[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON JUNE 18, 1979

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on June 18, 1979, by the Subcommittee on Taxation and Debt Management Generally of the Senate Finance Committee.

The pamphlet first briefly summarizes the bills. This is followed by a discussion of each bill, setting forth present law, the issues involved, an explanation of the bill provisions, the effective dates, and the estimated revenue effects. Appendix tables present certain information concerning trends in U.S. export trade.[1]

The bills described in the pamphlet are S. 231 and S. 935 [2] (relating to depreciation), S. 700 (relating to the investment tax credit for certain research and experimental expenditures), S. 1003 (relating to bad debt reserves for export receivables, and to the treatment of research and experimental expenditures and foreign currency losses on export receivables), and S. 1065 (relating to corporate charitable contributions for basic research).

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[1] The Appendix tables were supplied by the staff of the Senate Finance Committee.

[2] The bill, S. 935, was not listed in the press release announcing the hearing, but was subsequently scheduled for this hearing and included in the notice of hearings printed in the Congressional Record on May 24, 1979.

I. SUMMARY OF BILLS

S. 231—Senator Bentsen

The bill would increase the asset depreciation range under the Asset Depreciation Range (ADR) system from 40 percent (i.e., 20 percent above or below the ADR class lives) to 60 percent (30 percent above or below the ADR class lives) and would provide that salvage value could be ignored under the ADR system of depreciation.

The bill also would provide that certain small businesses may elect to use an abbreviated table of useful lives which are shorter than the useful lives other businesses may use. These shorter useful lives could be used only in connection with the straight-line method of depreciation.

S. 935—Senator Chafee

The bill would allow taxpayers to elect to depreciate tangible personal property (and certain other tangible property eligible for the investment credit) over a period of not less than 5 years. The bill also would shorten the period over which the amortizable basis of pollution control facilities can be amortized from 60 months to 24 months and would provide that the excess of this amortization deduction over the depreciation deduction otherwise allowable would no longer be a tax preference item.

S. 700—Senator Danforth

Present law generally provides a credit against income tax liability equal to 10 percent of the investment in certain business assets. Research and experimental expenditures which are currently deductible (or which, at the taxpayer's election, are capitalized and amortized) are not treated as being for qualifying property for purposes of this investment credit. The bill would make the investment credit available for these research and experimental expenditures, effective for expenditures incurred in taxable years beginning after December 31, 1979.

S. 1003—Senators Bentsen and Danforth

The bill contains three separate provisions that would provide additional deductions to certain taxpayers engaged in export operations and in the development of foreign markets and foreign patents. The first provision would allow the taxpayer to take a bad debt deduction for accounts receivable which arise from the sale of export property or services for use outside the United States, equal to the greater of 2 percent of these accounts receivable or 15 percent of the taxable income derived from these export operations. The second provision would allow the taxpayer to elect to treat certain amounts paid to develop export markets and export products as research and experimental expenditures and, thus, deductible in the year paid or accrued or amortizable over a 60-month period. The third provision would allow the taxpayer to elect, on a currency-by-currency basis, to deduct foreign currency losses on export receivables in the current year rather than in the year the receivable is paid.

S. 1065—Senators Danforth, Javits, and Moynihan

The bill generally would provide corporate taxpayers with a nonrefundable credit against Federal income tax liability for charitable contributions paid in cash during the taxable year to qualified educational organizations, if as a condition of the gift the donee must use the contribution exclusively for scientific basic research. The amount of the credit would be 25 percent of the qualified basic research contributions, adjusted according to a formula. The credit would generally apply to increases in the level of contributions made for basic scientific research. The formula is designed so that the amount eligible for the credit would be reduced if the gifts normally given to charitable organizations for other purposes were reduced. The provisions of the bill would apply to taxable years beginning after December 31, 1979.

II. CERTAIN BILLS RELATING TO DEPRECIATION

S. 231

EXPANSION OF THE ASSET DEPRECIATION RANGE (ADR) VARIANCE FROM 20 PERCENT TO 30 PERCENT AND TO PROVIDE A SIMPLIFIED TABLE FOR FASTER DEPRECIATION FOR SMALL BUSINESS

and

S. 935

CAPITAL COST RECOVERY ACT OF 1979

A. Present Law and Issues

Present law

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.

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.). These accelerated methods are not allowed for intangible assets. Administrative practice

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[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).

has permitted the 150-percent declining balance method to be used for used tangible personal property. (Rev. Rul. 57–352, 1957–2 C.B. 150; Rev. Rul. 59–389, 1959–2 C.B. 89.)

