[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS

RELATING TO

CAPITAL FORMATION INCENTIVES FOR SMALL BUSINESS

LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON MARCH 28 AND APRIL 1, 1980

PREPARED FOR THE USE OF THE

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BY THE STAFF OF THE

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CONTENTS

INTRODUCTION

The bills described in this pamphlet have been scheduled for hearings on March 28 and April 1, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally. The Senate bills described in the pamphlet relate generally to capital formation tax incentive proposals affecting small business, a well as depreciation and investment credit provisions (Capital Cost Recovery Act—S. 1435) which have been the subject of a prior Subcommittee hearing (October 18, 1979).

The first part of the pamphlet is a summary of the bills, presented in numerical order. This is followed by a more detailed description of the bills, setting forth present law, the issues involved, an explanation of the bills, the effective dates, and the estimated revenue effects.

I. SUMMARY

1. S. 110—Senators Nelson, Ford, Huddleston, Pell, Sasser, Weicker, Stewart, Matsunaga, Leahy, Hollings, and Durkin

Small Business Depreciation Reform Act

The bill would permit a taxpayer to elect to depreciate up to $25,000 in annual acquisitions of property over a 3-year period under the straight-line method of depreciation and to obtain the benefit of the full investment tax credit (based on the regular useful life of the property) with respect to property for which an election has been made.

The bill would apply to property placed in service in taxable years ending after the date of enactment.

2. S. 487—Senators Nelson, Stewart, Packwood, Hart, Hollings, and Durkin

Small Business Private Investment Act

The bill would provide a nonrefundable credit against the income tax liability of a citizen or resident of the United States who invests in incentive stock of certain small businesses. The credit would be equal to 10 percent of the first $10,000 of the taxpayer's investment in such stock acquired for money during the taxable year, plus five percent of any investment in excess of $10,000. The maximum credit allowed to an individual in a taxable year would be $3,000 ($6,000 in the case of a married individual filing a joint return). Estates and trusts would not be eligible for the credit.

To be eligible for the credit, an individual would have to first purchase qualifying incentive stock within 180 days of the date of issue. In addition, the individual would be required to hold the stock for specified periods.

The provisions of the bill generally would apply to stock acquired after the date of enactment.

3. S. 653—Senators Nelson, Baucus, Weicker, Huddleston, Hart, Hollings, and Durkin

Nonrecognition of Gain on the Sale of Certain Small Business Stock

The bill would provide for the elective nonrecognition of an individual's gain from the sale or exchange of certain small business stock if the proceeds were reinvested in other small business stock within 18 months of the sale. Under the bill, gain would be recognized to the extent that the sale price exceeds the cost of the small business stock purchased during the 18 months following the sale. If a taxpayer makes the nonrecognition election, the basis of the small business stock acquired during the 18-month period would be reduced by an amount equal to the unrecognized gain realized on the initial sale or exchange.

The provisions of the bill would apply to sales of stock after the date of enactment.

4. S. 1435—Senators Nelson, Bentsen, Packwood, Chafee, and 45 Other Cosponsors

Capital Cost Recovery Act

For most depreciable assets, the Capital Cost Recovery Act would replace existing depreciation rules with a system which provides an accelerated method of depreciation and useful lives which are generally substantially shorter than present useful lives for most eligible depreciable real and personal property (although the lives of some items of personal property would be lengthened). The bill generally would permit a 10-year writeoff for plants and buildings (other than residential real estate), a 5-year writeoff for machinery and equipment, and a 3-year writeoff for a limited amount of investment in automobiles and light trucks. In general, the bill would allow accelerated deductions in the early years of the recovery period, roughly equivalent to using double declining balance depreciation for the first few years and then switching to sum-of-the-years'-digits depreciation. This system of accelerated deductions would apply to both new and used property. Also, the period over which the cost of an asset could be recovered would begin with the earlier of the year in which such costs are paid or incurred or the year in which the asset is placed in service (rather than only with the year in which the asset is placed in service, as under current law). The bill contains transitional rules to phase in the application of the 10-year and 5-year writeoffs (in certain cases) over the period 1980–1983 so that the provisions would not be fully effective until 1984.

The bill also would shorten the useful life requirement for eligibility for the full 10-percent investment credit from 7 years to 5 years and would provide that assets qualifying for a 3-year writeoff would be eligible for a 6-percent investment credit (instead of a 3⅓ percent credit under existing law). The rules for the recapture of investment credit also would be liberalized.

Under the bill, the depreciation recapture rules for real estate covered by the new provisions would be revised to provide for a recapture of all depreciation (rather than only accelerated depreciation) upon sale or other disposition. The bill also would revise the "add-on" minimum tax so that, in the case of real property subject to the new rules, the tax preference for accelerated depreciation on real property would apply only to leased property.

5. S. 1481—Senators Weicker, Baucus, Hatch, Hayakawa, and Hollings

Small Business Participating Debentures

The bill would provide an income tax credit of up to five percent of the amount invested by a United States person in small business participating debentures issued by a qualified small business. A portion of the annual return on such debentures is to be measured by reference to the earnings of the issuer. This portion is to be treated as long-term capital gain by the investor but is to be deducted as interest by the business. If an individual investor incurs a loss with respect to such a debenture, the loss is generally to be treated as an ordinary loss (rather than a capital loss).

6. S. 1967—Senator Nelson

Capital Formation Incentive Aid

Under present law, a securities dealer must recognize any gain on the sale of a security, even if he is making a market for that particular security. The bill would allow securities dealers who are making a market for the securities of small businesses to defer up to $1 million of gain on the purchase and sale of those securities. The gain would be deferred for up to 10 years; at the end of 10 years the deferred gain would be taken into income.

7. S. 2136—Senators Nelson, Baucus, Boren, Matsunaga, Stewart, Pell, Weicker, Durkin, Schmitt, and Bumpers

Small Business Tax Reduction Act

Under present law, corporate taxable income is subject to tax at graduated rates. The corporate tax rate schedule includes five brackets. The bill, in general, would widen the third and fourth rate brackets and lower the rate in the first bracket. As a result of the changes made by the bill, the tax liability of a corporation with taxable income of $150,000 would be reduced from $49,750 to $43,750.

8. S. 2152—Senators Nelson, Baucus, Boren, Culver, Huddleston, Matsunaga, Pell, and Stewart

Used Machinery Investment Credit Adjustment Act

Present law provides a 10-percent regular investment credit. A taxpayer may claim this regular investment credit for the cost of up to $100,000 of used qualifying property acquired by purchase each taxable year. This limitation results in a maximum credit of $10,000 on used property for any taxable year.

The bill would increase the annual cost limitation on used property for purposes of the 10-percent regular investment credit from $100,000 to $200,000. The provisions of the bill would be effective for qualifying used property purchased after December 31, 1979.

9. S. 2168—Senators Nelson, Baucus, Boren, Huddleston, Matsunaga, Stewart, and Schmitt

Subchapter S Capital Formation Act

The bill would provide that qualified small business corporations (subchapter S corporations) could have 100 shareholders (present law allows 15 shareholders), and that the corporation could have more than one class of stock so long as the allocation of income among the shareholders is not affected.

59-775 O - 80 - 2

The provisions of the bill would be effective with respect to taxable years beginning with, or in calendar years beginning after, the date of enactment of the bill.

10. S. 2171—Senator Nelson

Time for Furnishing Form W-2 to Terminated Employees

Present law requires an employer to furnish to an employee who has terminated employment prior to the close of the calendar year a Form W-2 on the day the employee receives his or her last salary payment.

Under the bill, the employer of an employee who terminates employment prior to the close of the calendar year would be required to furnish the employee a Form W-2 no later than January 31 of the following calendar year (as is the case for other employees), unless the employee requests that it be furnished at an earlier date. If the employee requests that a Form W-2 be furnished prior to January 31, the employer would be required to furnish the form within 30 days after receipt of the employee's written request.

11. S. 2239—Senators Packwood, Nelson, and Cranston

Incentive Stock Options

Generally, under present law, an employee is taxed on a compensatory stock option at the time the option is received, or, if the option does not have a readily ascertainable fair market value, at the time it is exercised. The employer has a corresponding deduction as a business expense.

Under the bill, a stock option meeting certain requirements which is granted to an employee would be taxed at capital gains rates when the employee sells the stock. The employer would receive no deduction.

The bill would apply to options granted after the date of enactment.

II. DESCRIPTION OF BILLS

1. S. 110—Senators Nelson, Ford, Huddleston, Pell, Sasser, Weicker, Stewart, Matsunaga, Leahy, Hollings, and Durkin

Small Business Depreciation Reform Act

Present law

If a taxpayer acquires an asset with a useful life of more than one year for use in a trade or business or for the production of income, the cost of the asset must be capitalized. If the asset is property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion and to obsolescence, the adjusted basis (less salvage value in excess of 10-percent of cost) generally can be deducted over the asset's useful life either ratably or pursuant to a permissible "accelerated" method under which larger deductions are allowable in the earlier years of use. This approach to the recovery of the cost of an asset is referred to as depreciation.

In certain cases, the Code provides for a rapid cost recovery for acquisition costs of certain types of assets over a prescribed period which is not, and does not purport to be, related to their useful lives. For example, five-year amortization is allowed for certain rehabilitation expenditures for low-income housing (sec. 167(k)), for costs of certain pollution control facilities (sec. 169), for certain trademark and trade name expenditures (sec. 177), for the costs of certain railroad rolling stock (sec. 184), for certain child care facilities (sec. 188), and for certain rehabilitation expenditures for certified historic structures (sec. 191).

Issues

The major issues raised by the bill are whether taxpayers should be able to elect to use rapid depreciation for a limited amount of tangible personal property and whether, if such depreciation is elected, taxpayers could continue to use the regular useful life of the property for which an election is made for purposes of determining the investment credit.

Explanation of the bill

The bill would permit a taxpayer to elect to depreciate up to $25,000 in annual acquisitions of property over a 3-year period under the straight-line method of depreciation and to obtain the benefit of the full investment tax credit (based on the regular useful life of the property) with respect to property for which an election has been made.[1] Property which is depreciated under this provision is not

[1] Although it appears that these special depreciation rules are intended to be applicable only to tangible personal property, the bill by its terms would apply to any property (including real property) which is eligible for depreciation under section 167 of the Code.

eligible for additional first-year depreciation under Code section 179 (but no other changes are made with respect to sec. 179).

Effective date

The bill would apply to property acquired after the date of enactment and placed in service in taxable years ending after the date of enactment.

Revenue effect

Assuming that the bill would be amended to exclude real property, it is estimated that the bill would increase tax liabilities by $100 million in calendar year 1980 [2] and would reduce tax liabilities by $1.4 billion in calendar year 1981, by $3.3 billion in calendar year 1982, by $4.0 billion in calendar year 1983, and by $3.3 billion in calendar year 1984.

Other issues for committee consideration

The committee may wish to consider a number of other issues which relate to this new depreciation proposal. Most of these issues are relatively technical, and solutions to the problems raised may well be achievable without jeopardizing the basic policy goals of the proposal. One issue is whether controlled group and related party rules need to be adopted for purposes of preventing avoidance of the dollar limitation on eligible assets. Another issue is how these provisions are to be coordinated with other rules such as the minimum tax and the recapture rules. Still another issue is what conventions (half-year, modified half-year, etc.) should be allowed, or required, in connection with this proposal. An additional issue is whether these useful lives would (or should) apply to leased property. Also, it is not clear whether the dollar limitation on eligible assets applies at the partner level or the partnership level.

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[2] The increase in tax liabilities for calendar year 1980 would occur because, in the first year but not succeeding years, the reduced depreciation resulting from the inability to use additional first-year depreciation and accelerated methods of depreciation for property for which an election is made would more than offset the benefits from the shorter lives for such property.

2. S. 487—Senators Nelson, Stewart, Packwood, Hart, Hollings, and Durkin

SMALL BUSINESS PRIVATE INVESTMENT ACT

Present law

Under present law, credits against a taxpayer's income tax liability are provided for certain investments. For example, credits are allowed, within certain limits, for investment in certain depreciable business assets (secs. 38 and 46), for contributions to ESOPs based on the investment in depreciable business assets (sec. 46), and for qualified energy expenditures (sec. 44C). No credit is allowed for investment in stock of a corporation.

