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THE ROLE OF DEPRECIATION AND THE INVESTMENT TAX CREDIT IN TAX POLICY AND THEIR INFLUENCE ON FINANCIAL REPORTING DURING THE 20TH CENTURY

Abstract: Since the inception of the modern income tax, the investment tax credit and depreciation have been some of the most modified provisions. This paper traces the history of major changes in depreciation and the investment tax credit along with the tax policy justifications given at the time the changes were made. In addition, the influence of tax depreciation on financial reporting is also discussed. An historical perspective of these two major provisions in tax should be helpful to policymakers and researchers attempting to assess the effectiveness of these policies.

INTRODUCTION

All machinery is on an irresistible march to the junk heap, and its progress, while it may be delayed, cannot be prevented by repairs. This obvious economic fact is of momentous import to accounting, although full recognition has not been given to it in general practice... It implies that, in valuing all fixed assets, account must be taken of the lapse of time, and even in the case of machinery giving no evidence either of use or misuse, the bare fact that it is a year nearer its inevitable goal is an item of which technical account must be taken [Hatfield, 1927, p. 130].

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A depreciation deduction has been a part of modern U.S. income tax since its inception. It is at the nexus of several tax policy objectives that at times compete against and at other times complement one another. Since its debut with the corporate excise tax in 1909, the law regarding depreciation has been amended at least once in every decade. The tax policy motivations for these changes are attributed to any of the following: proper income measurement, raising revenue, encouraging capital formation, or ensuring a neutral tax system. Since so many tax policy goals can be ostensibly served by the deduction, it is not surprising that the law has changed so many times during the 20th century.

An historical perspective on the role of depreciation would not be complete without including a discussion of a related provision, the investment tax credit (ITC). The primary purpose of ITC is to spur capital formation. When capital formation is an important tax policy goal, there are often changes to depreciation, ITC, or both. The potential for depreciation and ITC to alter capital formation has drawn the attention of a wide variety of academicians. Despite years of study, the results from empirical research are far from conclusive.[1] Notwithstanding the lack of conclusive evidence about their effectiveness, tax policymakers have used depreciation and ITC as a means to alter investment spending. The purpose of this paper is to document the changes in depreciation and ITC, the tax policy motivations behind these changes, and the context for the changes that have occurred since the modern U.S. income tax began. By understanding the context for past legislation, both researchers and policymakers can better understand past, current, and potential changes.

The history of the role of depreciation in the income tax can be defined into five time periods: 1909-1953, 1954-1961, 1962-1980, 1981-1985, and 1986 to the present. The legislation of 1954, 1962, 1981, and 1986 represented major shifts with regard to tax policy and its relationship to depreciation or ITC. The discussion below documents the changes and the tax policy motivations for each change that occurred during each time period. In addition, economic and other relevant factors are also addressed.

[1]See Chirinko [1986, 1993] for critical analyses of empirical research related to investment spending.

THE EARLY YEARS: 1909-1953

An allowance for depreciation has been included as a deduction for determining taxable income since the inception of modern corporate and individual income taxes.[2] The corporate excise tax enacted as part of the Tariff Act of 1909 permitted "a reasonable allowance for depreciation of property, if any." The Revenue Act of 1913 permitted "a reasonable allowance for exhaustion, wear and tear of property arising out of its use in a business." The early rationale for the depreciation deduction is contained in the Bureau of Internal Revenue's Regulation 74, Article 202 in which it posited that the necessity for a depreciation deduction arises from the fact that certain business property is subject to exhaustion. Depreciation's role was primarily that of income determination. With its inclusion of depreciation in the income tax base, the government was actually taking a bold step that differed from much of financial reporting practice of the day.[3] In commenting about financial reporting practice in the early part of the 20th century, Hatfield [1927, p. 140] offered the following summary:

> Present practice unfortunately does not always correspond to current principle. Corporations are still apt to look upon the charge for depreciation as being an act of grace rather than of necessity, and the allowance is frequently less in the lean than in the prosperous years. But the improvement since . . . 1908 has been very marked. At that time any recognition of depreciation was relatively uncommon in the accounts of American corporations, and the relatively few companies that showed depreciation in prosperous years grew

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[2]The U.S. first enacted an income tax in 1861 to fund the Civil War. This tax did not mention depreciation. Depreciation was specifically excluded as a deduction for the 1894 income tax which was ruled unconstitutional. Thus, a depreciation deduction was not provided for in the calculation of taxable income prior to 1909. The corporation excise tax enacted in 1909 was a tax on corporate income. The inception of the modern-day individual income tax began with the ratification of the 16th Amendment to the U.S. Constitution on February 25, 1913, and the passage of the Revenue Act of 1913 on March 1, 1913.

[3]Grant and Norton [1949, p. 249] noted that, "it is significant that the first recognition of annual expense of depreciation for tax purposes occurred in the same year in which depreciation was first recognized by the Supreme Court [*Knoxville v. Knoxville Water Company*, 212 U.S. 1 (1909)] as an element in the regulation of public utility rates."

