulated companies and would enjoy a disproportionately large share of the total benefits of useful lives shortened to 5 years. In addition, some electric and gas utilities may prefer to be in a 10-year recovery class because the benefits of a 5-year recovery period would practically eliminate their taxable income and consequently reduce the amount of investment credits that could be used to offset tax liability. As explained above, investment credits generally get a more favorable treatment in ratemaking than the deferred taxes available from accelerated depreciation.

Roughly one-third of the public utility property owned by the telephone utilities would be recovered over a 5-year period. The telephone companies would prefer to be treated like unregulated companies for all of their property because they are, or will be, in direct or indirect competition with unregulated companies for some of the services they provide. The telephone companies also argue that certain telephone property used in direct competition with unregulated companies has been assigned an ADR guideline life that is too long and consequently will be included erroneously in the 10-year recovery class of property.

Under the Administration's original bill, public utility property placed in service after December 31, 1980, is treated as recovery property only if all the tax benefits of ACRS are normalized. As under present law, the benefits of computing Federal income taxes using an accelerated depreciation method instead of the method used for ratemaking purposes must be normalized. The treatment of the benefits of using ACRS shortened recovery periods, however, differs from present law. Under present law, the maximum benefit that must be normalized is the benefit of using the 20-percent ADR variance rather than the ADR midpoint life. Under ACRS, the rate charged utility customers must reflect the normalization of any benefit of using the shortened recovery period rather than the useful life used for ratemaking, which may be much longer than the present law useful life (based on either facts and circumstances or the ADR midpoint).

The Administration s original bill would not provide for any continuation of flow-through accounting for property placed in service after December 31, 1980. Thus, public utility property placed in service after December 31, 1980, that is the same type of property for which flow-through accounting is currently permitted, would nevertheless be subject to the normalization requirement. This is in contrast to present law rules, which permits flow-through accounting for public utility property placed in service after 1969 if the same type of property was subject to flow-through accounting in 1969.

The Administration's original bill would not change the present law normalization rules to provide a special normalization rule for depreciation of qualified progress expenditures. Utilities argue that ratemaking authorities should permit utilities to earn a rate of return on any construction work in progress for which depreciation is allowed under the proposed qualified progress expenditure provisions. Others argue that utility customers should not be forced to pay a rate of return on deferred Federal income taxes that have not been flowed through to customers and should not be forced to pay a rate of return on property until it is actually placed in service.

Revised Administration bill.—Under the Administration's revised bill, the treatment of accelerated depreciation for public utility property would be essentially the same as under the original bill. The principal difference is that the revised bill would classify public utility property as long-lived or short-lived based on the ADR midpoint life as of January 1, 1981, instead of December 31, 1980. Therefore, if Treasury were to shorten the ADR class life for telephone central office equipment so that such equipment would be in the 5-year class, it could do so without revising the class life for property placed in service before January 1, 1981. Under the revised bill, there is no provision for depreciation of qualified progress expenditures, and therefore the desirability of a special normalization rule for progress expenditures is irrelevant.

H.R. 1053.—Under H.R. 1053, public utility property would not be eligible recovery property unless it was subject to the same normalization requirement as proposed in the Administration's bill. Under H.R. 1053, public utility property would not otherwise be distinguished from any other type of property.

Simplified cost recovery.—Under the 1980 Finance Committee bill, public utility property would not be subject to the proposed simplified cost recovery rules. However, the present 20-percent ADR variance would be increased to 30 percent and the benefits of the variance would have to be normalized unless the property is eligible for flow-through accounting under present law. Although the benefits of inclusion in the present system might be more than some utilities could optimally use, many utilities have expressed a preference not to be excluded from an investment incentive system available to other taxpayers.

First-year cost recovery.—Under the first-year cost recovery bills, (H.R. 3443 and H.R. 3500) public utility property, including regulated oil pipeline property, would be depreciated under present law rules, except that a 30-percent ADR useful life variance would be permitted.