Issue

The principal issue is whether a credit against income tax liability should be allowed to individuals who invest in original issue stock of certain small businesses. Another issue is the appropriate size limitation for corporations whose original issue stock could qualify as small business incentive stock.

Explanation of the bill

The bill would provide a nonrefundable credit against the income tax liability of a citizen or resident of the United States who invests in incentive stock of certain small businesses.[1] The credit would be equal to 10 percent of the first $10,000 of the taxpayer's investment in such stock acquired for money during the taxable year, plus five percent of any investment in excess of $10,000. A taxpayer's investment in incentive stock would be his adjusted basis in such stock. The maximum credit allowed to an individual in a taxable year would be $3,000 ($6,000 in the case of married individuals filing a joint return). Estates and trusts would not be eligible for the credit.

Under the bill, incentive stock means original issue common or preferred stock which is registered under the Securities Exchange Act of 1934 and offered to the public in an unrestricted offer. The aggregate sale price of the offer could not exceed $7,500,000. The incentive stock would have to be issued by a domestic corporation (other than a subchapter S corporation) having equity capital of $25 million or less.[2] In addition, the amount of passive investment income a qualifying issuing corporation could have would be limited.

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[1] Under the bill, no credit would be allowed with respect to incentive stock if the taxpayer elected deferral of gain with respect to the same stock under the provisions of S. 653.

[2] In the case of a corporation which is a member of a controlled group of corporations, the equity capital of all members of the controlled group would be treated as the equity capital of the issuing corporation.

The credit would not be allowed (1) to an individual who at any time during the taxable year possesses 80 percent or more of the total combined voting power of all classes of stock entitled to vote or (2) to an individual who is claimed as a dependent by another taxpayer. Also, the credit would not be allowed for the acquisition of incentive stock by an underwriter in the ordinary course of the underwriter's trade or business.

To be eligible for the credit, an individual would have to first purchase qualifying incentive stock within 180 days after the date on which it is issued. In addition, the individual would be subject to certain holding requirements with respect to the stock. The individual would have to hold the incentive stock on the date for filing his tax return for the taxable year of the acquisition. If the taxpayer claimed a credit for incentive stock for a preceding taxable year and failed to hold the stock for more than six months, his tax for the year of disposition would be increased by the amount of the credit.

The limitations with respect to the holding period of incentive stock would not generally apply in the case of a bequest or gift unless the bequest or gift were a deductible charitable donation or the recipient disposed of the stock before it was held for more than six months (including any period of time during which the stock was held by the decedent or donor).

Effective date

The provisions of the bill generally would apply with respect to stock acquired after the date of enactment.

Revenue effect

It is estimated that the bill would reduce budget receipts by $25 million in fiscal year 1981, $30 million in 1982 and 1983, $35 million in 1984, and $40 million in fiscal year 1985.

3. S. 653—Senators Nelson, Baucus, Weicker, Huddleston, Hart, Hollings, and Durkin

Nonrecognition of Gain on the Sale of Certain Small Business Stock

Present law

Present law generally requires recognition of the entire amount of gain or loss realized on the sale or exchange of property, except as otherwise provided in the Code (Code sec. 1001(c)). However, in a number of instances, the Code provides for the nonrecognition of gain or loss realized on the sale or exchange of property, e.g., section 351 (relating to transfers to corporations controlled by the transferor), section 354 (relating to exchanges in certain reorganizations), section 721 (relating to certain partnership contributions), section 1031 (relating to certain exchanges of business or investment property), section 1033 (relating to certain involuntary conversions), section 1034 (relating to certain residential sales or exchanges), and section 1039 (relating to certain sales of low-income housing projects). Generally, none of these nonrecognition provisions would apply to gain realized on the sale of small business stock.

Issue

The principal issue is whether nonrecognition of gain should be allowed where the proceeds of the sale or exchange of certain small business stock are reinvested in other qualifying small business stock. Another issue is the appropriate size limitation for corporations whose stock could qualify as small business stock. An additional issue is whether there should be a required holding period for the small business stock which is purchased in compliance with the reinvestment requirement.

Explanation of the bill

The bill would provide for the elective nonrecognition of a taxpayer's long-term capital gain from the sale or exchange of certain small business stock if the proceeds are reinvested in small business stock within 18 months of the sale.[1] Under the bill, gain would be recognized to the extent that the sale price exceeds the cost of the small business stock purchased during the 18 months following the sale. If a taxpayer made the nonrecognition election, the basis of the small business stock acquired during the 18-month period would be reduced by an amount equal to the unrecognized gain realized on the sale.

To be eligible for the nonrecognition election, both the interest sold and the interest subsequently acquired would have to qualify as "small

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[1] Under the bill, nonrecognition would not be allowed with respect to small business stock if the taxpayer elected a tax credit on the purchase of the stock under the provisions of S. 487.

business stock." Under the bill, "small business stock" means common or preferred stock issued by a domestic corporation or small business investment company [2] (other than a subchapter S. corporation), which has equity capital of $25 million or less.[3] In addition, the amount of passive investment income a qualifying corporation could have would be limited.

The nonrecognition election would not be available to an underwriter who acquires small business stock in the ordinary course of his trade or business as an underwriter.

Under the bill, if a taxpayer has a gain on the sale of small business stock held for at least 12 months and if the taxpayer purchases other small business stock within 18 months of the sale, the holding period of the second stock would include the holding period of the first stock. Thus, with respect to small business stock, the acquisition of which resulted in the nonrecognition of gain from the sale of other small business stock, the gain or loss generally would be treated as long-term capital gain or loss.

In addition, the bill would provide that the statutory period for the assessment of any deficiency would not expire until three years after the date that the taxpayer notified the Secretary of the Treasury of (1) the cost of purchasing the small business stock which the taxpayer claims resulted in nonrecognition of gain, or (2) the intent not to purchase or the failure to purchase other qualifying small business stock within the specified time.

Effective date

The provisions of the bill would apply with respect to stock acquired after the date of enactment.

Revenue effect

It is estimated that the bill would reduce budget receipts by $300 million in fiscal year 1981, $700 million in 1982, $800 million in 1983, $900 million in 1984, and $1.0 billion in fiscal year 1985.

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[2] A small business investment company is defined by reference to the term as used in the Small Business Investment Company Act of 1958 (15 USC 681 et seq.).

[3] In the case of a corporation which is a member of a controlled group of corporations, the equity capital of all members of the controlled group would be treated as the equity capital of the issuing corporation.

4. S. 1435 *—Senators Nelson, Bentsen, Packwood, Chafee, and 45 Others

Capital Cost Recovery Act

Present Law

A. Depreciation

Depreciation in general

If a taxpayer acquires an asset with a useful life of more than one year for use in a trade or business or for the production of income, a current deduction of the cost generally is not allowed. Rather, the cost of the asset must be capitalized. If the asset is property which is subject to wear and tear, decay or decline from natural causes, exhaustion and obsolescence,[1] the adjusted basis (less salvage value in excess of 10 percent of cost) generally can be deducted over the asset's useful life either ratably or pursuant to a permissible "accelerated" method under which larger deductions are allowable in the earlier years of use.[2] This approach to the recovery of the basis of an asset is referred to as depreciation.

Depreciation of personal property

For new tangible personal property with a useful life of 3 years or more, the accelerated methods allowed include the 200-percent declining balance method, the sum-of-the-years-digits method, or any other method used consistently by the taxpayer which does not result in the allowance of greater aggregate depreciation deductions during the first two-thirds of the useful life of the property than would be allowable under the 200-percent declining balance method (e.g., methods based on units of production, machine time, etc.). Administrative practice has permitted the 150-percent declining balance method to be used for used tangible personal property.[3]

The key factors which determine the amount and the timing of depreciation deductions with respect to any depreciable asset are: (1) the cost of the asset; (2) the salvage value of the asset; (3) the useful life assigned to the asset; and (4) the method of depreciation (e.g.,

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*A prior hearing was held on this bill on October 18, 1979, by the Subcommittee.

[1] If the asset is not subject to these factors, depreciation is not allowable. For example, land is not depreciable.

[2] In certain cases, the Code provides for a rapid cost recovery for acquisition costs of certain types of assets over a prescribed period which is not, and does not purport to be, related to their useful lives. For example, five-year amortization is allowed for certain rehabilitation expenditures for low-income housing (sec. 167(k)), for costs of certain pollution control facilities (sec. 169), for certain trademark and trade name expenditures (sec. 177), for the costs of certain railroad rolling stock (sec. 184), for certain child care facilities (sec. 188), and for certain rehabilitation expenditures for certified historic structures (sec. 191).

[3] Rev. Rul. 57-352, 1957-2 C.B. 150; Rev. Rul. 59-389, 1959-2 C.B. 89.

Accelerated methods are not allowed for intangible assets (sec. 167(c)).

59-775 O - 80 - 3

straight line or an accelerated method). Since determinations of the first three of these factors are essentially factual and are based on circumstances which may be unique to the taxpayer's situation, many controversies arise between taxpayers and the Internal Revenue Service on appropriate useful lives and salvage values. Thus, a major purpose for establishing the ADR system was to reduce the controversies relating to useful lives and salvage values for certain types of property. Similarly, a repair allowance system was provided to reduce controversies over the classification of expenditures as currently deductible repairs or as capital improvements.

ADR System

In general

The regular rules relating to allowable methods of depreciation generally are applicable under the ADR system. However, in the case of new tangible personal property with a useful life of three years or more, a taxpayer who elects ADR may select only the straight-line, declining balance (up to 200 percent), or sum-of-the-years-digits methods. For used depreciable personal property, accelerated depreciation is limited to the 150-percent declining balance method, i.e., 150 percent of the straight-line rate.

Election

A taxpayer must make an irrevocable election to apply the provisions of the ADR system to eligible property placed in service during the taxable year. This election is applicable to all eligible assets placed in service during the taxable year and is effective as to those assets for all subsequent taxable years. This election must be made on Form 4832 and filed with the taxpayer's income tax return for each year that application of the ADR system is elected. If, in a subsequent taxable year, the taxpayer does not elect to apply the ADR system, the regular rules regarding depreciation will be applicable to any depreciable assets placed in service during that taxable year. A valid election to apply the ADR provisions must contain the taxpayer's consent to comply with all of the ADR requirements and must specify certain information (for example, the asset guideline class and the first-year convention adopted by the taxpayer for the taxable year of election). In addition, the taxpayer must maintain books and records from which certain specific information can be drawn (for example, the depreciation period and salvage value for each vintage account established for the taxable year and each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance). Also, taxpayers who elect the ADR provisions must respond to infrequent data surveys conducted by the Treasury Department.[4]

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[4] The information reporting requirements for an electing taxpayer were reduced and simplified by the Treasury Department on January 26, 1979 (Treas. Reg. § 1.167(a)-11, as amended by T.D. 7593, 44 Fed. Reg. 5419). In general, much of the information which was required on IRS form 4832 is no longer automatically required to be submitted. Instead, the books and records of the taxpayer must be maintained so that such information is readily available, and if the Treasury Department surveys the taxpayer, the information called for must be submitted on the survey request.

Eligible property

An ADR election applies only to eligible property. Generally, eligible property is new or used depreciable property for which an asset guideline class and an asset guideline period have been prescribed by the Treasury Department for the taxable year of election. If used property constitutes a significant portion of the property placed in service during a taxable year (10 percent), a taxpayer may elect to apply the ADR system only to new property.

Presently, with certain very limited exceptions, the ADR system does not apply to depreciable real property. Until class lives under the ADR system are prescribed for real estate, a taxpayer who has elected the ADR system may elect to determine the useful life of depreciable real property under Revenue Procedure 62-21 (which reflects the prior general IRS position on useful lives) as in effect on December 31, 1970, or on the basis of the facts and circumstances of the particular case.[5]

Vintage accounts

Under the ADR system, the allowance for depreciation is computed on the adjusted basis of the assets grouped together in a vintage account. The vintage of the account refers to the taxable year during which the eligible property is first placed in service. Each eligible property may be placed in a separate vintage account or, under certain circumstances, assets in the same guideline class may be placed in the same vintage account. However, new and used eligible property may not be combined in a single vintage account. Certain other property also may not be combined in a single vintage account, e.g., property eligible for additional first-year depreciation may not be combined with ineligible property.