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., 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 only select the straight-line, 200-percent declining balance (up to 200 percent), or sum-of-the-years-digit 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.[3]

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.[4]

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.

[3] 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.

[4] Section 5 of Public Law 93–625.

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).

"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 guideline 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 taxpayer 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 for small business

Under present law, there are no special provisions pertaining to the depreciation of assets by a small business. Thus, a small business may depreciate its assets on a facts and circumstances basis or make an election to apply the ADR system. The same depreciation methods are allowable for small business as are allowable for other taxpayers.

Although not limited to small businesses, the provision for additional first-year depreciation (sec. 179) was enacted to provide a special incentive for small businesses to make investments in depreciable property. Under this provision, an owner of tangible personal property with a useful life of 6 years or more is eligible 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).[5] Thus, the maximum additional first-year depreciation deduction is limited to $2,000 ($4,000 for individuals filing a joint return).

Amortization of pollution control facilities

In general, if expenditures for pollution control take the form of a separate plant or equipment with a useful life in excess of one year, the

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[5] 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.

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expenditures must be capitalized and depreciated over its useful life. Also, an investment credit is normally available for such expenditures pursuant to the normal property qualification and useful life rules.

A taxpayer may elect to amortize the amortizable basis of any certified pollution control facility over a period of 60 months (sec. 169). In general, the term "certified pollution control facility" means a new identifiable treatment facility which is used, in connection with a plant or other property in operation before January 1, 1976, to abate, control or prevent water or atmospheric pollution or contamination and which is certified by State and Federal authorities. To qualify, the facility also must not significantly increase the output or capacity, extend the useful life, or reduce the total operating cost of the plant or other property or alter the nature of the manufacturing or production process or facility. Special rules are provided for situations where the facility has a useful life in excess of 15 years (sec. 169(f)(2)). Under section 169, the amortizable basis of a pollution control facility which is eligible for 60-month amortization is only that portion of the basis which is attributable to the first 15 years of the asset's useful life. Any remaining basis would be depreciated under the normal depreciation rules.

In addition, taxpayers may be able to finance all or a portion of the cost of providing air or water pollution control facilities with industrial development bonds, the interest from which is exempt from Federal income taxation (sec. 103(b)(4)(F)).

If both (1) five year amortization is elected, and (2) tax-exempt financing is utilized, the normal investment credit will be reduced by 50 percent to the extent the property is financed by the proceeds of an applies only with respect to the portion of the basis of property which is eligible for 60-month amortization.

Among the items which are tax preferences (subject to the "add-on" minimum tax) is the amount by which the amortization deduction for certified pollution control facilities under section 169 exceeds the depreciation deduction which would otherwise be allowable under section 167 (sec. 57(a)(4)).[6]

Issues

The bills (S. 231 and S. 935) raise four major issues. The first issue is whether it is appropriate to provide for acceleration of depreciation deductions to a degree greater than that provided under existing law as an incentive for exports and as a method of increasing productivity. If it is desirable to provide for greater acceleration of depreciation deductions, a second major issue is whether it is appropriate to do so by increasing the ADR variance or by use of a cost recovery approach which is not related to estimated useful lives. A third major issue is whether it is appropriate to provide additional depreciation benefits to small business by allowing eligible businesses to use statutorily prescribed depreciation lives for depreciating certain classes of assets (under a straight-line method) rather than using actual useful lives.

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[6] In computing this item of tax preference, accelerated methods of depreciation can be used to determine the amount of depreciation otherwise allowable (at least where such methods are consistent with the taxpayer's treatment of the portion of the basis of the facility which is not eligible for amortization). Reg. §1.57–1(d)(4).

The fourth major issue is whether it is appropriate to reduce the amortization period for pollution control facilities from 60 months to 24 months (and to provide that this accelerated deduction is not a tax industrial development bond. Also, the investment credit limitation preference).

B. Description of S. 231

Explanation of provisions

ADR system

The bill would increase the asset depreciation range from 40 percent (i.e., 20 percent above or below the asset guideline period) to 60 percent (30 percent above or below the asset guideline period). Thus, under the bill, the asset depreciation range would be a period of years which extends from 70 percent of the asset guideline period to 130 percent of such period. Any fractional part of a year would be rounded to the nearer of the nearest whole or half year.

With respect to the determination of depreciable basis of eligible property under the ADR system, the bill would provide that salvage value may be ignored. Thus, eligible property may be depreciated to a zero adjusted basis.