Investment tax credit

Original Administration bill.—Under the Administration's original bill, the investment credit normalization rules would be changed to permit a reduction in both the ratemaking investment base and the ratemaking depreciable basis by the amount of the credit. The effect of this change would be to permit ratemaking authorities to deny the utilities a profit or rate of return on the credit and deny any capital recovery of the credit in ratemaking. This is in contrast to present law, which generally permits the ratemaking authority to deny one of these benefits (depending on which election the taxpayer has made), but not both. The denial of both benefits would still permit the utility to use the investment credit as capital, but the entire capital cost savings would be passed through to ratepayers.

Revised Administration bill.—Under the Administration's revised bill, the normalization rules for the investment credit would not be amended.

Other proposals.—The other proposals do not include changes in the normalization rules for the investment credit.

O. Retirement-Replacement-Betterment ("RRB") Property

Present Law

The railroad industry generally uses what is called the retirement-replacement-betterment (RRB) method of depreciation for rail, ties, and other items in the track accounts such as ballast, fasteners, other materials, and labor costs. This method is used instead of the depreciation procedures described in section 167 (b) and (c), which provide for an annual deduction for each item of property. Before 1981, the RRB method was not specifically recognized as an allowable method of depreciation under the Internal Revenue Code, but it had been allowed in court decisions as the equivalent to ratable depreciation and was recognized by the Internal Revenue Service in revenue rulings.[1] The Service's application of this method for tax purposes was based upon the application of this method by the Interstate Commerce Commission (ICC) for ratemaking purposes. Section 2(a) of Public Law 96-613, December 28, 1980, added section 167(r) to the Code, explicitly approving the use of the RRB method by a common carrier railroad. The legislative history of the codification of the RRB method indicates that it was premised on an understanding that the Treasury and the railroad industry would cooperate to find a more conventional depreciation system for railroad property that could be considered when Congress reviewed the overall capital cost recovery issue.

For assets accounted for under the RRB method, when a new railroad line is laid (an "addition"), the cost (both materials and labor) of the line is capitalized. No depreciation is claimed for this original installation, but a deduction for these original costs may be claimed if this line is retired or abandoned. If the original installation is replaced with components (rail, ties, etc.) of a like kind or quality, the cost of the replacements (both materials and labor) are deducted as a current expense. When the replacement is of an improved quality, the improved portion of the replacement is a "betterment"; that is, it is capitalized, and the remainder of the replacement cost is deducted as a current expense.[2] Because the regular investment credit is allowed for both costs that are expensed and costs that are capitalized under the RRB method, the total capital cost recovery allowances are more generous than simple expensing in the case of replacements but less generous in the case of additions and betterments. Upon the retirement or replacement of rail and other track assets, the salvage value (meas-

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[1] Rev. Rul. 67-22, 1967-1 C.B. 52; Rev. Rul. 67-145, 1967-1 C.B. 54; and Rev. Rul. 78-199, 1978-1 C.B. 66.

[2] Railroads also may claim the regular 10-percent investment credit on their track costs, including both costs which are capitalized as costs of a new line (or a betterment) and those which are currently deducted replacement costs (Code secs. 48(a)(1)(B) and 48(a)(9). Regs. § 1.48-1(d)(4)).

ured by current fair market value) of the recovered materials is treated as ordinary income.[3]

The use of the RRB method has caused certain administrative problems. The principal problems are disputes over salvage value and disputes whether certain labor expenses are expenses of removing old track (for which no investment credit is allowed) or expenses of adding replacement track (for which the investment credit is allowed).

Issue

Should RRB property come under the coverage of a revised and accelerated capital cost recovery system?

Description of Proposals

Original Administration bill.—Under the Administration's original bill, property placed in service after December 31, 1980, that would have been depreciated under the RRB method if placed in service on or before December 31, 1980, would be 5-year recovery property and may not be depreciated using the RRB method. Under the bill, there would be no phase-in of the 5-year recovery period for RRB property.