Certain special rules have been provided to account for ordinary and extraordinary retirement of assets in a vintage account. Likewise, special rules are provided in connection with the recognition of gain or loss on retirements.

Useful lives and asset guidelines class

In general, the estimated useful life of assets in each asset guideline class is established by the Office of Industrial Economics of the Treasury Department. Each asset guideline class consists of a category of assets that have certain common characteristics or that are utilized in the same or related activities. Generally, a class life is established to reflect the actual asset replacement practices being employed by taxpayers and other factors, such as obsolescence. The taxpayer may use a depreciation life within a range (asset depreciation range) of 20 percent below or above the predetermined life of the asset guideline class. For example, if the asset guideline period for a certain asset guideline class is 10 years, the taxpayer may elect a useful life with respect to assets in that guideline class that is not less than 8 years (20 percent below the asset guideline period) nor more than 12 years (20 percent above the asset guideline period). Under the ADR system, there are 14 asset classes for specific categories of depreciable assets. These categories apply to assets of specific types (e.g., automobiles) regardless of the type of business in which the assets are used. There are also

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[5] Section 5 of Public Law 93-625.

approximately 118 classes (or subclasses) of depreciable assets grouped by the type of activity in which the assets are used. Table 1 illustrates the useful lives of a limited number of asset classes under ADR.

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 fabricated metal products—special tools	2.5	3	3.5
Manufacture of motor vehicles—special tools	2.5	3	3.5
Breeding hogs	2.5	3	3.5
Manufacture of electrical equipment—special tools	4.0	5	6.0
Certain intermediate-lived assets:			
Data handling equipment except computers	5.0	6	7.0
Assets used in drilling of oil land gas wells	5.0	6	7.0
Manufacture of electronic products	6.5	8	9.5
Certain long-lived assets:			
Railroad cars and locomotives, except those owned by railroad transportation companies	12.0	15	18.0
Vessels, barges, tugs, and similar water transportation equipment, except those used in marine contract contruction	14.5	18	21.5
Industrial steam and electric generation and/or distribution systems	17.5	22	26.5
Telephone central office equipment	16.0	20	24.0

Source: Revenue Procedure 77-10, 1977-1 C.B. 548, as modified by Rev. Proc. 79-26, 1979-18 I.R.B. 21.

"Half-year convention" rules

Under the ADR system, two alternative conventions are provided for purposes of determining depreciation for the year during which property is first placed in service. First, the "modified half-year convention" provides that depreciation for a full year is allowed for all eligible property placed in service during the first half of the taxable year. All other eligible property will be treated as being placed in service on the first day of the next taxable year. Second, the "half-year convention" provides that depreciation is allowable for a half-year for all eligible property placed in service during the taxable year. The same convention must be used for all vintage accounts of the same taxable year but may be changed as to vintage accounts of subsequent taxable years.

Salvage value

In general, the allowance for depreciation is computed on an asset's basis for purposes of determining gain. However, an asset may not be depreciated below a reasonable salvage value. With respect to depreciable personal property with a useful life of three years or more, salvage value taken into account may be reduced by up to 10 percent of the amount of the adjusted basis of the asset for purposes of determining gain. Thus, if salvage value is less than 10 percent, it may be ignored. The salvage value of each vintage account must be estimated by the taxpayer at the time of electing the ADR system for assets placed in service for a taxable year. The estimate is made on the basis of the facts and circumstances existing at the end of that taxable year.

Treatment of repairs, maintenance, etc.

Under present law, the characterization of certain expenditures for the repair, maintenance, rehabilitation, or improvement of property is a factual determination. If these expenditures substantially prolong the life of an asset or are made to increase its value or adapt it to another use, the expenditures are capital in nature and are recoverable in the same manner as the cost of a capital asset. All other expenditures for repair, maintenance, etc., are allowed as a deduction during the taxable year in which paid or incurred.

If a taxpayer elects to apply the ADR provisions, the taxpayer may make a further election to apply the provisions of the asset guideline class "repair allowance." Under these provisions, a taxpayer is allowed a current deduction for amounts paid or incurred for certain repairs, maintenance, and similar expenditures to the extent that the expenditures do not exceed, in general, the average unadjusted basis of all repair allowance property multiplied by the repair allowance percentage. "Repair allowance property" is eligible property in an asset guideline class for which a repair allowance percentage is in effect for the taxable year. The repair allowance percentage is a predetermined rate established for each asset guideline class. Property improvements (including the amount of repairs, maintenance, etc., in excess of the asset repair allowance) and excluded additions are capitalized in a special basis vintage account, subject to the ADR rules. If a taxpayer does not elect to use the asset guidelines class repair allowance for assets in an asset guideline class, the regular rules regarding the treatment of expenditures for the repair, maintenance, rehabilitation, or improvement of property are applicable. If the repair allowance is elected, the taxpaper must maintain books and records to identify repair expenditures relating to specific classes of property, to allocate to specific classes of property the expenditures relating to properties in two or more classes, and to identify expenditures for excluded additions, e.g., expenditures which are clearly for capital items.

Recognition of gain or loss on retirement

In general, a taxpayer recognizes gain or loss upon each sale or other disposition of depreciable personal property. Thus, under normal tax rules, each retirement of depreciable personal property (coupled with a sale, exchange, or abandonment) would result in current recognition of gain or loss.

Under the ADR system, recognition of gain or loss may be postponed for "ordinary retirements" of assets included in a vintage account, i.e., retirements occurring for routine causes during the range of years selected for the account. In this case, the proceeds from the retirement are added to the depreciation reserve of the vintage account. However, in the case of an "extraordinary retirement," any gain or loss resulting from the retirement is recognized. (The characterization of gain or loss is governed by the normal rules relating to depreciation recapture and gain or loss on property used in a trade or business (secs. 1231 and 1245).) For this purpose, an extraordinary retirement would include a retirement attributable to an insured casualty.

Depreciation of real property

Accelerated methods

Under present law, a depreciation deduction is allowed for the exhaustion, wear, and tear of buildings used in a trade or business or held for the production of income. 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 aggregate 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 year 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 properties 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.

Certain rehabilitation expenditures for low-income rental housing may be amortized on a straight-line basis over a period of 60 months. Qualified rehabilitation expenditures for certified historic structures also may be amortized over a 60-month period. Alternatively, in some cases, the cost of an historic structure, including the rehabilitation expenditures, may be depreciated as a new building, for example, under the 200-percent declining balance method for residential property or the 150-percent declining balance method for nonresidential property.

A 60-month amortization method is also available for certified pollution control facilities and certain expenditures for child care facilities.

Generally, in the case of all real estate other than certain low-income rental housing, depreciation in excess of straight-line depreciation is subject to recapture as ordinary income upon a sale or exchange of the property (rather than being considered long-term capital gain). All of the depreciation allowable, including straight-line depreciation, is recaptured as ordinary income if the property is not held for more than 12 months. Any gain in excess of the amount recaptured as ordinary income is treated as gain from the sale or exchange of property used in a trade or business (sec. 1231). This portion of a gain is aggregated with gains and losses from other sales or exchanges of property used in a trade or business. After aggregation, a net gain is eligible for capital gains treatment and a net loss is treated as an ordinary loss.

In the case of 5-year amortization, gain is generally recaptured as ordinary income for the full amount of the amortization allowable in the same manner as recapture for depreciable personal property. However, in the case of low-income housing rehabilitation expenditures and qualified rehabilitation expenditures for certified historic structures, gain is recaptured as ordinary income only to the extent of the amortization allowable in excess of straight-line depreciation in essentially the same manner as for depreciable real property generally.

Accelerated depreciation on real property in excess of straight-line is treated as a tax preference for minimum tax purposes, reduces the amount of personal service income eligible for the 50-percent maximum tax on personal service income, and is not taken into account in determining the earnings and profits of a corporation.

Useful lives

Under present law, depreciation for real estate may be determined by estimating useful lives under a facts-and-circumstances test or under lives prescribed under Revenue Procedure 62–21, as in effect on December 31, 1970. Guideline lives under the class life asset depreciation range system (ADR) generally have not been prescribed for real property.

Under Revenue Procedure 62–21, useful lives are prescribed for certain types of buildings. The useful lives are based on a composite account for the structural shell and all integral parts, including air-conditioning, fire prevention, and power requirements, and equipment such as elevators and escalators. The lives exclude special-purpose structures which are an integral part of a production process and are normally replaced when the equipment housed is replaced. The lives are set forth in Table 2.

TABLE 2.—GUIDELINES LIVES FOR CERTAIN BUILDINGS UNDER REVENUE PROCEDURE 62–21

Type of Building	**Useful life (years)**
Apartments	40
Banks	50
Dwellings	45
Factories	45
Garages	45
Grain Elevators	60
Hotels	40
Loft Buildings	50
Machine Shops	45
Office Buildings	45
Stores	50
Theaters	40
Warehouses	60

Generally, as indicated in Table 3, taxpayers have claimed useful lives that are shorter than those listed in Rev. Proc. 62–21.

TABLE 3.—COMPARISON OF 1962 GUIDELINES AND LIVES CLAIMED FOR CERTAIN BUILDING TYPES

[In years]

Building type	Guideline lives under revenue procedure 62–21	Average lives claimed by taxpayers (new buildings only)	Percentage of taxpayers claiming lives shorter than guideline lives
Retail (including shopping centers)	50	36	93
Warehouses	60	37	99
Factories	45	37	77
Office buildings	45	41	91
Banks	50	43	79
Apartments	40	32	78

Source: Office of Industrial Economics. Department of the Treasury, *Business Building Statistics* (GPO, Washington, 1975).

Furthermore, by use of the component depreciation method, some taxpayers have claimed depreciation deductions which approximate the deductions which would be obtained by the use of composite lives of as short as 16–20 years on certain new commercial buildings.[6] However, there is no certainty that these deductions would be allowed by IRS or the courts.

Other rules relating to depreciation

Additional first-year depreciation

Under present law, the provision for additional first-year depreciation (sec. 179) permits an owner of tangible personal property with a useful life of six years or more to elect, for the first year the property is subject to depreciation, a deduction for additional first-year depreciation in an amount not exceeding 20 percent of the cost of the property. The cost of the property which may be taken into account may not exceed $10,000 ($20,000 for individuals who file a joint return).[7] Thus, the maximum additional first-year depreciation deduction is limited to $2,000 ($4,000 for individuals filing a joint return).

Recapture

Under present law, with certain limited exceptions, gain from the disposition of depreciable personal property (and certain other prop-

[6] Under this depreciation method, a taxpayer allocates the cost of a building to its basic component parts and then assigns separate useful lives to those components. These components would include the basic building shell, plumbing and heating system, roof, and other identifiable components. Each of the component parts is then depreciated as a separate item of property.

[7] In the case of depreciable property owned by a partnership, the $10,000 limitation is applied at both the partnership level and the partner level.

erty—generally property which is eligible for the investment credit) is "recaptured" as ordinary income to the extent of the depreciation taken (sec. 1245). Gain in excess of the depreciation taken may be treated as capital gain under section 1231 (unless the gain is offset by losses on sec. 1231 assets).

Generally, in the case of all real estate other than certain low-income rental housing, depreciation in excess of straight-line depreciation is subject to recapture as ordinary income upon a sale or exchange of the property (rather than being considered long-term capital gain). All of the depreciation allowable, including straight-line depreciation, is recaptured as ordinary income if the property is not held for more than 12 months. Any gain in excess of the amount recaptured as ordinary income is treated as gain from the sale or exchange of property used in a trade or business (sec. 1231). This portion of a gain is aggregated with gains and losses from other sales or exchanges of property used in a trade or business. After aggregation, a net gain is eligible for capital gains treatment and a net loss is treated as an ordinary loss.

Accelerated depreciation and the minimum tax

Under present law, 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 and one-half of the amount of the regular income tax in the case of an individual.[8]

One of the tax preferences in the minimum tax is accelerated depreciation on leased personal property.[9] The tax preference is the amount by which the income tax deduction for depreciation (or amortization) exceeds the depreciation deduction which would have been allowed if the property had been depreciated under the straight line method of depreciation for each year of its useful life for which the taxpayer owned the property. If the leased property is depreciated under the ADR system and the taxpayer chooses to use a shorter life than the ADR class life established for the asset, any increase in depreciation for the year on account of using a useful life shorter than the class 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. This tax preference does not apply to corporations other than personal holding companies and subchapter S corporations.