Small business depreciation schedules

The bill also would allow small businesses to use an abbreviated table of useful lives for depreciation purposes. It would give small firms the opportunity to choose useful lives for assets which are shorter than the useful lives that other businesses can use. The shorter lives are set so that the present value of the economic benefits of straight line depreciation using those lives in equivalent to the benefits which bigger firms receive using ADR lives and double declining balance depreciation. The lives for different assets would be set forth in a table.

The proposed system would be available to any business with an adjusted tax basis in assets (other than most real estate assets) of $250,000 or less. It is intended that the use of shorter lives would not affect the small business' ability to use the investment tax credit which would have been available if it had used the longer normal ADR lives.[7]

[7] It is not clear that the bill language accomplishes this. A technical amendment may be required to ensure that the regular ADR lives can be used for purposes of the investment tax credit.

The straight line depreciation table prescribed by the bill for small business assets would be as follows:

DEPRECIATION LIVES FOR SMALL BUSINESS ASSETS

Asset	*Years*
Specific depreciable assets used in all business activities:	
Office furniture and fixtures	5
Information systems (computers) and other data handling equipment	2
Airplanes	2
Automobiles	1
Buses	4
Light trucks	1
Heavy trucks	2
Truck trailers	2
Vessels and barges	9
Land improvements	14
Depreciable assets used in broad activity groups:	
Farming assets	5
Farm buildings	12
Mining	5
Construction	2
Manufacturing:	
A. Production of electronic products, textured yarn, sawmill and logging operations and oil well drilling	3
B. Production of machinery; metal, stone and clay, glass, rubber, chemical, wood, plastic, textile, apparel, leather, paper, electric and aerospace products; boat building, and printing and publishing	5
C. Production of grain, sugar and vegetable food products, tobacco products, and petroleum refining	8
Wholesele and retail trade, recreational activities, and personal and professional services	5

Effective date

The provisions of the bill would apply to property placed in service in taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce budget receipts by $1 billion in fiscal year 1980, $1.6 billion in fiscal year 1981, $2.1 billion in fiscal year 1982, $2.6 billion in fiscal year 1983, and $3.1 billion in fiscal year 1984.

Other issues for committee consideration

The committee may wish to consider a number of other issues which relate to this new small business depreciation approach. 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 the value of assets test as proposed is appropriate. (Some technical problems may also be present involving the time for testing, the appropriate assets to be included, and the appropriateness of adjusted basis as a measure.) Another issue is whether controlled group and related party rules need to be adopted for purposes of preventing avoidance of the asset limitation. 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 apply to leased property (or whether, or to the extent, this proposal is limited by the use of the term "business"). There may also be some definitional problems concerning the definition of "real estate" for purposes of the exclusion; also it is not clear whether the asset limitation applies at the partner level or the partnership level.

C. Description of S. 935

Explanation of provisions

Depreciation

The bill would provide, in general, that a taxpayer could elect to depreciate tangible personal property, and certain other tangible property which is eligible for the investment credit (i.e., property described in sec. 48(a)(1)(B)), over a period of not less than 5 years. The useful life selected for depreciation purposes also would be used for investment tax credit purposes. This election could be made on a property-by-property basis, but if a taxpayer made this election for any eligible property, the taxpayer would be required to use the half-year convention (which treats all eligible property as being placed in service on the first day of the second half of the taxable year) for all eligible property. Also, the taxpayer would not be permitted to deduct additional first year depreciation (under sec. 179) with respect to property for which an election has been made.

Amortization of pollution control facilities

The bill also would shorten the period over which the amortizable basis of any certified pollution control facility could be amortized from 60 months to 24 months. Further, the bill would repeal the provision of the Code (sec. 57(a)(4)) which provides that, for purposes of the "add-on" minimum tax the excess of the amortization deduction for pollution control facilities over the depreciation deduction otherwise allowable is a tax preference.

Effective date

The provisions of the bill would apply to property placed in service on or after the date of enactment.

Revenue effect

It is estimated that the bill would result in a reduction in budget receipts of $1.2 billion in fiscal year 1980, $4.4 billion in fiscal year 1981, $7.3 billion in fiscal year 1982, $8.5 billion in fiscal year 1983, and $10.2 billion in fiscal year 1984.

III. S. 700

INVESTMENT TAX CREDIT FOR CERTAIN RESEARCH AND EXPERIMENTAL EXPENDITURES

A. Present Law and Issue

Present law

Investment tax credit

A credit against income tax liability is provided for a taxpayer's investment in certain types of depreciable business assets with a useful life of three years or more. Generally, the rate of this credit is 10 percent of qualified investment.