Some amounts included as replacement costs under RRB would be treated as repair expenses under ACRS, which means that these costs would be expensed under either method. However, under ACRS, unlike RRB, no investment credit would be allowed for such repair expenses.

The unrecovered capitalized costs of additions and betterments placed in service before January 1, 1981, would not be recovered under the RRB method (i.e., they would not be recovered when the property is retired), but they would not be recovered as 5-year property either. Instead, the amount of unrecovered pre-1981 capital costs would be recomputed under regulations as if the taxpayer had always used a conventional depreciation method (e.g., the straight-line method). Generally, the recomputed amount would be more than the actual amount of unrecovered costs. The recomputed amount would be recovered over a 10-year period, using either the straight-line method or a conventional accelerated method, at the taxpayer's election. To the extent the recomputed amount of unrecovered capital costs exceeds the actual amount of unrecovered capital costs, the taxpayer would be recovering the same costs twice. The amount of these double recoveries attributable to periods before January 1, 1954, would be taken into account by the taxpayer as adjustments increasing taxable income. The adjustments would be spread evenly over a 10-year period. The treatment of unrecovered capital costs under the Administration's original bill is substantially equivalent to the normal procedures involved in a change of method of accounting initiated by the Secretary of the Treasury. The purpose of this complex transition procedure under the bill is to mitigate the adverse effects of a temporary discrepancy between annual RRB allowances and annual ACRS allowances.

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[3] See e.g., *Seaboard Coast Line Railroad Company, Successor by Merger to Atlantic Coast Line Railroad Company* v. *Commissioner*, 72 T.C. 855 (August 22, 1979, and cases cited therein.

Revised Administration bill.—Under the Administration's revised bill, the RRB method would be repealed as of January 1, 1981, as under the original bill. The unrecovered costs of railroad property placed in service before 1981 would be recovered over a period not less than 5 years using a depreciation method as accelerated as the 200-percent declining balance method with a switch to the sum-of-the-years-digits method.

The capital costs of railroad property placed in service after December 31, 1980, would be classified as either costs that would have been capitalized under RRB (additions and betterments) or costs that would have been expensed under RRB (replacements). Costs of property that would have been capitalized under RRB would be treated the same as other 5-year property under ACRS. Thus, such costs would be subject to the depreciation method transition rules for property placed in service in the years 1981 through 1985.

Replacement property (which would be expensed under RRB) would be phased-in to ACRS over 5 years. Replacement property placed in service in 1981 would be expensed. Replacement property placed in service in 1982 through 1984 would be recovered over 2, 3, and 4 years, respectively, using a prescribed accelerated method based on the 200-percent declining balance method with a switch to the sum of the years-digits method. Replacement property placed in service in 1985 and later years would be treated the same as other 5-year property under ACRS. However, because 1985 would be the last year of the depreciation method transition period, replacement property placed in service in 1985 would be depreciated using a prescribed method based on the 175-percent declining balance method with a switch to the sum of the years-digits method.

Other proposals.—The other capital cost recovery proposals exclude RRB property from their coverage thereby permitting the continued use of the RRB method.

P. Flexibility

Present Law

Overview.—As a general rule, present law requires taxpayers to determine income and deductions on an annual accounting period basis. Deductions for depreciation for a year are intended to represent the decline in value of the asset during the year. The depreciation allowable for a year must be computed in accordance with a reasonable consistent plan for allocating the cost of the asset to the various years of property is used to produce income. In order to clearly reflect income for each year, depreciation deductions generally must be taken in the year allowable under the plan.

Although deductions and income generally must be reported on an annual basis, taxpayers are allowed a certain degree of flexibility in determining the timing of depreciation deductions. In particular, taxpayers are given certain options in determining the useful life of the property and the method of computing the depreciation. Also, taxpayers are permitted some flexibility in the timing and use of investment tax credits.