With respect to real property (sec. 1250 property), accelerated depreciation, i.e., the excess of the deduction for depreciation (or amortization) over straight line depreciation, is a tax preference item.

These tax preference items also reduce the amount of personal service taxable income eligible for the 50-percent maximum tax on personal service taxable income.

Earnings and profits

Generally, a corporate distribution with respect to the corporation's stock is a dividend only if it is made out of the corporation's current

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[8] The 15-percent minimum tax is separate and apart from the alternative minimum tax (under sec. 55).

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

or accumulated "earnings and profits." Generally, earnings and profits are computed in a manner similar to the manner in which taxable income is computed. However, a number of adjustments and special rules apply.

Under one of these special rules, for taxable years beginning after June 30, 1972, depreciation in excess of straight-line depreciation is not taken into account for purposes of determining earnings and profits (sec. 312(k)).

B. Investment tax credit

Present law provides a 10-percent regular investment credit and a 10-percent energy investment credit for investments in certain tangible property used in a trade or business or for the production of income. The amount of each credit is generally 10 percent of a taxpayer's eligible cost in acquiring qualifying property. The credits are used to offset the taxpayer's income tax liability.[10]

To be eligible for these credits, property must be depreciable or amortizable and must have a useful life of three years or more. However, reduced credits are allowed where property has a useful life of less than seven years. Under these rules, if the property has a useful life of three or four years, a credit is allowed on one-third of the cost of the property. Similarly, a credit is allowed on two-thirds of the cost where the property has a useful life of five or six years. This determination is generally made on the basis of the useful life which is used for purposes of depreciation or amortization. These useful life limitation rules are also applied where the credit has been claimed and the property is later disposed of by the taxpayer before the end of its useful life. In such situations, the credit is recomputed on the basis of its actual useful life in the hands of the taxpayer, which may result in a reduction in the allowable credit and a recapture of the excess credit from the taxpayer.

For purposes of the regular investment credit, qualifying property includes tangible personal property (such as motor vehicles, machinery and office equipment) and also other tangible property (such as blast furnaces, pipelines, railroad track, and utility poles) used as an integral part of manufacturing, production, extraction or furnishing certain services, including electrical, gas, and steam utility services. However, buildings and their structural components are not generally eligible for the regular investment credit. Qualifying property for purposes of the energy investment credit includes boilers, burners, and related fuel handling and pollution control equipment to burn substances other than oil or natural gas or to convert these alternate substances into a fuel. In addition, energy property includes equipment which uses solar, wind, or geothermal energy, and equipment to produce either natural gas from geopressurized brine or oil from shale. Equipment used to recycle solid waste, as well as certain specially

[10] Under certain circumstances, a corporate taxpayer may elect an additional one percent investment tax credit if an amount equal to one percent of the qualified investment for the year is contributed to an employee stock ownership plan (ESOP). Further, an additional one-half of one-percent investment tax credit is available if (a) an equivalent amount is contributed to the ESOP by the taxpayer and is matched by employee contributions and (b) certain other requirements concerning the operation of the ESOP are met.

defined equipment (such as heat wheels) added to existing facilities to utilize otherwise wasted heat and gases, also qualifies as energy property. The energy credit is available for buildings and their structural components which otherwise qualify as energy property. However, the energy credit does not extend to energy property used to provide electrical, gas, steam, and other public utility services.

Generally, the investment credits are claimed for the taxable year in which qualifying property was placed in service. However, in cases where property is constructed over a period of two or more years, an election is provided under which the credit may be claimed on the basis of progress expenditures made during the period of construction before the property is completed and placed in service.

The regular investment credit may be used to offset the first $25,000 of tax liability plus a percentage of tax liability in excess of $25,000. This percentage is 60 percent for 1979 and will increase by increments of 10 percentage points a year to 90 percent for 1982 and later years. The energy credit applies against all tax liability not offset by the regular credit (and the ESOP credit), and energy credits for solar and wind energy property are fully refundable to the extent they exceed tax liability. Other excess regular and energy credits from a taxable year may be carried over to supply against tax liability for the three preceding and seven succeeding years.

Depreciation and Other Investment Incentives in Selected Foreign Countries

In general

It is argued that increases in productivity are lower in the United States than in other industrialized nations in part because the United States provides lesser tax incentives for capital investment than other industrialized nations. Brief summaries of the depreciation rules (and other tax incentives for investment) of five industrialized nations are set forth below. In general, the nations selected are either major competitors or major trading partners of the United States. These rules are generally the rules in effect as of January 1, 1978.[11] Since these summaries are not exhaustive, in some cases definitive conclusions cannot be drawn as to whether the countries referred to below provide greater tax incentives for capital investment than the United States.

West Germany

Depreciation

In general

The beneficial owner of fixed tangible or intangible assets which have a determinable useful life in excess of one year may deduct a reasonable allowance for depreciation. In general, a taxpayer is required to deduct depreciation only in the year in which it is allowable, and the deduction may not be deferred to a later year. However, it appears that depreciation allowances which have been inadvertently unclaimed when allowable may be deductible in later years.

The basis of an asset for purposes of depreciation is the cost of acquisition or manufacturing. Immovable assets can be depreciated

[11] Where depreciation rules are different for individuals and corporations, the rules applicable to corporations are set forth.

only by using the straight-line method. On the other hand, in the case of movable fixed assets, straight-line, 2.5 times declining balance, and the production basis methods are permitted. If the declining balance method is used, the rate may not exced 25 percent. Additional depreciation may be claimed when assets are subject to heavy use. In these situations, the straight line rates may be increased by 25 percent for two-shift use and by 50 percent for three-shift use.

A change from the declining balance method to the straight-line method is permissible, but not vice versa. Salvage value may be ignored at the taxpayer's election unless the salvage value is expected to be substantial. Because profits on disposal of fixed assets are taxable at the same rates as ordinary commercial profits, this factor has little significance and German companies seldom take it into account in determining their depreciation policy. At any time during the life of a movable asset, the going concern value, if lower than the adjusted cost basis, may be substituted for it. Also, it appears that a deduction for obsolescence resulting from technological or economic factors is allowable. However, on movable fixed assets which are being depreciated on the declining balance method, special depreciation for obsolescence cannot be deducted.

The depreciation taken in the commercial financial statements may exceed the depreciation shown on the tax statements, but not vice versa. This rule appears to require that depreciation claimed for tax purposes must be reflected in earnings statements.

The rates of depreciation permissible for fixed assets other than buildings are not fixed by statute, but the Federal Ministry of Finance publishes a table of recommendations. Since local finance offices can deviate from the tables in individual cases, the actual rates are a matter of negotiation. It appears that the following straight-line rates are generally accepted: machinery, 10–12 percent; automobiles and trucks, 20–25 percent; office equipment, 10–20 percent; computers, 20 percent; industrial buildings, such as factories and warehouses, 2–4 percent; office furniture, 10 percent.

Movable fixed assets can be depreciated under a 250-percent declining balance method at an annual rate not in excess of 25 percent.

In general, the depreciation rate for buildings is fixed by statute at a straight-line rate of 2 percent. However, buildings completed on or after December 1, 1977, can be depreciated under the declining balance method at the following rates:

(1) for the year of completion and each of the 11 subsequent years, 3.5 percent.

(2) for each of the following 20 years, 2 percent; and

(3) for each of the following 18 years, 1 percent.

Expenditures on movable fixed assets which cost DM 800 (about $460, as of October 1, 1979) or less may be written off in full during the year of acquisition.

Special depreciation and amortization for specific types of investment

Among the special rules for the recovery of costs of specific types of investment are the following:

(1) An initial allowance of 60 percent is permitted for depreciable personal and immovable assets serving the purposes of

environmental protection (air pollution, water pollution, noise protection, etc.) if such assets are acquired or manufactured after December 31, 1974, but before January 1, 1979. In subsequent years, an annual depreciation rate of 10 percent is permissible until full amortization.

(2) In addition to normal depreciation, an initial allowance of 50 percent of the cost of movable fixed assets and 30 percent of the cost of immovable fixed assets is granted for investments in certain qualifying private hospitals, provided the assets are acquired or manufactured after December 31, 1976.

(3) Enterprises situated on the borders of the Iron Curtain Countries may be allowed a writeoff in the initial five years of 50 percent of the cost of movable fixed assets and 30 percent of the cost of buildings.

(4) An initial allowance of 40 percent is granted for new merchant ships and of 30 percent for aircraft registered in Germany. This allowance may be spread over five years if (a) the ship or aircraft is acquired or manufactured before January 1, 1979, and (b) the ship is held for a period of not less than eight years (six years in the case of aircraft).

Under general rules for the application of special accelerated depreciation allowances, such allowances may not be used to create or increase a loss.

Other investment incentives

No investment tax credit is provided.

Japan

Depreciation

In general

Depreciation is allowed for all tangible fixed assets such as buildings, machinery, ships, etc. However, leasehold rights are not depreciable assets. The initial value of assets for purposes of depreciation is the acquisition cost of purchased assets, the total costs of manufacture or construction of assets produced internally, or the fair market value of assets acquired by gift, exchange or otherwise. Both the straight line and the declining balance (where allowable) calculations assume residual value of 10 percent of the acquisition cost of almost all tangible assets, but assets may be depreciated or amortized down to a residual value of 5 percent for tangible assets and 0 percent for intangibles. Certain manufacturing plants and the equipment therein are depreciated as a unit.

Depreciation may be deducted for tax purposes as entered on the books of the company and may be charged against profits, up to the limits established by law. Apparently this rule requires that all the depreciation deducted for tax purposes be taken into account in computing earnings for financial purposes.[12]

The entire cost of depreciable assets may be deducted currently if the cost is less than 100,000 yen per unit or if the useful life is less than one year.

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[12] If the depreciation deducted for financial purposes exceeds the statutory limits, the excess may be carried over and, taken together with subsequent book depreciation, deducted up to the statutory limits in subsequent years.

The Ministry of Finance has established standard useful lives for almost all depreciable assets. If shorter useful lives can be justified to the relevant regional tax bureau, the shorter lives may be used. If a shorter useful life is approved due to obsolescence, depreciation for previous years may be recomputed on the basis of the shorter useful life and the excess depreciation (as computed over the depreciation actually deducted during such years) may be currently expensed.[13]

"Ordinary depreciation" is allowed for most assets, and the statutory limits on deductibility are calculated to reflect the average actual decline in economic value of the assets, as determined in accordance with generally accepted accounting principles. However, the Special Tax Measures Law allows special accelerated depreciation for certain types of assets.

Ordinary depreciation

Most assets eligible for ordinary depreciation may be depreciated using the straight-line method, the declining balance method, or another method specifically approved by the relevant regional tax bureau. The unit of production method may be used for assets used in the mining industry. A change in depreciation methods is subject to the prior approval of the relevant local tax office.

Special accelerated depreciation

A corporation meeting certain requirements may accelerate the depreciation of certain specified assets by either of two accelerated methods. In addition to ordinary depreciation, under the "special additional depreciation" method, a corporation may deduct during each year an additional percentage of the ordinary depreciation taken for such year. Examples of the amounts of special additional depreciation allowed for certain eligible assets are as follows:

(*a*) newly constructed rental housing, 100–150 percent of ordinary depreciation (depending on the useful life);

(*b*) qualified crude oil storage tanks, 50 percent of ordinary depreciation; and

(*c*) new machinery, plant, etc. of a small corporation installed as part of an approved modernization plan, 50 percent of ordinary depreciation.

Under the "special initial depreciation" method, a certain percentage of the acquisition costs of eligible assets may be deducted during the year when the assets are first placed in use. Examples of the amounts of special initial depreciation allowed for certain eligible assets are as follows:

(*a*) qualified manufacturing plants installed in the Okinawa free trade zone, 33⅓ percent of acquisition cost;

(*b*) qualified facilities to prevent pollution, 50 percent of acquisition cost;

(*c*) qualified plants equipped with special antipollution devices and qualified energy efficient plants, 25 percent of acquisition cost; and

(*d*) certain machinery using data processing equipment, 25 percent of acquisition cost.

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[13] A corporation may make its own reasonable estimate of the remaining useful life of used property.