Property eligible for the investment tax credit includes tangible personal property (such as machinery and equipment) which is used in a trade or business or for the production of income. The investment credit is also allowed for other tangible property which is used as an integral part of manufacturing, production, extraction, or in furnishing certain utility services, even though such tangible property may otherwise be considered real (and not personal) property under local law. Buildings (including structural components) and intangible property are not generally eligible for the credit (Regs. § 1.48–1).[1]

Research and experimental expenditures

Present law also provides an option with respect to the tax treatment of research and experimental expenditures. Under these provisions, a taxpayer may elect to deduct research and experimental expenditures in the year incurred (Code sec. 174(a)), or the expenditures may be capitalized and amortized on a straight-line basis over a period of at least 60 months beginning with the month the taxpayer first realizes benefits from these expenditures (Code sec. 174(b), Regs. § 1.174–4). The amortization method is available only if the property resulting from the expenditures does not have a determinable useful life. An election of either of these methods is binding on the taxpayer for all subsequent taxable years unless a different method is authorized by the Internal Revenue Service.

Research and experimental expenditures for purposes of these provisions are those trade or business expenditures incurred by the taxpayer directly or by someone else (such as a research institute or an engineering company) on his behalf, to develop a product, a pilot model, a plant process, a formula or an improvement to property of this type (Regs. § 1.174–2(a)). The term also includes the costs of ob-

[1] However, agricultural and horticultural structures, rehabilitation expenditures for certain buildings, and motion picture films and video tapes are eligible for the credit under specific statutory provisions. (Code secs. 48(a) (1) (D), 48 (a) (1) (D), 48(a) (1) (E), and 48(k).)

taining a patent on this property. (When a patent is issued, the unrecovered research and experimental expenditures attributable to the patent must be amortized over the term of the patent (Regs. § 1.174–4(a)(4).) Research and experimental expenditures do not include costs for acquiring land and depreciable or depletable property, including such property acquired in the course of research or experimental work (Code sec. 174(c)). However, depreciation and depletion deductions with respect to such property used in connection with research and experimental activities are considered as research and experimented expenditures. In addition, the term does not include costs of acquiring another's patent, model, production or process and it does not include research expenditures in connection with literary, historical and similar projects.

Issue

The issue is whether the investment credit should be extended to research and experimental expenditures.

B. Description of the Bill

Explanation of provisions

The bill would extend the investment credit to research and experimental expenditures, as defined under the present statutory provisions which allow taxpayers to deduct or amortize these expenditures. Thus, for this purpose the qualified research and experimental expenditures paid or incurred by the taxpayer during a taxable year would be eligible for the credit, i.e., the credit base would be the total qualified expenditures paid or incurred whether the taxpayer elected to take a current deduction or elected to capitalize and amortize these expenditures.

Effective date

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

Revenue effect

It is estimated that this provision will reduce budget receipts by $0.8 billion in fiscal year 1980, $2.0 billion in fiscal year 1981, and $2.3 billion in fiscal year 1982.

Other issues for committee consideration

The committee may wish to consider whether the investment credit should not be extended to depreciation deductions which are treated as qualified research and experimental expenditures in order to prevent allowance of double credits with respect to the same item, e.g., an initial credit would be allowed with respect to the cost of the property under the regular investment credit provisions (for example, when the property is first placed in service) and also a second credit would be allowed with respect to depreciation on the property if it is treated as a research and experimental expenditure.

IV. S. 1003

BAD DEBT RESERVES, EXPORT MARKET DEVELOPMENT EXPENDITURES, AND FOREIGN CURRENCY LOSSES

A. ESTIMATION OF BAD DEBT RESERVE FOR EXPORT RECEIVABLE

1. Present Law and Issues

Present law

Under present law taxpayer can take a deduction for a business bad debt in the year the debt actually becomes worthless or he can take a deduction for a reasonable addition to a reserve for bad debts in the year the debt arises. The reserve method is intended to reflect the amount of accounts receivable that arose in the current year that are expected to become worthless in some future period. The taxpayer's bad debt deduction under the reserve method is limited, in general, to the historical percentage that his actual bad debt bears to his accounts receivable.

Issues

The issue is whether taxpayers engaged in the business of exporting goods and services should be allowed a deduction for an addition to a bad debt reserve that may be greater than the amount of the deduction the taxpayer would have been allowed using his historical bad debt percentage. Also at issue is whether this provision would be considered to inconsistent with any of the obligations of the United States under the General Agreement on Tariffs and Trade (GATT).