Net operating loss carryovers.—Under present law, if depreciation deductions, together with other business deductions, exceed taxable income for a taxable year, the loss may be carried back against taxable income for the 3 preceding years permitting a refund and carried forward 7 years. Since current deductions generally are applied before net operating carryovers, the net operating losses still may be unused by the end of the carryover period. In that case, the tax benefit would be lost permanently. Therefore, taxpayers with expiring loss or credit carryovers may have an incentive to delay deductions to future years (i.e., claim less accelerated depreciation).

Options in determining useful life.—Under the ADR system, taxpayers generally may use a useful life that is 20 percent shorter or longer than the applicable class life (ADR midpoint life). Selection of a useful life at the lower end of the permissible range would accelerate deductions. Taxpayers in a loss situation currently may choose a useful life at the higher end of the range to push deductions to later years anticipating long-term profitability.

Optional methods of depreciation.—Under present law, taxpayers are also permitted faster or slower methods of computing depreciation deductions for certain types of property. Although, in general, the length of the period required to recover costs by depreciation does not vary according to the method of depreciation used, accelerated methods, such as the 200-percent declining balance method, push more of the deductions into the earlier years. Taxpayers that anticipate losses in the early years may use the straight-line method of depreciation, permitting recovery of cost ratably over the useful life of the property.

Investment tax credit carryovers.—Since investment tax credits are limited to a certain portion of tax liability, taxpayers with NOL's and, thus, no tax liability are unable to use investment tax credits in the year the credit is earned. To reduce the possibility of a loss of these unused credits, a 3-year carryback and a 7-year carryover is permitted. Under a first-in first-out (FIFO) rule, carryovers of unused credits are applied before credits earned for the year or carrybacks, reducing the possibility of a permanent loss of credits.

Election to claim credits on progress expenditures.—For property with a normal construction period of at least 2 years, a portion of the credit may be taken during each year of the construction period. In addition to accelerating the credit, these rules spread the credit over a number of years, increasing the likelihood that the credit may be used in the year earned.

Other matters.—There are numerous instances under present law, apart from the desire to prevent expirations of loss or credit carryovers, in which taxpayers would prefer to postpone deductions. These include cases in which a taxpayer will be in a higher tax bracket in the future than in the current year, when the net income limit on percentage depletion applies, and when additional deductions would affect capital gains income for integrated timber companies.

Issues

(1) Should taxpayers be able to claim less than the amount of depreciation allowable in any year and "bank" it for use in any future year or, alternatively, be allowed an unlimited or extended net operating loss and investment credit carryover?

(2) Should the recovery periods and methods used in computing depreciation deductions be mandatory?

Description of Proposals

Original Administration bill.—As originally proposed, the Administration's ACRS system would provide for the recovery of costs over mandatory recovery periods generally shorter than present law useful lives. For property in the 10-, 5-, and 3-year recovery periods, a fixed rate of depreciation equivalent to the fastest method permitted under present law (i.e., 200-percent declining balance in the first year, switching to SYD for later years) would be required. Depending upon the type and use, real property would be required to be depreciated on a composite basis at a fixed rate over a mandatory 10-year, 15-year or 18-year life. Although, as under present law, the taxpayer would have to take all depreciation deductions in the year allowable, the bill would extend the carryover period for net operating losses and unused credits from 7 to 10 years.

Revised Administration bill.—To increase flexibility, the revised Administration bill would permit taxpayers to use the extended recovery periods prescribed for earnings and profits purposes in computing depreciation. In addition, taxpayers could elect to use the straight-line method rather than the prescribed accelerated method over either the applicable regular or extended recovery period. As under the original bill, the net operating loss and investment carryforward periods would be extended from 7 to 10 years.

H.R. 1053.—H.R. 1053 also provides mandatory recovery periods and methods similar to the Administration's original bill. However, the bill provides for an elective deferral of deductions—generally referred to as "banking" which would permit a taxpayer to elect to deduct less depreciation than the amount allowable in any taxable year and deduct it in any later year at the taxpayer's choice.