Both the special additional depreciation and the special initial depreciation may be accounted for in the normal way by reducing the basis of the assets, thus reducing the amount of depreciation in future years. Alternatively, these amounts may be credited to a special depreciation reserve account, in which case basis is not reduced and ordinary depreciation may be taken on the remaining basis. If this latter approach is used, the amounts credited to the special depreciation reserve account must be taken back into income in equal installments over the immediately succeeding seven years. (Any allowable special depreciation which was not actually taken during the preceding three years may be credited to this special depreciation reserve account currently.)

Any tangible asset may not be depreciated, either through ordinary or special depreciation, to a residual value of less than 5 percent of original cost.

Investment credit, etc.

No general investment tax credit is provided. However, a special tax credit is allowed for any corporation which has increases in its research and experimental expenses and training costs of programmers and systems engineers for electronic computers. This tax credit cannot exceed 10 percent of the corporation tax.

Certain special incentives are also available for overseas investment and reserves for designated percentages of export gross receipts.

France

Depreciation

In general, tangible assets are usually depreciated over the following useful lives—

Industrial buildings	20 years.
Commercial buildings	20 to 50 years.
Equipment and tools	4 to 10 years.
Office furniture	10 years.

Under French tax law, most depreciable assets must be depreciated on the straight-line method. However, new industrial and commercial equipment, plants to be used for conserving raw materials, and certain other assets may be depreciated under the declining balance method. Generally, the rates of depreciation under the declining balance method are obtained by multiplying the straight-line rates by a special co-efficient which is 1.5 for assets with a normal useful life of 3 to 4 years, 2 from 5 to 6 years and 2.5 from 6⅔ to 20 years.

The declining balance method is not allowed for:

(1) buildings (except for hotels and light buildings, the useful life of which does not exceed 15 years);

(2) passenger cars;

(3) pickup trucks;

(4) typewriters, telephone installations, and office furniture; and

(5) used property.

The cumulative depreciation on fixed assets recorded on a company's books as of each year must be at least equal to the normal cumulative straight-line depreciation for each category of fixed assets. If any part of this minimum depreciation is not recorded in a given year, it could not be claimed in the future as a deduction against taxable income. This rule also applies if a company is in a loss position, before or after charging off this minimum depreciation. If a company is in a loss position, the deficit resulting from a properly recorded depreciation charge may be carried forward without time limit. (The rule in the preceding sentence is an exception to the normal five year limitation on net operating loss carryforwards.)

Special depreciation allowances are granted in certain cases where investments are considered particularly fruitful to the French economy. Among these are:

> Special accelerated first-year depreciation of 50 percent of the cost of buildings used for technological or scientific research is allowed. A similar rule applies to costs of certain assets used for industrial water purification and pollution control, if they are acquired before December 31, 1980, and are parts of industrial installations existing on December 31, 1976.
>
> An exceptional writeoff during the year of completion is permitted for 25 percent of the cost of buildings erected for industrial and commercial purposes, if the building has been started by December 31, 1977 (subject to Ministerial approval).

United Kingdom

Depreciation

In general, the full cost of all machinery and equipment (other than automobiles not used for public hire or the conveyance of goods or passengers) may be deducted in the year the expenditure is made. This rule applies to both new and used property. Also, it appears that the taxpayer may deduct all or any portion of the amount allowable and carry the rest over to succeeding years in such amounts as he desires.

An industrial building may be depreciated by taking a depreciation deduction of 50 percent in the first year and thereafter writing down the building at a rate of 4 percent per annum.

An alternative means of recovering expenditures for machinery and plant is to write down the undepreciated capital cost at a rate of 25 percent per year (on the declining balance method.) This declining balance method of depreciation at a rate of 25 percent per annum generally applies to automobiles which do not qualify for the full deduction in the year of the expenditure. Depreciation allowances are generally recaptured on the disposal of the assets.

Depreciation may be deducted only with respect to certain specified categories of assets. It appears that the main types of assets for which depreciation is not allowable are nonindustrial buildings (e.g., offices, hotels, show rooms, and retail shops), intangible assets other than patents, and, in certain circumstances, know-how.

Other investment incentives

It appears that development area grants of 20 percent to 22 percent of the capital expenditure on machinery and plant are available for certain expenditures. These grants do not reduce a taxpayer's basis for depreciation purposes. Other incentives may also be available in development areas for certain investments.

Canada

Depreciation

In Canada, depreciation for tax purposes takes the form of a capital cost allowance which is computed on a basis of pools of assets with relatively few separate classes of property. The annual cost recovery allowances are generally determined by applying a prescribed rate to each class on a declining balance method. Thus, for example, the prescribed annual rate on most machinery and equipment is 20 percent; on automotive equipment, 30 percent; on most buildings, 5 percent. A taxpayer may defer a deduction for depreciation by claiming less than the amount allowable. In general, capital cost allowances previously claimed are recaptured where assets are sold for proceeds in excess of the undepreciated cost. However, it appears that the class system operates to defer any recapture of capital cost allowance until such time as the proceeds of disposition of an item of depreciable property exceed the undepreciated capital cost of the entire class of property to which that item belongs.

In addition, a special 2-year writeoff is allowed for machinery and equipment for Canadian manufacturing and processing operations.

Unlike certain other systems described above, tax depreciation is not required to conform to book depreciation.

Other incentives

Certain regional development incentives are available under various Federal and provincial programs. These programs offer substantial incentives to encourage corporations to locate their manufacturing facilities in areas of slow economic growth.

Canada provides an investment tax credit of 5 percent (or 7½ percent or 10 percent, depending upon the region in Canada) of the cost of certain buildings, machinery, and equipment if such assets are (1) acquired before July 1, 1980, and (2) are to be used in manufacturing, processing, or other specified activities. This credit reduces capital cost for tax depreciation purposes. The amount of this credit allowable may not exceed the sum of $15,000 plus one-half of the amount by which the Federal income tax otherwise payable exceeds $15,000. Any unused investment credit may be carried forward for up to 5 years.

Issues

The bill raises a number of issues. The most general issue is whether additional tax incentives should be provided at this time to encourage capital formation or increase productivity. If so, a second issue is whether an approach which focuses mainly on accelerating depreciation allowances would be more appropriate than an approach which would be based primarily on rate reductions, incentives for research and development costs, or an increased investment tax credit.

If it is appropriate to adopt an approach based on accelerating the deductions for the cost of depreciable property, the specific issues raised by this bill include the following:

(a) Whether the period over which assets are to be written off should be a specified period unrelated to the asset's economic useful life.

(b) Whether asset classes should be limited to a very few classes.

(c) Whether percentages of asset cost should be prescribed for each year of a recovery period (or useful life) in a manner which reflects accelerated methods of cost recovery.

(d) Whether used property should be entitled to the same type of depreciation or cost recovery rules (including accelerated methods) as new property.

(e) Whether cost recovery (or depreciation) should initially be allowable when payment is made rather than when an asset is placed in service (if the payment date precedes the time that the asset is placed in service).

(f) Whether the taxpayer should be permitted to defer any portion of an otherwise allowable deduction for the cost of property until the taxpayer choose to use it.

(g) Whether the types of assets allowed to use a 3-year recovery period should be limited to automobiles and light trucks.

(h) Whether the dollar amount of assets which can be recovered over a 3-year period should be limited to $100,000 of investment per year.

(i) Whether a cost recovery system reflecting relatively short useful lives and accelerated depreciation should apply to depreciable real property.

(j) Whether the cost recovery system should apply to utility property (since utilities are required to normalize depreciation and the investment tax credit for rate-making purposes).

(k) Whether the investment tax credit should be revised to provide eligibility for the full credit for otherwise eligible assets using a 5-year cost recovery period and for a 60-percent credit for otherwise eligible assets using a 3-year recovery period.

(l) Whether investment tax credit recapture should be revised to provide for proportional recapture based on the number of years the asset is actually in service.

(m) Whether the depreciation recapture rules should apply to all depreciation on real property rather than only the accelerated portion of such depreciation.

(n) Whether the item of tax preference for accelerated depreciation on real property should apply to all real property or only to leased property.

Another issue is whether the expected capital formation and productivity gains to be expected from this measure are appropriate taking into account the revenue effects. A further issue is the extent to which budget constraints may limit or delay the implementation of tax revisions such as those suggested by the bill.

Explanation of the Bill

A. In general

For most depreciable assets, the bill would replace existing depreciation rules with a system which provides an accelerated method of depreciation and useful lives which are generally substantially shorter than present useful lives for most eligible depreciable real and personal property (although the lives of some items of personal property would be lengthened, e.g., certain machine tools). The bill would generally permit a 10-year writeoff for plants and buildings (other than residential real estate), a 3-year writeoff for a limited amount of investment in automobiles and light trucks, and a 5-year writeoff for all other tangible personal property. In general, the bill would allow accelerated deductions in the early years of the recovery period, roughly equivalent to using double declining balance depreciation for the first few years and then switching to sum-of-the-year's-digits depreciation. This system of accelerated deductions would apply to both new and used property. Also, the period over which the cost of an asset could be recovered would begin with the earlier of the year in which such costs are paid or incurred or the year in which the asset is placed in service (rather than only with the year in which the asset is placed in service, as under current law). The bill contains transitional rules to phase-in the application of the 10-year and 5-year writeoffs (in certain cases) over the period 1980–1983 so that the provisions would not be fully effective until 1984.

The bill would shorten the useful life requirement for eligibility for the full 10-percent investment credit from 7 years to 5 years and would provide that assets qualifying for a 3-year writeoff would be eligible for a 6-percent investment credit (instead of 3⅓ percent credit under existing law). The rules for the recapture of investment credit also would be liberalized.

Under the bill, the depreciation recapture rules for real estate covered by the new provisions would be revised to provide for a recapture of all depreciation (rather than only accelerated depreciation) upon sale or other disposition. The bill also revises the "add-on" minimum tax so that, in the case of real property subject to the new rules, the tax preference for accelerated depreciation on real property would apply only to leased property.

B. Capital cost recovery deduction

Eligible property

Most property currently subject to an allowance for depreciation would be covered by the new capital cost recovery system. Eligible property, referred to as "recovery property," would generally include both new and used tangible property (other than land) that is used in a trade or business or held for the production of income. However, recovery property would not include: (1) property placed in service by the taxpayer before January 1, 1980; (2) residential rental property; (3) property which may be amortized (in lieu of depreciated) and for which the taxpayer elects such amortization; (4) property subject to a method of depreciation not expressed in a term of years (such as property depreciated under the units of production or machine-hour methods of depreciation); (5) leasehold improvements properly depreciated over the term of the leasehold, if the taxpayer elects to exclude such property or improvements from the rules of this new provision; and (6) property which is acquired from a person who had used the property before January 1, 1980, if either (a) the property is leased back to the person from whom it was acquired within one year after acquisition, or (b) the taxpayer and the person using the property before January 1, 1980, are related parties (within the meaning of sec. 267(b)).

Computation of recovery deduction

The recovery deduction would be determined by applying a statutory percentage to the capital cost of the recovery property. Recovery property would be separated into three classes, and the applicable percentage would be provided in the following capital cost recovery table.

Capital Cost Recovery Table

If the recovery year is—	*The applicable percentage for the class of property is:* Class 1	Class 2	Class 3
1	10	20	33
2	18	32	45
3	16	24	22
4	14	16	
5	12	8	
6	10		
7	8		
8	6		
9	4		
10	2		

In general, use of this table would result in a deduction which approximates the deduction which would result from using—(1) double declining balance depreciation for the earliest years of the recovery period, (2) sum-of-the-year's-digits depreciation for later years, (3) the half-year convention (under which all capital cost is treated as added to capital account on the first day of the second half of the taxable year), and (4) no salvage value.

Real property

Class 1 would include buildings and their structural components. When fully effective (in 1984), the capital cost of class 1 property would be recovered over a period of ten recovery years and the applicable percentages would range from 10 percent in the first recovery year and 18 percent in the second recovery year to 2 percent in the tenth recovery year.[14]

The bill contains a transitional rule which provides a phase-in for the recovery of costs of class 1 property. For capital costs added to capital account in 1980, 1981, 1982, or 1983, the recovery periods are 18 years, 16 years, 14 years, and 12 years, respectively. These transitional rules apparently contemplate the same general type of accelerated recovery as would apply under the general rules.