2. Description of the Bill

Explanation of provision

The bill would allow taxpayers who are engaged in the trade or business of selling export property for use or for services rendered for use outside the United States to establish a separate bad debt reserve for that trade or business. Under this provision, the special bad debt deduction for the year would be equal to the greater of:

(1) 15 percent of the taxable income which is from sources outside the United States and which is attributable to the export operation, or

(2) 2 percent of the taxpayer's accounts receivable which are outstanding at the close of the year and which arose from the sale of export property or services outside the United States.

The taxpayer's export bad debt deduction for any year would be limited in that it could not cause the taxpayer's export bad debt reserve to exceed a ceiling equal to 5 percent of the export receivables outstanding at the end of the year.

Effective date

This provision would be effective for taxable years beginning after September 30, 1980.

Revenue effect

It is estimated that this provision will reduce budget receipts by $86 million in fiscal year 1981, $164 million in fiscal year 1982, $88 million in fiscal year 1983, $35 million in 1984, and $39 million in fiscal year 1985.

B. TAX TREATMENT OF CERTAIN EXPENDITURES TO DEVELOP FOREIGN MARKETS AND FOREIGN PATENTS

1. Present Law and Issues

Present law

Expenditures made in the conduct of a trade or business which relate to an asset that has a useful life substantially beyond the taxable year must be capitalized rather than currently expensed. This capitalized expenditure may be amortized over the useful life of the asset. If the useful life cannot be ascertained, the capitalized expenditure will be part of the asset's basis which will be subtracted from the sales price of the asset if and when it is eventually sold.

Under present law, certain amounts paid with respect to exploring and developing a new business must be capitalized by taxpayers who are not already engaged in that business. These expenditures usually occur in the period the taxpayer is investigating the possibility of establishing the new business, and in the period after the taxpayer has decided to establish the business but before it is actually operating. Since these expenditures relate to the new business itself, rather than a tangible asset, they would be amortizable over the life of the business or product. However, since the useful life of a business or a product is, generally, not readily ascertainable, such capitalized expenditures usually cannot be amortized.

In the situation where the foreign business is not a new business but an extension of an existing business, expenditures for the development of foreign markets and foreign products are, in general, presently being deducted by taxpayers. It is not completely clear as to the deductibility of some expenses (e.g., market or product studies) relating to the extension of an existing business into a foreign market.

Under current law, the Internal Revenue Service has held that the cost of acquiring a foreign patent where the U.S. patent is owned by another party is not deductible.

Issues

The issue is whether taxpayers should be permitted to elect to deduct currently, or to amortize over a 60-month period rather than capitalize the cost of establishing foreign markets and foreign products and the cost of acquiring and maintaining foreign patents and trademarks. Also at issue is whether this provision would be considered inconsistent with any of the obligations of the United States under the General Agreement on Tariffs and Trade (GATT).

2. Description of the Bill

Explanation of provision

The bill would provide that the taxpayer could elect to treat the following amounts as research or experimental expenditures for purposes of section 174 of the Code:

(1) Amounts paid in connection with the survey or analysis of foreign markets and foreign products;

(2) Amounts paid in connection with marketing U.S. goods outside the United States, including amounts paid in adapting U.S. products to meet foreign market requirements; and

(3) Amounts paid in applying for, and maintaining, international and foreign patents and trademarks for use in the taxpayer's trade or business. (This provision would apply regardless of whether the taxpayer is the owner of the U.S. patent or the owner of the rights to the U.S. patent.)

Treatment of these costs as research or experimental expenditures under section 174 would permit the taxpayer to elect to deduct such expenditures as expenses in the year incurred or amortize them over a 60-month period.

Effective date

This provision would apply to taxable years beginning after September 30, 1980.

Revenue effect

The revenue effect of this provision is estimated to reduce budget receipts by less than $5 million annually.

C. The Tax Treatment of Foreign Currency Losses on Export Receivables

1. Present Law and Issues

Present law

As a general rule, gains and losses are not taken into account as income or deductions until the gains and losses are realized. An increase in the value of an asset held by a taxpayer will not be included as income, and a decrease in the value of an asset will not be allowed as a deduction, until the amount of the gain or loss is fixed by a sale of the asset or some other realization event. One application of this general rule is that foreign currency gains and losses on accounts receivables are not taken into account until the receivable is actually paid.

Foreign currency losses on accounts receivable usually arise where a taxpayer sells a product with a sales price denominated in a foreign currency. An accrual basis taxpayer will include in income on the sale date the dollar value of the sales price. If the value of the foreign currency declines relative to the dollar in the time between the sale date and date of payment, the taxpayer will have a currency loss equal to the difference between the dollar equivalent of the amount initially taken into income on the foreign currency contract and the dollar equivalent of the amount finally paid on the contract. (He will receive the same number of units of the foreign currency that were originally bargained for but they will translate into fewer dollars on the date the receivable is paid as opposed to the date the receivable arose.) Conversely, if the dollar depreciates in value in the period between the time of sale and the time of payment, the taxpayer will have a foreign currency gain which is includible in income in the year the payment is made.