Simplified cost recovery.—The 1980 Finance Committee bill would require costs of personal property to be recovered over mandatory recovery periods approximately 40 percent shorter than present law useful lives. Unlike the Administration's bill, taxpayers would be able to choose one of several declining balance methods of depreciation (200-, 150-, or 100-percent declining balance rates). Taxpayers could also elect to move property into the next higher recovery class for both depreciation and investment credit. For real property, taxpayers would have the option of using the audit-proof lives (20 years or 15 years) or determining the useful life on the basis of facts and circumstances. As under present law, the taxpayer would be required to take all depreciation in the year allowable, and the carryover periods for net operating losses and investment credit would not be changed.

General Analysis

All of the bills described above would substantially deviate from the present law concept of matching income and deductions on the basis of annual accounting periods since costs would be recovered over periods much shorter than their actual useful lives. Shortening recovery periods would produce more deductions in the early years of the property's use. Unless the taxpayer has sources of income other than depreciable assets, deductions in those years will exceed income, generating net operating losses and unused credits. For taxpayers currently unable to use all deductions and credits, including any companies in the steel, airline, automobile, mining, and railroad industries, no current benefit would be realized under the proposals. Even if long-term profitability were assumed, future benefits from carryovers of increased allowances would not satisfy the need for current relief and increased cash flow. Further, increased allowances would increase the likelihood of permanent loss of credits and deductions.

Acceleration of depreciation can have similar effects on deductions limited to a certain percentage of taxable income for the year, such as the charitable contributions deduction and the depletion deduction. In order to maximize these other deductions, it may be advantageous not to claim depreciation at the most accelerated rate allowable. Mandatory acceleration of depreciation may also cause the loss of foreign tax credits. If a taxpayer's depreciation deductions produce a U.S. source loss, the excess deductions will be used to reduce its foreign source taxable income. However, since many taxpayers have sufficient foreign tax credits to offset fully their U.S. tax on their foreign source of income, the use of the excess depreciation deductions against that income would be wasted.

In addition, substantially accelerated depreciation deductions would increase the likelihood that depreciation deductions would exceed a taxpayer's ordinary income and thus be "wasted" by their use to offset income taxed at reduced capital gains rates. In many situations, it would be more advantageous for the taxpayer to claim smaller depreciation deductions in the current year, pay tax at reduced rates on the long-term capital gains and defer the excess depreciation deductions to a later year when they can be used against ordinary income.

A principal argument against providing flexibility in the use of depreciation deductions is that it complicates the law. The more options available to a taxpayer, the more difficult it becomes to decide which option is best. Some systems, however, permit flexibility with less complexity than other systems. An open-account system, for example, permits something fairly close to the "banking" concept in H.R. 1053 simply by permitting the taxpayer to vary his recovery percentages each year.

Q. Leasing—Transfer of Tax Benefits

Present Law

Under present law, the benefits of depreciation deductions and investment credits generally are available only to the owner of property. Thus, if the transaction is viewed as a leasing transaction, the lessor/owner receives tax benefits associated with ownership of the asset. The lessee, which in the case of a leveraged lease generally has possession of the leased asset for the greater portion of its useful life, receives the benefits of a lease rate that is generally lower than the cost which would have been incurred if the asset had been purchased by the lessee.

The Internal Revenue Service has published certain guidelines which it will consider in determining whether a transaction is a lease rather than a secured financing or a sale.[1] Under these revenue procedures, a transaction must meet the following requirements to be considered a lease: (1) the lessor, at all times, must have a minimum "at-risk" investment in the asset of at least 20 percent of its cost; (2) the lessor must be able to show that the transaction was entered into for profit, apart from the transaction's tax benefits (i.e., benefits obtained from the tax deductions, allowances, credits and other tax attributes arising from the transaction); (3) the lessee must not have a contractual right to purchase the property at less than its fair market value nor may the lessor have a contractual right to cause any party to purchase the asset; and (4) the lessee may not have furnished any part of the purchase price of the asset nor have loaned or guaranteed any indebtedness created in connection with the acquisition of the property by the lessor.