[14] Under present law, neither the double declining balance method nor the sum-of-the-year's digits method is available for the type of real property (i.e., commercial real property) described in class 1. New commercial buildings may be depreciated under the declining balance method at 150 percent of the straight-line rate, and used commercial property must be depreciated under the straight-line method.

Tangible personal property

Class 2 would generally include all tangible personal property not included in class 3 (relating to certain automobiles, etc.), and, when fully effective, the capital cost would be recovered over a period of five recovery years. The applicable percentages for class 2 property would range from 20 percent in the first recovery year and 32 percent in the second recovery year to 8 percent in the fifth recovery year. For recovery property included in class 2, transitional recovery periods and recovery percentages are to be provided for recovery property subject to the new recovery allowance rules if the capital cost of the recovery property is paid or incurred prior to 1984. Under these rules, the recovery period of assets for which the shortest permissible useful lives under ADR are more than 5 years but not less than 9 years [15] would be as follows:

For additions to capital account in—	*The cost recovery period is—*
1980	ADR lower limit.
1981	ADR lower limit minus 1 year.
1982	ADR lower limit minus 2 years.
1983	ADR lower limit minus 3 years.

For purposes of these transitional rules, if the shortest permissible life of a class 2 asset is more than 9 years under ADR, its shortest permissible life will be treated as equal to 9 years. These transitional rules contemplate the same general type of accelerated recovery as would apply under the general rules.

Automobiles, taxis, and light-duty trucks

Class 3 property would include automobiles, taxis, and light duty trucks, but the capital cost of such items to be taken into account could not exceed $100,000 for any taxable year. The capital cost of class 3 recovery property would be recovered over a term of 3 years, the applicable percentages amounting to 33 percent, 45 percent, and 22 percent in the first, second, and third recovery years respectively.[16] The bill provides that any capital cost in excess of $100,000 for automobiles, taxis, and light duty trucks for any taxable year would be included in class 2. Special rules are also provided for (1) apportioning the $100,000 limit among the component members of a controlled group of corporations, (2) reducing the limit in the case of husband and wife filing separate returns, and (3) applying the limitation at both the partner and partnership levels.

Special rules for public utility property

The bill provides that public utility property is eligible to be treated as recovery property (i.e., eligible for the benefits of the bill) only if the taxpayer uses a normalization method of accounting. In general, a normalization method of accounting requires that, for ratemaking purposes, the tax benefits from accelerated depreciation, the investment credit, and other tax incentives are *not* immediately flowed

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[15] Under this rule, any ADR lower limit which is not a whole number of years would be rounded down to the next lower whole number of years.

[16] Under the ADR system, an automobile or a taxi may be depreciated over a period of from 2.5 years to 3.5 years, and light general purpose trucks may be depreciated over a period of from 3 to 5 years.

through to customers but instead are prorated over the useful lives of the properties with respect to which the benefits are given. The rule in the bill (proposed sec. 168(g)(3)) is similar to rules in present law relating to the investment credit and accelerated depreciation (secs. 46(f) and 167(l)).

Commencement of cost recovery period

In general, the capital cost of recovery property is to be taken into account for purposes of computing the recovery allowance at the earlier of the year payment is made or the year property is placed in service. However, for self-constructed assets, the cost of recovery property is to be taken into account in the earlier of the year the property is placed in service or the year for which the cost is properly added to capital account under the taxpayer's method of accounting.[17] The bill indicates that any amount paid or incurred prior to January 1, 1980, would not be taken into account (proposed sec. 168(d)(3)).[18]

Also, the bill provides that public utilities (unlike other taxpayers) may elect to treat advance payments (i.e., amounts paid or incurred in a year prior to the year an asset is placed in service) as additions to capital account only in the year the asset is placed in service.

Salvage value

In general, the allowance for depreciation is computed on an asset's basis for purposes of determining gain. However, an asset may not be depreciated below a reasonable salvage value. With respect to depreciable personal property with a useful life of three years or more, salvage value taken into account may be reduced by up to 10 percent of the amount of the adjusted basis of the asset for purposes of determining gain (sec. 167(f)). Thus, if salvage value is less than 10 percent, it may be ignored. A taxpayer must estimate the salvage value of each asset placed in service in a taxable year. The estimate is made on the basis of the facts and circumstances existing at the end of that taxable year.

The bill would result in the elimination of salvage value limitations on cost recovery deductions for both real property and personal property if the cost of such property is recovered under the new capital cost recovery provisions.

While these changes would not appear to have a significant effect for most depreciable personal property, the elimination of the salvage value restrictions may have a significant effect for depreciable real property (because the salvage value of such property tends to be significant and such property is not subject to the "10-percent of basis" reduction rule described above).

Election to deduct less than amount allowable

In any recovery year, the entire amount of the allowable recovery deduction may be taken into account, or, at the election of the tax-

[17] The rules for commencement of the cost recovery period, as described in the text, are those intended by the proponents of the bill. The language of the bill apparently would require technical changes to reach these results.

[18] Taken literally, this provision would appear to preclude any depreciation or cost recovery on amounts paid in 1979 (or prior years) with respect to assets placed in service in 1980 (or later years).

payer, only a portion thereof. The amount taken into account may be increased or decreased by the taxpayer before the expiration of the time for making a claim for refund. If only a portion of the recovery deduction is taken into account, the unused amount may be carried forward and taken into account in a subsequent taxable year. By contrast, under present law, depreciation must be deducted in the year in which it is allowable, and even if no depreciation deduction is claimed in such year, the basis of a depreciable asset must be reduced by the depreciation allowable.

Under the bill, if only a portion of the recovery deduction is taken into account in a taxable year, that portion is to be apportioned among all the recovery properties. The apportionment formula is a fraction, the numerator of which is the allowable recovery amount for each recovery property (without regard to any elected reduction) and the denominator of which is the allowable aggregate recovery deduction for all recovery property (without regard to any elected reduction). If a recovery deduction of a subsequent recovery year is increased as a result of a carryover of an unused recovery deduction, the carryover recovery deduction is to be similarly apportioned among all recovery properties.

Gain or loss on disposition

Gain or loss on disposition, including retirements, would be recognized unless nonrecognition is otherwise provided for. Under regulations to be provided by the Treasury, if mass accounts are maintained by the taxpayer, an election may be made to include in income all proceeds from the disposition. If gain or loss on a disposition is recognized, a recovery deduction with respect to the disposed recovery property is not allowed in the taxable year in which the disposition takes place.

C. Changes in the investment tax credit

Useful life requirement

Under present law, 100 percent of the cost of qualified property with a useful life for depreciation purposes of 7 years or more is eligible for the investment tax credit. If the useful life for depreciation purposes is 3 years or more but less than 5 years, only 33⅓ percent of the cost of the property qualifies for the investment credit, and if the useful life is 5 years or more but less than 7 years, 66⅔ percent of the cost of the property qualifies for the investment credit.

The bill would provide that, for class 1 or class 2 property (i.e., property for which the recovery period is at least 5 years), 100 percent of the capital cost is to be taken into account for purposes of the investment credit, and, for class 3 property, 60 percent of the capital cost is to be taken into account for such purposes. The investment tax credit would be allowable, subject to present law rules, in the first taxable year for which a recovery deduction is allowable with respect to the property if the property can reasonably be expected to qualify as investment tax credit property under present law rules.[19]

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[19] The changes which the bill would make in the investment credit rules relating to the useful lives of eligible assets and recapture would also affect the energy investment credit and the additional investment tax credits available in connection with certain ESOP contributions.

Recapture rules

The bill would also provide for new rules with respect to recapturing the investment tax credit on recovery property qualifying under this new provision. Qualified investment tax credit property which is classified as either class 1 or class 2 property would be subject to investment tax credit recapture if the property were to be disposed of within the first five years of it having been placed in service. One hundred percent of the investment tax credit claimed with respect to qualified investment tax credit property in classes 1 and 2 would be recaptured if a disposition of the property occurs in the first year in which the property is placed in service; the amount of investment tax credit recaptured thereafter would decrease at the rate of 20 percent per year. Thus, at the beginning of the fifth taxable year after the qualified property was placed in service, the investment tax credit claimed with respect to such property would not be recapturable. For qualified investment tax credit property which falls within the definition of class 3 property, 100 percent of the investment tax credit claimed would be subject to recapture if a disposition occurs in the first taxable year in which the property is placed in service; if the property is disposed of in the first taxable year after the taxable year in which it is placed in service, 66 percent of the investment tax claimed with respect to such property would be recaptured. If the property is disposed of during the second taxable year following the taxable year in which such property was placed in service, 33 percent of the investment tax credit claimed would be subject to recapture. Subsequent to the second taxable year following the taxable year in which such property is placed in service, any investment tax credit claimed with respect to such property would not be subject to investment tax credit recapture. (These rules contrast with the current recapture rules which generally recapture any investment credit which would not have been allowable if the useful life taken into account in computing the credit had been the period from the date the asset had been placed in service until the date of disposition.)

D. Other changes relating to depreciation

Additional first-year depreciation

Under present law, additional first-year depreciation amounting to 20 percent of the cost of tangible personal property with a useful life of six years or more (subject to certain dollar limitations) is allowed as a deduction. The bill would provide that property which is recovery property would not be entitled to additional first-year depreciation.

Recapture

Under present law, all depreciation allowable with respect to personal property is subject to depreciation recapture and treated as ordinary income upon disposition at a gain. Similarly, with certain exceptions, depreciation allowed on real estate in excess of straight-line depreciation (but not straight-line depreciation) is also subject to recapture. The bill would provide that all depreciation allowed with respect to recovery property, whether personal or real property, would be subject to depreciation recapture under the rules currently applicable to personal property. Thus, the allowable recovery amount deducted under the provisions of this bill would be subject to ordinary income treatment upon the disposition of the recovery property to the extent of gain.

Minimum tax

Under present law, the accelerated portion of depreciation on real property is an item of tax preference in the "add-on" minimum tax. This item of tax preference applies to both corporate and noncorporate taxpayers. Also, for individual taxpayers, subchapter S corporations, and personal holding companies, accelerated depreciation on leased personal property is an item of tax preference. (This tax preference takes account of the acceleration due to use of the ADR variance as well as acceleration due to the accelerated methods of recovery.)

Under the bill, these present law rules would not apply to recovery property. For leased recovery property which is in either class 1 or 2, the recovery deduction allowed in excess of straight-line capital cost recovery would be a tax preference item subject to the minimum tax. Straight-line capital cost recovery would be an amount determined by depreciating the property on a straight-line basis using a ten-year life for class 1 property and a five-year life for class 2 property. For purposes of computing the straight-line capital cost recovery amount, the taxpayer would be deemed to have begun depreciation of recovery property beginning with the middle of the taxable year in which the property was first placed in service.

Under the bill, the minimum tax provisions with respect to this tax preference item would not be applicable to corporations other than subchapter S corporations and personal holding companies; also these provisions would not be applicable to property manufactured or produced by the taxpayer.

Earnings and profits

Under present law, earnings and profits of corporations are generally computed by taking into account only straight-line depreciation. Under the bill, earnings and profits would be computed by taking into account only straight-line capital recovery.

Carryover of corporate attributes

Under present law, many corporate attributes (such as net operating loss carryovers) of an acquired corporation may be utilized by another corporation which acquires the acquired corporation (or its assets) in any of certain types of tax-free reorganizations. The bill provides that the unused capital cost recovery deduction of a corporation is a tax attribute subject to these carryover rules. In general, the carryover of this unused deduction is subject to the same limitations as apply to the carryover of net operating losses.

Effective Date

The amendments made by this bill would be effective with respect to taxable years ending after December 31, 1979.

Revenue Effect

The staff of the Joint Committee on Taxation has not yet made an estimate of the revenue effects of the bill. However, estimates of the revenue impact of this bill have been made by the Treasury and by two economic consultants. These estimates are shown in the table below.

SELECTED REVENUE ESTIMATES OF S. 1435

(THE "10–5–3" CAPITAL RECOVERY SYSTEM)

(Billions of dollars)

	Calendar Year Liabilities				
	1980	*1981*	*1982*	*1983*	*1984*
***Treasury* (10/22/79)**					
Initial impact (without feedback	−3.8	−10.1	−21.1	−35.2	−51.9
***Data Resources, Inc.* (6/79)**					
Initial impact (without feedback)	−4.8	−12.6	−19.2	−26.3	−32.9
Net of feedback	−4.2	−9.8	−11.8	−14.6	−16.1
***Norman B. Ture, Inc.* (1/11/80)**					
Initial impact (without feedback)	−6.0	−13.0	−25.0	−38.0	−51.0
Net of feedback	−3.0	−9.0	−21.0	−34.0	−48.0

5. S. 1481—Senators Weicker, Baucus, Hatch, Hayakawa, and Hollings

Small Business Participating Debentures

Present law

Under present law, there is no credit (or other specific tax incentive) for a person who makes a debt or equity investment in a business.