These rules may be illustrated by an example of a taxpayer who sold his product to a United Kingdom corporation for 200 pounds sterling on October 1, 1979, at a time when 200 pounds would translate into $400, but the account receivable was not paid until March 1, 1980, when 200 pounds would only translate into $300. Since, under the accrual method of accounting, the taxpayer recorded the sale at $400 in 1979, he will now show a $100 loss in 1980 to reflect the fact that ultimately he only received $300 on the sale of his product. If the depreciation of the foreign currency relative to the dollar actually occurred on December 1, 1979, under current law the taxpayer may not recognize the loss in 1979 but instead must show income on the sale of $400. The taxpayer may recognize the loss only in the year the receivable is paid and the loss is fixed, i.e., 1980.

Issues

The issue is whether the present rule that currency gains and losses cannot be included in income until they are fixed by final payment should be modified to allow a taxpayer to elect annually, on a currency-by-currency basis, to deduct foreign currency losses in the year the depreciation occurs rather than the year in which the receivable is actually paid. Also at issue is whether this provision would be considered inconsistent with any of the obligations of the United States under the General Agreement on Tariffs and Trade (GATT).

2. Description of the Bill

Explanation of provision

The bill would allow the taxpayer an annual election, on a currency-by-currency basis, to deduct foreign currency losses incurred on export receivables. Export receivables are receivables that arise from the sale of export property and services for use outside the United States. The foreign currency loss is the decline in the dollar value of an export receivable at the later of the beginning of the year or when the receivable arises over the dollar value of that export receivable at the end of the year.

The foreign currency loss is only allowed to the taxpayer whose trade or business created the export receivable. Thus, financial institutions that purchase export receivables as part of a factoring business would not be allowed this deduction.

When the export receivable is actually paid the taxpayer would recapture any losses taken under this provision in excess of its actual foreign currency loss.

In determining the taxpayer's bad debt deduction, the amount of the receivable would be its adjusted basis less all foreign currency losses taken with respect to that receivable.

Effective date

This provision will be effective for taxable years beginning after September 30, 1980.

Revenue effect

The revenue impact of this provision is indeterminate because of uncertainties about future exchange rate fluctuations.

V. S. 1065

INCOME TAX CREDIT TO CORPORATIONS FOR CHARITABLE CONTRIBUTIONS FOR BASIC RESEARCH

A. Present Law and Issue

Present law

Present law provides a Federal income tax deduction, within certain limitations, for contributions of cash or property to qualified charitable organizations, including colleges and universities (sec. 170). In the case of a corporate donor, the deduction is limited to five percent of the corporation's taxable income (computed with certain adjustments). To be deductible for a particular taxable year, the contribution must either be made within the corporate taxable year or accrued within that year and paid within two and a half months after the close of the year.

If a corporation makes an otherwise deductible charitable contribution exceeding the five-percent limitation, the excess may be carried forward for five succeeding years. The carryforward is added to the subsequent year's charitable contributions and may be deducted subject to the five-percent limitation as computed for the carryforward year.

Issue

The issue is whether corporations should be provided a Federal income tax incentive, in addition to the present law deduction for charitable contributions, to contribute funds to educational organizations to be used for scientific basic research.

B. Description of the Bill

Explanation of provisions

General rules

The bill would provide corporate taxpayers (other than subchapter S corporations) a nonrefundable credit against Federal income tax liability for charitable contributions paid in cash during the taxable year to qualified educational organizations, if as a condition of the gift the donee must use the contribution exclusively for scientific basic research. The bill would define scientific basic research as "fundamental research in the physical sciences the results of which are fully available to the general public." To qualify for the credit, the contribution would have to be made to an educational organization, other than a primary or secondary school, which is otherwise eligible to receive tax deductible donations.

The amount of the credit would be 25 percent of the qualified basic research contributions, adjusted according to a formula. The formula would reduce the qualified basic research contributions actually made (1) by the average of the amounts contributed for qualified basic research over the preceding four taxable years, and (2) by the amount of any reduction in other charitable contributions for the taxable year. Charitable contributions (other than qualified basic research contributions) would be considered to be reduced if they were less than the preceding four-year average. Thus, the new 25-percent credit would generally apply only to charitable contributions earmarked for scientific basic research, and after the first year would apply only to the extent of increases in such contributions. The formula is designed so that the amount eligible for the credit would be reduced if gifts normally given to charitable organizations for other purposes were reduced.