Generally, most equipment lessors are corporations. This is because present law allows the investment tax credit to noncorporate lessors in only two situations: (1) when the property subject to the lease has been manufactured or produced by the lessor or (2) in the case of certain short-term lease transactions.[2] These limitations were enacted by the Congress in the Revenue Act of 1971 because it was concerned that individuals were using tax benefits from leasing transactions (the credit, and depreciation and interest deductions) to shelter from tax a substantial portion of income from other sources. Thus, these limitations would allow the credit only to those individuals deemed to be engaged in actual business activities, i.e., leasing of property manufactured or produced by the taxpayer; short-term leasing. Short-term leasing activities were viewed as constituting

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[1] Rev. Proc. 75–21, 1975–1 C.B. 715; Rev. Proc. 75–28; 1975–1 C.B. 752.

[2] A noncorporate lessor will be allowed the credit if the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and if the deductions allowable to the lessor with respect to the property exceed 15 percent of the rental income produced by the property for the first twelve months after the property is transferred to the lessee. Code sec. 46(e)(3).

business activities rather than mere investment or financing arrangements because such arrangements are generally long-term.

Issues

(1) Should the tax benefits of a capital cost recovery system be freely transferable?

(2) If such benefits are to be transferable, what mechanism should be permitted, e.g., through lease transactions, or transfer of benefits in some other manner, e.g. through sale?

Description of Revised Administration Bill

Under the Administration's revised bill, a safe harbor would be created so that certain transactions of corporate lessors would be characterized as lease transactions, thereby permitting such lessors to pass through to its lessees the tax benefits of ACRS. The bill would allow the tax benefits of ownership to be taken into account in determining the profitability or cash flow of the investment and would reduce the owner's required minimum at-risk investment in the property from 20 to 10 percent. Only new property eligible for the investment credit could be leased under these rules and the property must be leased within three months after it is acquired by the lessor. If the property is acquired from the lessee, it must be acquired by the lessor within three months of the lessee's acquisition of the property.

None of the other proposals contain a similar provision.

General Analysis

Under present law, certain tax attributes of cost recovery may be transferred either directly or indirectly by the owner of the property to the lessee of the property. For example, the lessor/owner of eligible property may make an election under which the lessee will be treated as the owner of the property and will receive the investment credit (sec. 48(d)). Or, tax attributes may be directly passed through to a lessee through lower rentals for the leased property.

There are two main types of leases—direct leases and leveraged leases. In a direct lease, the funds used to purchase the leased asset are provided entirely from the lessor's own funds. However, in a leveraged lease, the lessor purchases the asset by providing only a percentage (generally 20–40%) of the necessary capital. The remainder is borrowed, generally on a nonrecourse basis, secured by a first lien on the equipment, an assignment of the lease, and an assignment of the lease rental payments. The credit rating of the lessee is taken into account in determining the cost of the non-recourse borrowing. Thus, the lease rate depends, in part, on the interest rate on the debt and the risk of the transaction. The lessor claims all of the tax benefits incidental to ownership, assuming that all the requirements of a lease are met, even though only 20–40 percent of the capital was provided by it.

All of the capital cost recovery proposals would provide substantially increased deductions and credits to taxpayers. Many companies, however, may not be able to use these increased benefits for a variety of reasons. For example, (1) the taxpayer may have net operating losses and unused investment tax credits; (2) the taxpayer may be a newly formed corporation unable to utilize fully the tax advantages; (3) the taxpayer may not wish to exhibit on its financial statements the liability that would otherwise be incurred to purchase assets; or (4) the taxpayer may be unable to incur further indebtedness to acquire assets due to existing indenture restrictions. These factors may be expected to cause an increase in the number of leveraged leases.

It has been suggested that taxpayers should be free to sell unused credits and net operating losses likely to result under any of the capital cost recovery proposals. A number of companies, including those in the steel, automobile, mining, airline, and railroad industries presently have unused investment tax credits and net operating losses. Further build-up of both can be anticipated under any system which liberalizes cost recovery.