An investor who receives periodic distributions from a business by reason of a debt instrument is taxed at ordinary income rates on such income. This income is denominated interest even if it is, in part, based on the earnings of the business. Similarly, an investor who receives periodic distributions with respect to an investment in common or preferred stock in the business is normally required to treat such income as ordinary income (to the extent that an exclusion or deduction for dividends received is not available).[1]

Furthermore, in the case of an investor (other than a dealer), the loss on sale or disposition of debt instruments or preferred stock purchased for investment is ordinarily a capital loss. Similarly, a loss on the sale or disposition of common stock is ordinarily a capital loss unless Code section 1244 applies. Under section 1244, an individual may treat losses from the disposition of certain common stock issued by small business as an ordinary loss (subject to certain limitations). This ordinary loss treatment under section 1244 is not available to an investor who invests in preferred stock or debt.

Under present law, a taxpayer may deduct interest paid or accrued on business indebtedness; however, a corporation is not entitled to deduct amounts paid as dividends on preferred or common stock.

Issues

The principal issue is whether tax incentives should be provided to encourage the issuance of, and the investment in, securities issued by small businesses which are characterized by participation in the current earnings of the business but not the underlying appreciation of the business. If so, a second issue is whether the types of investments to be encouraged should be those investments referred to as small business participating debentures. A third issue is whether the types of incentives created by the bill—namely, a tax credit on original investment, treatment of a portion of periodic income as capital gains, ordinary loss treatment on sale or other disposition, and a deduction to the issuer of all the periodic distributions (including those measured by reference to the profits) are appropriate.

If such tax incentives are to be created, other issues include the following:

(1) How should the qualified small business be defined?

[1] See generally Code secs. 116 and 243.

(2) What should be the nature of the incentives which would cause a qualified small business to issue the debentures?

(3) What should be the maximum amount of a taxpayer's credit for investing in the debentures?

Explanation of the bill

In general

The bill would provide tax incentives for the creation of and investment in a new type of security, the Small Business Participating Debenture (SBPD). The SBPD could be issued only by a qualified small business and would be an instrument having characteristics of both debt and equity. Interest payments received under the SBPD would be reportable as ordinary income by the taxpayer, while payments received as a share of the issuer's earnings would be treated as long-term capital gain. The small business issuing the SBPD would be permitted to treat all payments made under the SBPD as interest and, thus, would be allowed to deduct the amounts paid as shares of its earnings as interest (under Code sec. 163).

A taxpayer who invests in a SBPD would receive in the year of its acquisition up to a $5,000 credit against income tax. (In the case of a joint return, the credit would be up to $10,000.) Provisions are made for the carryover of unused credit and for the disallowance (or proration) of the credit in certain situations. Losses incurred on an SBPD issued to an individual would generally be treated as if it were a loss on section 1244 stock.

Investor's credit

Under the bill, a United States person who acquires an SBPD from a qualified small business would generally be allowed a credit against income tax liability. The amount of the credit would equal the lesser of (1) the product of one-half of 1 percent of the proceeds of the SBPD which is acquired during the taxable year, multiplied by the number of years ending after the date of acquisition and before the maturity date of the SBPD or (2) 5 percent of the proceeds of the SBPD. The credit for any taxable year would be limited to $5,000 ($10,000 in the case of a joint return). The credit could not exceed the tax imposed for the year, reduced by certain other credits. However, any unused credit for a taxable year could be carried over to each of the 7 succeeding taxable years, but would be subject to the limitations set forth above.

In the case of a subchapter S corporation, the amount of the credit allowable for the taxable year would be apportioned among the persons who are its shareholders on the last day of the taxable year, and the dollar limitations would apply with respect to the corporation and each shareholder.

A credit would not be allowed for a SBPD which is issued by a small business in which the taxpayer has an interest. In the case where the small business is a corporation, the taxpayer would be considered as owning an interest if the taxpayer is considered, under Code section 318, to own 10 percent or more in value of the stock or the taxpayer owns stock which represents 10 percent or more of the voting rights in the corporation (or in a corporation which is a member of the same controlled group of corporations, within the meaning of Code sec. 1563(a)). If an SBPD is issued by a small business which is not a corporation, the investor would be considered to own an interest if more than 10 percent of the profits or capital in the business is owned by the investor. A taxpayer would also not be allowed a credit for the acquisition of an SBPD from a small business if that small business or a person with an interest in that small business has previously acquired an SBPD from the taxpayer or any small business in which the taxpayer has an interest. The credit is disallowed to the extent the amount of the proceeds of the acquired SBPD is equal to the amount of the proceeds of any SBPD which has been acquired from the taxpayer or a small business in which the taxpayer has an interest.

A premature disposition of the SBPD would cause a taxpayer to lose part or all of the allowable credit. No credit would be allowed if the SBPD which is acquired during a taxable year is disposed of before the filing date for the taxpayer's return for the taxable year and the taxpayer has held the SBPD for less than 12 months and 1 day. Other dispositions (as defined below) would cause the amount of the taxpayer's tax liability for the taxable year of the disposition to be increased by an amount which bears the same ratio to the amount of the credit allowed to the taxpayer upon acquisition of the SBPD as the number of months between the date of disposition and the date of maturity of the SBPD bears to the number of months between the date of acquisition and the date of maturity of the SBPD. A taxpayer would be treated as having disposed of the SBPD if the taxpayer becomes a related party to the issuer. Certain actions by the issuer could cause the taxpayer to be treated as having disposed of the regulation by the Securities and Exchange Commission during a 2-year period after the issuance of the SBPD; (2) ceasing to derive more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks and securities during any taxable year before the maturity date of the SBPD; or (3) being a party to a reorganization during any taxable year before the maturity date of the SBPD.

Definitions of SBPD and a qualified small business

The bill defines an SBPD as a written debt instrument issued by a qualified small business which is (1) a general obligation of the business, (2) bears a stated rate of interest not less than the rate prescribed by the Secretary under section 483, (3) has a fixed maturity, (4) grants no voting or conversion rights in the qualified small business to the purchaser, and (5) provides for the payment of a share of the total earnings of the issuer.

A qualified small business would be any domestic trade or business (whether or not incorporated) which (1) has equity capital not exceeding $25 million immediately before the SBPD is issued and the face value of all the outstanding SBPDs (including the SBPD being issued) does not exceed $1 million and (2) has no securities outstanding which are subject to regulation by the Securities and Exchange Commission. For purposes of determining qualification as a qualified small business, the equity capital and outstanding SBPDs of all members of a controlled group would be taken into account. A controlled group would consist of all businesses under common control with the issuing corporation within the meaning of section 1563(a), except that a more-than-50-percent test would be applied rather than the more-than-80-percent test. The same general principles (as determined under regulations prescribed by the Secretary) would be applied to commonly controlled businesses which are not incorporated.

Tax treatment by the investor of income, gains, losses, etc. on the SBPD

Amounts paid to a taxpayer as a share of the issuer's earnings on the SBPD would generally be treated as long-term capital gain. However, to the extent any portion of the share of earnings could not be treated as capital gain because the credit (or a portion thereof) was not allowable, the payments would be treated as dividends under section 301. Any payments of such earnings received by the taxpayer during the taxable year of a premature disposition of the SBPD (or in any subsequent year) would also be treated as a dividend.

For the purpose of determining the tax treatment of any loss on the SBPD, the taxpayer would treat the loss (to the extent a credit was allowed) as if it were on a loss on section 1244 stock. Thus, the taxpayer would be allowed an ordinary loss rather than a capital loss from the worthlessness or sale or exchange of the SBPD. Such treatment would not apply, however, to any such loss occurring during the taxable year of the premature disposition of the SBPD.

Tax treatment by the qualified small business of SBPD payments

Generally, both the amounts paid as interest and the amounts paid as a share of the issuer's earnings would be treated as interest and deductible under section 163 by the qualified small business which has issued the SBPD. However, if the credit (or a portion thereof) is not allowable to the purchaser of the SBPD, the amounts (or a portion thereof) paid by the small business as a share of earnings could not be deducted as interest.

Effective date

Generally, the provisions of the bill would apply to taxable years beginning after December 31, 1979, and to SBPDs acquired after the date of the enactment of the bill. However, the provisions of the bill would not apply to any SBPD issued before or during the calendar year 1980 if the proceeds of such SBPD are used to repay any loan of the issuing small business other than a loan with a stated rate of interest in excess of the prevailing rate of interest for businesses in the area where the business is located and which is secured by its inventory or accounts receivable.

Revenue effect

The staff has been unable to estimate the revenue effect of this proposal because of the unprecedented nature of the financial instrument that would be created.

6. S. 1967—Senator Nelson

Capital Formation Incentive Act

Background

In general, an important aspect of investing in equity securities is the subsequent marketability of the security. Apparently, this is particularly true in the case of new offerings of small business securities. In order for a securities dealer to sell a new offering of a small business equity security, it must be willing to support that security in the "after-market" by purchasing those shares of the security which others are unwilling to buy in daily trading. A securities dealer's support of the security in the "after-market" is known as "making a market" for the security.

Present law

Under present law, a securities dealer must recognize any gain on the sale of equity securities, even if he is making a market for the securities. Generally, this gain will be treated as ordinary income.

Issue

The issue is whether dealers in corporate securities should be allowed to defer for 10 years the net gain (up to $1 million) from the sale of small business equity securities where the dealer is making a market in the security.

Explanation of the bill

Under the bill, a corporation which is engaged in market making activities during the taxable year would be allowed to establish a deductible reserve for the net gains for that year from the sale of certain small business equity securities in which it makes a market. The deduction would be equal to the addition to the taxpayer's reserve. However, the reserve could not exceed $1 million. Moreover, the deduction could not exceed the taxpayer's taxable income for the year nor could it exceed 30 percent of the fair market value of the taxpayer's average monthly inventory positions in over-the-counter equity securities carried for market making activities for the year.

This provision would apply to equity securities held by the taxpayer for sale in the ordinary course of its trade or business which are not traded on a registered security exchange and which are of corporations that had $25 million or less of debt and equity outstanding on the last day of the preceding taxable year.

A corporation would be considered to be engaged in market making activities if it is a securities dealer and it holds itself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy over-the-counter equity securities for its own account on a regular or continuous basis.

Under the bill, the amount of an addition to the reserve for a taxable year would not be taken back into income until the tenth year following the year of the addition. However, the taxpayer could withdraw amounts from the reserve at any time during the 10-year period. A withdrawal is deemed to be from the earliest remaining addition to the reserve. Any early withdrawals would be taxed in the year of the withdrawal. The unwithdrawn balance of any addition to the reserve would be subject to tax in the tenth year following the year it was added to the reserve.

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1979.

Revenue effect

Revenue estimates for the bill will be available at the time of the hearing.

7. S. 2136—Senators Nelson, Baucus, Boren, Matsunaga, Stewart, Pell, Weicker, Durkin, Schmitt, and Bumpers

Small Business Tax Reduction Act

Present law

Under present law, as amended by the Revenue Act of 1978, corporate taxable income is subject to tax at a five-step graduated rate structure. The corporate tax rates under present law are:

Taxable income	*Tax rate percent*
$0 to $25,000	17
$25,000 to $50,000	20
$50,000 to $75,000	30
$75,000 to $100,000	40
Over $100,000	46

Prior to 1979, corporate income was subject to a normal tax of 20 percent on the first $25,000 of taxable income and 22 percent on taxable income in excess of $25,000. In addition, a surtax of 26 percent was imposed on corporate taxable income in excess of $50,000. This rate structure was enacted temporarily in the Tax Reduction Act of 1975 and was extended through the end of 1978 in subsequent legislation.

Issue

The issue is whether corporate income tax rates should be reduced.