The new basic research credit would be in addition to the present law deduction for charitable contributions. Therefore, a qualifying contribution for scientific basis research could be eligible for both the basic research credit and the charitable deduction.

Controlled group of corporations

The bill would treat all members of the same controlled group of corporations as one corporation for purposes of applying the basic research credit rules. In the case of a controlled group of corporations, each member of the group would be allowed a credit based on its proportionate contribution of qualified basic research contributions which give rise to the credit.

In determining which corporations are members of a controlled group of corporations, the corporate controlled group rules would generally apply (sec. 1563). However, the normal rule which requires at least 80-percent control in a parent-subsidiary controlled group would be changed for purposes of this provision. Under the bill, generally, there would be a parent-subsidiary controlled group if one corporation has more than 50-percent control of another corporation.

Adjustment for certain acquisitions

If a taxpayer acquires the major portion of a trade or business, then for purposes of applying the basic research credit rules for any year ending after the acquisition, the amount eligible for the basic research credit would be adjusted by charitable contributions made by the acquired trade or business. With respect to the taxpayer disposing of a major portion of a trade or business, its charitable contributions for purposes of determining the amount eligible for the basic research credit would also be adjusted.

Effective date

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

For taxable years beginning before January 1, 1984, the formula for computing the amount of the qualified basic research contribution to which the credit applies would take into consideration only qualified basic research contributions made in taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that this provision will reduce budget receipts by $8 million in fiscal year 1980, $20 million in fiscal year 1981, and $22 million in fiscal year 1982.

VI. APPENDIX TABLES

Table 1.—Comparison—U.S. Merchandise Trade Balance—Imports Valued C.I.F. Versus F.A.S.[1]

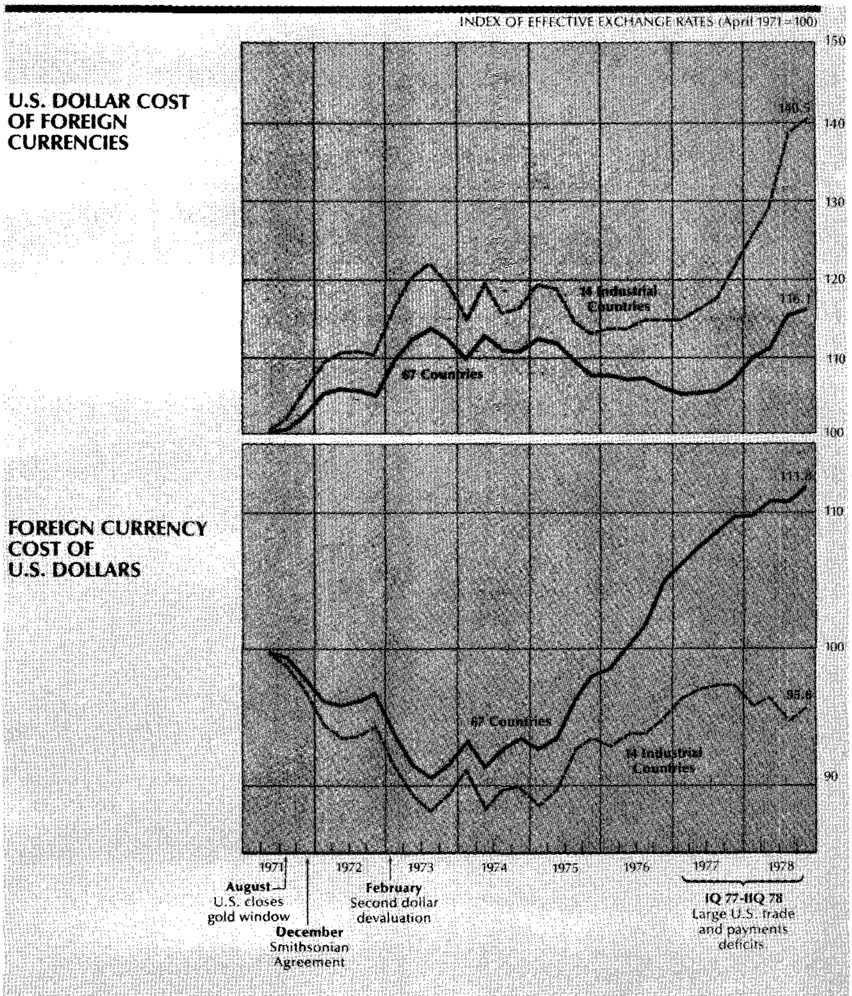
[Billions of dollars]

	Import f.a.s.[1]	Imports c.i.f.[1]
1970	2.6	0.8
1971	−2.3	−5.0
1972	−6.4	−10.0
1973	0.9	−3.1
1974	−5.3	−9.5
1975	9.0	4.2
1976	−9.4	−14.6
1977	−31.1	−36.3
1978	−28.5	−39.6
1979: I[2]	−7.4	−11.3

[1] C.i.f.—cost, insurance, freight; f.a.s.—free alongside ship.
[2] First quarter of 1979.