By liberalizing the present rules for determining whether a transaction is a lease, the Administration's revised bill indirectly addresses the issue of whether the tax benefits of a capital cost recovery system should be transferable. Lessors have argued that unless the rules are liberalized, the intended increase in tax benefits through accelerated depreciation would not fully accrue to the benefit of lessees. Under present rules, one of the requirements of a lease transaction is that the transaction must meet a cash flow or profitability test, independent of tax benefits. Lessors argue that these benefits cannot be passed through to lessees in lower rents even though the marketplace would accommodate the lower pricing to the lessees because the lower rents will cause the leases to violate the cash flow or profits test of the revenue procedures. The Administration has responded to this argument by (1) permitting tax benefits to be taken into account in determining the profitability of the transaction and (2) reducing the required minimum at-risk investment of the lessor.

Lessors argue that by liberalizing the limitations on leveraged leases, the most cost effective method of transfering the benefits of accelerated cost recovery can occur via equipment leasing. They maintain that leasing permits corporations to transfer tax benefits through marketplace payments without the added costs and inefficiencies resulting from direct Federal aid to corporations through subsidies. It is also argued that leasing is preferable to other alternatives as a method of enabling certain taxpayers indirectly to receive currently the benefit of the investment credit and depreciation deductions. Lessors are said to perform a policing function because they make sure that the lessee is economically viable and that the leased equipment is in place and operating. Leasing proponents argue that it would be difficult for the Government to perform this function if credits were refunded or sold to third parties. Those who favor other methods of permitting taxpayers to utilize excess credits such as transferability or refundability argue that those methods could be easily structured to provide the same administability and efficiency as leasing.

Some argue that the Administration's proposed changes to the existing lease rules are not sufficient in many cases to allow lease financings to be used efficiently to pass on tax benefits to lessors in exchange for reduced lease payments. For example, some suggest that a rule should be adopted which would clearly permit the lessee to keep the residual value of the property at the close of the lease. It is also argued that leveraged leasing would be more effective to transfer tax benefits in many situations if no restrictions were imposed in the case of limited use property.

R. Effective Dates and Transition Rules

Issues

Should limitations be placed on the eligibility of used property for increased investment incentives?

Should increased investment incentives be phased in over a transition period?

Analysis of Proposals

Original Administration bill.—Under the Administration's original bill, the new capital cost recovery system would be phased in over 5 years. Also, limitations would be placed on the eligibility of used property for increased investment incentives and the increase in incentives would be phased-in over a 5-year transition period.

To prevent the "churning" of property placed in service before the effective date for the purpose of making this property eligible for more generous depreciation, the Administration's bill would require that the costs of "churned" property be recovered using the straight-line depreciation method over extended recovery periods. The extended recovery periods, which are also used for other purposes under ACRS, are 5 years for three-year property, 10 years for 5-year property, 20 years for 10-year personal property, and 30 years for real property. These anti-churning provisions would apply to used property leased back to someone who used the property before 1981 (the "prior user"), used property acquired from a prior user related to the purchaser, used property acquired from a prior user engaged with the purchaser in trades or businesses under common control, and used property acquired with the principal purpose of avoiding the limitations on used property.

Revised Administration bill.—Under the Administration's revised bill, the 5-year phase-in of shortened recovery periods for both personal and nonresidential real property under the original bill would be replaced by a 6-year phase-in of accelerated depreciation methods for personal property. Also, the limitations on the eligibility of property placed in service before the effective date would be stricter under the original bill.

The revised bill would phase in the accelerated depreciation methods to be used for personal property. For personal property placed in service in the years 1981 through 1984, the prescribed accelerated method would approximate the benefits of the 150-percent declining balance method with a switch to the straight-line method. For property placed in service in 1985, the prescribed accelerated method would approximate the benefits of the 175-percent declining balance method with a switch to the sum-of-the-years-digits method. For property placed in service in 1986 and later years, the prescribed accelerated method would approximate the benefits of the 200-percent declining balance method with a switch to the sum-of-the-years-digits method.

The shortened recovery periods would not be phased in but would be immediately effective for property placed in service after 1980.