Explanation of bill

The bill, in general, would widen the existing corporate tax rate brackets and lower the rate in the first bracket. Under the bill, corporate tax rates would be:

Taxable	*Tax rate percent*
$0 to $25,000	15
$25,000 to $50,000	20
$50,000 to $100,000	30
$100,000 to $150,000	40
Over $150,000	46

As a result of the changes made by the bill, the tax liability of a corporation with taxable income of $150,000 would be reduced from $49,750 to $43,750.

Effective date

The provisions of the bill would be effective for taxable years beginning after September 30, 1979.

Revenue effect

It is estimated that this bill would reduce budget receipts by $291 million in fiscal year 1980, $662 million in 1981, $695 million in 1982, $729 million in 1983, $767 million in 1984, and $809 million in fiscal year 1985.

8. S. 2152—Senators Nelson, Baucus, Boren, Culver, Huddleston, Matsunaga, Pell, and Stewart

Used Machinery Investment Credit Adjustment Act

Present law

Present law provides a 10-percent regular investment credit as well as a 10-percent business energy credit for certain energy-related investments.[1] The energy credit provisions require that energy property be new property which is first used by the taxpayer claiming the energy credit (Code sec. 48(1)(2)(B)(ii)). However, the regular investment credit is allowed for a limited amount of used property each taxable year.

Under the used property limitation applicable to the regular investment credit (Code sec. 48(c)), a taxpayer may claim the credit for the cost of up to $100,000 of used qualifying property acquired by purchase each taxable year.[2] (Used qualifying property is property which qualifies for the investment credit but which was originally used by someone other than the taxpayer.) This limitation results in a maximum credit of $10,000 on used property for any taxable year. Where the taxpayer's cost in qualifying used property purchased during the taxable year exceeds $100,000, the taxpayer may select the property on which the regular investment credit is claimed. Rules are also provided which apply the $100,000 limitation to married individual taxpayers, controlled groups of corporations, and partnerships. In addition, the credit is not allowed where used property is acquired from a related taxpayer, such as a family member or an affiliated corporation, or where the same taxpayer continues to use the property both before and after its acquisition (for example, through a sale and leaseback transaction).

Issue

The issue is whether the annual used property limitation for purposes of the regular investment credit should be increased from $100,000 to $200,000.

Explanation of the bill

The bill would increase the annual cost limitation on used property for purposes of the 10-percent regular investment credit from $100,000 to $200,000.

Effective date

The provisions of the bill would be effective for qualifying used property purchased after December 31, 1979.

Revenue effect

It is estimated that this bill would reduce budget receipts by $45 million in fiscal year 1980, $115 million in 1981, $127 million in 1982, $141 million in 1983, $156 milion in 1984, and $170 million in 1985.

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[1] The rates and effective period of the business energy credits are extensively modified under H.R. 3919, the Crude Oil Windfall Profit Tax Act of 1980.

[2] The limitation was $50,000 prior to 1975. It was increased for a temporary period to $100,000 under the Tax Reduction Act of 1975, and the $100,000 limitation was made permanent under the Revenue Act of 1978.

9. S. 2168—Senators Nelson, Baucus, Boren, Huddleston, Matsunaga, Stewart, and Schmitt

Subchapter S Capital Formation Act

Present law

Under present law, a corporation is eligible to elect to be taxed as a small business corporation (subchapter S corporation) if it is a domestic corporation which is not a member of an affiliated group and which does not have more than 15 shareholders; does not have as a shareholder a person (other than an estate and certain trusts) who is not an individual; does not have a nonresident alien as a shareholder; and does not have more than one class of stock.

In general, if a subchapter S election is made by a qualified small business corporation, income (whether or not distributed) and loss pass through the corporation and are reported separately by the shareholders on their respective income tax returns. Except in the case of certain capital gains, a subchapter S corporation is not subject to Federal income tax.

Issues

The two main issues raised by the provisions of the bill are: (1) should the allowable number of subchapter S corporation shareholders be increased; and (2) should a subchapter S corporation be allowed to issue more than one class of capital stock.

Explanation of the bill

The bill would provide for an increase in the absolute number of shareholders in a subchapter S corporation, without any change in the definition of the shareholder class, from present law 15 shareholders to 100 shareholders.

Additionally, the bill would provide that a subchapter S corporation would be treated as having authorized and issued only one class of stock notwithstanding that other classes of stock are issued if the classes of stock are issued in accordance with regulations prescribed by the Treasury which set forth circumstances under which the issuance of more than one class of stock will not have any effect upon the allocation of income among the shareholders of the corporation.

Effective date

The provisions of the bill would apply with respect to taxable years beginning with or in calendar years beginning after the date of enactment.

Revenue effect

Enactment of this bill could result in substantial revenue losses if a significant number of regular corporations elected to become subchapter S corporations. The revenue loss would come about as the losses of the electing corporations were flowed through to their shareholders rather than increasing corporate net operating losses. Because we do not know how to make a realistic forecast of either the number of corporations that would make the election or their tax losses, no revenue estimate has been prepared for this bill.

10. S. 2171—Senator Nelson

Time for Furnishing Form W–2 to Terminated Employees

Present law

Every employer who pays wages subject to Federal income tax withholding or FICA must furnish each employee a statement (Form W–2) setting forth: the names of the employer and employee; the amount of wages subject to income tax withholding and the amount withheld; and the amount of FICA wages and FICA tax withheld (Code sec. 6051). In the case of most employees, W–2 Forms for the calendar year must be furnished no later than January 31 of the following year. However, if an employee terminates employment prior to the close of the calendar year, that employee must be furnished with a Form W–2 on the day on which his or her last salary payment is received (Code sec. 6051(a)).

The Internal Revenue Service has recently published regulations (T.D. 7656, Nov. 28, 1979) which provide that the employer may furnish a Form W–2 to an employee whose employment terminates prior to the close of the calendar year at any time after the termination but no later than January 31 of the following year. However, if an employee who terminates employment prior to the close of the calendar year requests earlier receipt of a Form W–2, and if there is no reasonable expectation on the part of the employer and employee of further employment during the calendar year, then the employee must be given a Form W–2 on or before the later of the 30th day after the request or the 30th day after the last salary payment (Treas. Reg. § 31.6051–1(d)(1)).[1]

Issues

The bill presents two issues:

(1) Whether employees who terminate employment prior to the close of the calendar year should, as a general rule, receive W–2 Forms at the same time as all other employees; and

(2) Whether employees who terminate employment prior to the close of the calendar year should be given the option to receive W–2 Forms early, if they so desire.

Explanation of the bill

Under the bill, the employer of an employee who terminates employment prior to the close of the calendar year would be required to furnish the employee with Form W–2 no later than January 31 of the following calendar year, unless the employee requests early receipt. If a terminated employee makes a written request for early receipt of a Form W–2, then the employer would be required to furnish the em-

[1] It is not clear that there is a statutory basis for this approach.

ployee a W–2 no later than 30 days after the receipt of the written request.

In addition, the bill would require an employer to furnish a terminating employee with written notice that he or she may request early receipt of Form W–2 and that if he or she does not so request, then a Form W–2 will be sent to the employee's last known address before January 31 of the next calendar year. This written notice would have to be provided on the day on which the employee receives his or her last salary payment.

Effective date

The provisions of the bill would be effective 30 days after enactment.

Revenue effect

This bill would have no direct effect on revenues.

11. S. 2239—Senators Packwood, Nelson, and Cranston

Incentive Stock Options

Present law

Under present law, the taxation of stock options granted by an employer to an employee as compensation is governed by the rules of section 83 of the Internal Revenue Code. Generally, under section 83, the value of the option constitutes ordinary income to the employee if the option itself has a readily ascertainable fair market value at the time it is granted to the employee. If the option does not have a readily ascertainable value when granted, it does not constitute ordinary income at the time granted; when the option is exercised, however, the spread between the option price and the value of the stock at that time constitutes ordinary income to the employee. Personal service income is generally taxed at a maximum rate of 50 percent.

In addition, the employer generally is allowed a business expense deduction in the amount includible in the employee's income in its corresponding taxable year (Code sec. 83(h)).

Background of tax treatment of stock options

Restricted stock options

The Revenue Act of 1950 added provisions for the use of a "restricted stock option" under which no income tax was imposed either when the option was granted or exercised. Instead, tax generally was imposed at the time the stock involved was sold by the employee. In the case of those restricted stock options where the option price was at least 95 percent of the market price of the stock at the time the option was granted, the entire amount of any gain realized by the employee at the time he sold the stock was treated as capital gain. Where the stock option price was between 85 and 95 percent of the market price at the time the option was granted, the difference between the option price and the market value of stock at the time of the grant of the option was treated as ordinary income when the stock was sold. Any additional gain at the time the stock was sold in such cases was treated as capital gain. In the case of these restricted stock options, employers were not allowed any deduction for the amount of the gain realized by the employee, whether this gain was treated as capital gain or ordinary income.

For a stock option to be classified as a restricted stock option and be eligible for the treatment outlined above, the option price must have been at least 85 percent of the market price of the stock at the time the option was granted; the stock and/or the option must have been held by the employee for at least 2 years after the date of the granting of the option and the stock held for at least 6 months after it was transferred to him; the option must not have been transferable other than at death; the individual may not have been a 10-percent shareholder in the corporation (unless the option price was at least 110 percent of the fair market value); and the option must not have been for a period of more than 10 years.

Qualified stock options

The Revenue Act of 1964 repealed the restricted stock options provisions and added provisions allowing so-called "qualified stock options".

These qualified stock options were taxed in a manner similar to restricted stock options. These options, however, must have been granted with an option price of at least the market price when the option was granted (subject to a 150-percent tax where a good faith attempt to meet this requirement failed).

In addition, qualified stock options were subject to the additional rules that the stock must be held 3 years or more; the option may not have been held more than 5 years; stockholders' approval must have been obtained; the options must have been exercised in the order granted; and no option may have been granted to shareholders owning more than 5 percent of the stock (increased up to 10 percent for corporations with less than $2,000,000 equity capital).

1969 Tax Reform Act—Minimum tax and maximum tax

The Tax Reform Act of 1969 added a minimum tax under which a tax was imposed equal to 10 percent of the items of tax preference (reduced by a $30,000 exemption plus regular tax liability). Both the bargain element on restricted and qualified stock options and the excluded portion of capital gains were items of tax preference.

In addition, a 50-percent maximum marginal tax rate on income from personal services was added. However, the income eligible for this rate was reduced generally by the sum of the items of tax preference in excess of $30,000.

1976 Tax Reform Act—Repeal of qualified stock options, etc.

The Tax Reform Act of 1976 repealed qualified stock option treatment for options granted after May 20, 1976, (except for certain transitional options which will cease to be qualified after May 20, 1981). This Act also increased the minimum tax rate to 15 percent, reduced the exemptions for the minimum and maximum tax and permitted deferred compensation to qualify for the 50-percent maximum rate on personal service income.

Revenue Act of 1978

However, the Revenue Act of 1978 removed the excluded portion of capital gains from the minimum and maximum tax and made it subject to a new alternative minimum tax. In addition the taxes on capital gains were reduced so that the maximum rate of tax on these gains is 28 percent.

Issue

The issue is generally whether Congress should reinstitute a stock option provision under which an employee may be granted an option to buy his employer's stock and be taxed at capital gains rates at the time he or she sells the stock.

Explanation of the bill

The bill would create an "incentive stock option", which would be subject to taxation in a manner similar to the tax treatment previously available to restricted and qualified stock options—i.e., there would be no tax consequences at the time the option is exercised, and the employee would be eligible for capital gain treatment when the stock is sold.

For an option to qualify as an "incentive stock option"; (1) the exercise price must be not less than fair market value of the stock at the time the option is granted (in the case of a variable option, determined as if the option had been exercised when granted); (2) the option must be exercised within 10 years of the date granted; (3) shareholder approval is required; (4) the individual may not be an employee owning more than 10 percent of the value or voting power of stock of the company (unless the option price is at least 110 percent of the stock's fair market value); (5) the optionee must be an employee continuously from grant of the option to 3 months prior to exercise; (6) the option may be transferred only at death; and (7) the stock must be held for at least 2 years after the date of the granting of the option and for at least one year after the option is exercised.

Effective date

The provisions of the bill would apply to options granted after the date of enactment of the bill.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than $2.5 million per year in fiscal years 1980–1983, and would increase budget receipts by $15 million in fiscal 1984 and $30 million in fiscal 1985.

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