Source: U.S. Department of Commerce.

Table 2.—Index of Effective Exchange Rates

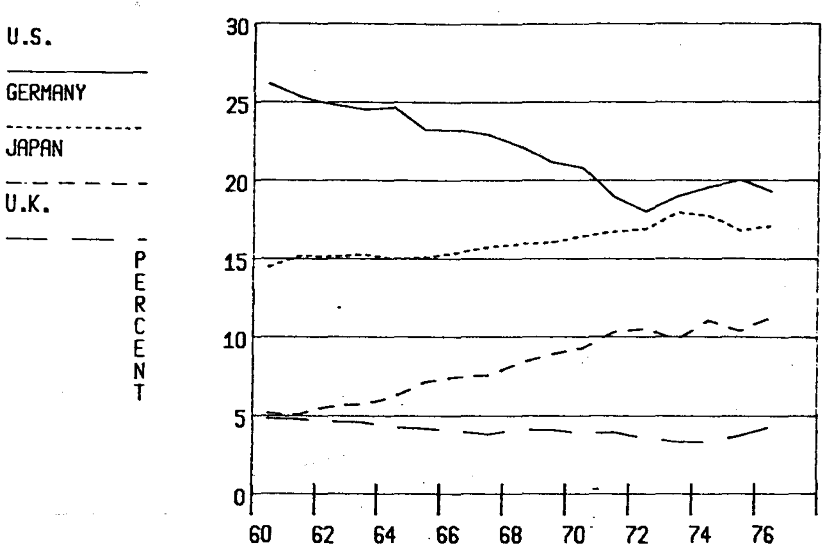


Source: Commerce Department, International Economic Indicators (March 1979).

Table 3.— Export Shares

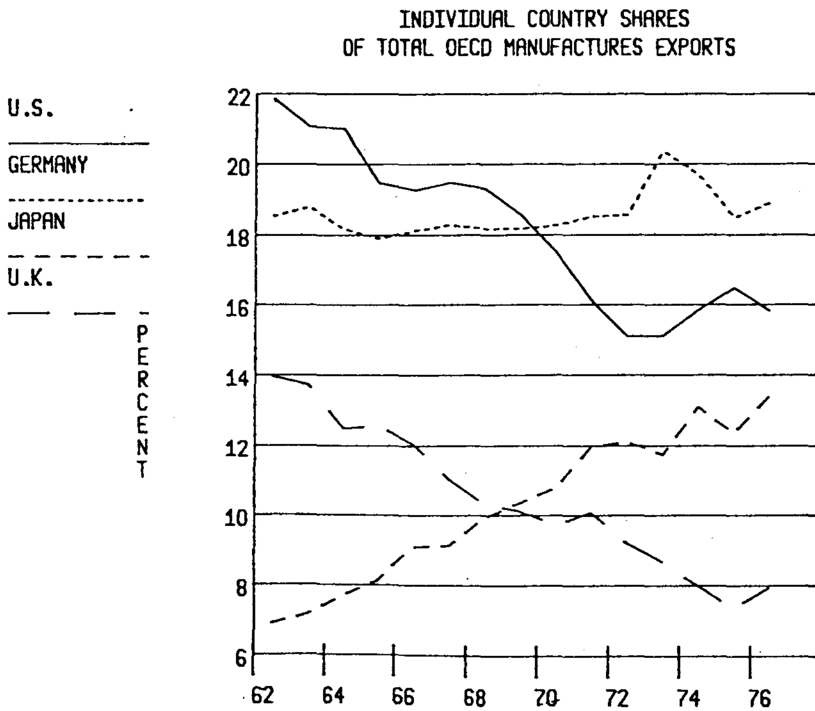
Figure 1

INDIVIDUAL COUNTRY EXPORTS
AS A PERCENTAGE OF
INDUSTRIAL COUNTRIES' EXPORTS



SOURCE:
IMF INTERNATIONAL FINANCIAL STATISTICS

Figure 2



SOURCE:
OECD TRADE SERIES C