Under the revised bill, property would not be eligible under ACRS and would be depreciated under present law rules if it was used before January 1, 1981 and was acquired after December 31, 1980, in certain types of transactions. For personal property, these "churning" transactions generally would include transactions in which either the owner or the user of the property before 1981 (or a person related to such owner or user) is the owner or the user immediately after the transaction. For real property, the churning transactions generally would include transactions in which the owner before 1981 (or a person related to the owner) is the owner after the transaction. In addition, certain transactions involving substituted basis would be churning transactions for real property. For both real and personal property, churning transactions would include transfers involving the tax-free formation of a corporation or a partnership or certain tax-free reorganizations.

Anti-churning rules based on those that would apply to property used before 1981 would apply to property used before 1985 and property used before 1986. The purpose of these rules is to prevent taxpayers from avoiding the limitations on eligibility for the more accelerated methods available for property placed in service in 1985, 1986, and later years.

H.R. 1053.—Under H.R. 1053, both new and used property would be eligible for increased investment incentives. H.R. 1053 does not, however, provide rules to limit the churning of used property.

H.R. 1053 provides phase-in rules that are similar to those under the original Administration bill.

Simplified cost recovery.—Under the 1980 Finance Committee bill, both new and used property would be eligible for increased investment incentives. No limitation would be placed on used property eligible for simplified cost recovery. However, the cost of used property acquired from a related taxpayer could not be expensed under the $25,000 expensing provision. The new incentives would be made available for eligible property placed in service after December 31, 1980, without any phase-in. Unlike the other proposals, the Senate Finance Committee bill provides that the undepreciated costs of property acquired before 1981 could become eligible for simplified cost recovery after 1984 at the taxpayer's election.

First-year capital cost recovery.—Under H.R. 3443 and H.R. 3500, both new and used property would be eligible for first-year capital cost recovery, although the amount of used property eligible for such treatment would be limited until 1984. Both bills would further limit the increased benefits available to used property by providing an anti-churning rule that excludes property acquired after 1980 if such property is used by either a person who used the property before 1981 (a "prior user") or a person related to a prior user.

Under both bills, the system would not become fully effective immediately, but would be phased-in. Under H.R. 3500, a phase-in rule is provided for property placed in service before 1986. Under this rule, the deduction for property placed in service during the phase-in period would be spread over two to five years. Under H.R. 3443, a phase-in rule is provided for property placed in service before 1990.

Under this phase-in rule, an increasing percentage of the first-year deduction would be allowed currently for property placed in service in 1981 through 1989. The portion of the deduction not currently allowed would be placed in a suspense account. An increasing percentage of the suspense account balance would be allowed as a deduction for the years 1982 through 1990. An additional amount would be credited to the suspense account balance each year to compensate for the deferral of deductions. The compensatory amount—similar to a nontaxable interest payment—would be computed by multiplying the suspense account balance by one-half of the interest rate currently payable on refunds and deficiencies (generally 90 percent of the prime rate).

Analysis of Proposals

Phase-in.—A phase-in of an accelerated cost recovery system can reduce revenue losses in the early years and can even out the revenue loss from year to year to facilitate budgeting. However, certain kinds of phase-in systems can give taxpayers an incentive to delay investments until the accelerated cost recovery provisions are fully phased-in. The Committee, therefore, may want to consider the phase-in system in H.R. 3443 which is designed to even out the revenue loss without giving taxpayers an incentive to delay investments. This is done by deferring otherwise allowable deductions during the phase-in period but by, in effect, paying "interest" on the deferred deductions.

Anti-churning.—Any acceleration of capital cost recovery for purchases of used property carries with it the risk that existing assets will be sold just to realize tax benefits. Simply making accelerated cost recovery inapplicable to property in existence on the effective date would be hard to administer because taxpayers would not always know when the used property they buy was originally placed in service. Thus, most pending proposals limit their "anti-churning" rules to cases of sales and leasebacks, sales between related parties, or transactions involving nonrecognition of gain.

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