> faint-hearted when business was poor. But an examination of the balance sheets during the trying period after the Great War shows that many of them made charges for depreciation even though that resulted in a net deficit. This closer adherence to correct accounting principles was doubtless stimulated by the provisions of the income-tax law.

Saliers [1923] offered a similar summary, noting that firms refused to allow for depreciation expense early in the 20th century. In his view, corporations in 1922 were still varying their depreciation deductions with their earnings. By 1932, Paton [1932, p. 578] noted:

> Depreciation accounting has by no means attained an ideal state, but there is now almost universal agreement as to the general significance of depreciation and the importance of recognizing the phenomenon in some appropriate manner. The cost of plant assets which have a limited useful life must evidently be taken into consideration, in some other way if not in the form of systematic accruals, if costs of production are to be accurately calculated, periodic income determined on a sound basis, and the integrity of investment maintained. The income tax regulations have no doubt been more potent in bringing about this condition than the admonitions of accountants or the arguments of academicians.

Thus, it appears that early efforts to define taxable income by including depreciation had an impact on financial reporting practice in the early part of the 20th century. Apparently, however, financial managers exercised a considerable degree of discretion with regard to the amount of depreciation, if any, that was expensed on their income statements for financial reporting. For the first third of the 20th century, they also had a great degree of latitude with regard to how much depreciation they deducted for income tax purposes.

In 1920, the Treasury first issued Bulletin F, leaving the determination of the amount of depreciation to the taxpayer based on his judgment and experience, with final approval by the

Commissioner. Thus, taxpayers had a considerable degree of freedom in determining their depreciation deductions. During the 1924-1931 time period, depreciation allowances increased substantially.

By 1931, claimed depreciation deductions exceeded corporate taxable income [U.S. Congress, House, Committee on Ways and Means, 1934]. In 1931, the Treasury issued a revised Bulletin F. It attached a preliminary study that gave "probable useful lives" for over 2,700 different kinds of industrial assets. Determining a depreciation deduction remained at the taxpayer's discretion, however. The deduction would not be disallowed unless the government could demonstrate "by clear and convincing evidence" that the deduction was "unreasonable." By 1934, the House Ways and Means Committee considered substantial across-the-board 25 percent reductions in depreciation allowances for the 1934 to 1936 time period. It estimated that the government would receive an additional $85 million in tax revenue per year from the recommended changes.

The Treasury Department, however, opposed an arbitrary reduction. It believed that the matter could best be resolved by administrative rather than legislative action. Treasury Secretary Morgenthau proposed that the Treasury require taxpayers to furnish supporting schedules, require depreciation to be limited to an asset's useful life, and switch the burden of proof for a reasonable deduction to the taxpayer. Rather than mandating depreciation deductions through legislation, the choice was made to handle it administratively through guidelines drafted by the Treasury.

In 1934, the Treasury Department issued Treasury Decision 4422, 1934 CB 58 (TD 4422). TD 4422 outlined the Treasury's change in policy as Secretary Morgenthau had proposed. TD 4422 required taxpayers to furnish a schedule showing their calculation of depreciation expense to substantiate their deductions. Taxpayers were allowed to allocate the cost of an asset over its useful life using the straight-line or units-of-production method. Until 1934, the burden of proof fell on the Internal Revenue examiner to demonstrate that a taxpayer had misstated income by improperly calculating his depreciation expense by clear and convincing evidence. This policy was changed in 1934, shifting the burden of proof from the government to the taxpayer.

In 1942, the Treasury Department issued a second revision of Bulletin F. Bulletin F recommended useful lives for over 5,000 assets. The Treasury's estimates of useful lives, however, were

based on surveys conducted during the Great Depression of the 1930s when businesses tended to replace their obsolete assets less frequently. Thus, the useful life estimates listed in Bulletin F's revision were generally longer than an asset's actual useful life and longer than in the 1931 version of Bulletin F. This disparity resulted in tax depreciation deductions being less than what was considered economic depreciation. This policy continued until 1954.

During this time a taxpayer could also use the "facts and circumstances" method, whereby assets were assigned useful lives based on the taxpayer or industry's general experience. However, if the taxpayer chose to define an asset's depreciable life using Bulletin F rather than the "facts and circumstances" method, he avoided controversy in an audit. Thus, many assets were depreciated using either the straight-line or units-of-production method over the assets' useful lives as defined in Bulletin F. It was not until 1954 that the tax laws were revised to bring tax depreciation more in line with what was considered economic depreciation.

A SHIFT IN TAX POLICY PERSPECTIVE: 1954-1961

Until 1954, Congress viewed depreciation solely as a deduction necessary for proper income determination. The deduction was an allowance which reflected the "exhaustion, wear and tear of property used in a trade or business" [IRC §167(a)]. The enactment of the Internal Revenue Code of 1954, however, marked a major shift in depreciation's role in tax policy. For the first time Congress considered using tax depreciation as an economic incentive for stimulating investment. It also marked the first time Congress, rather than the Treasury, decided the allowable means for calculating the deduction.

The tax law change in 1954 allowed businesses to use any method of depreciation as long as it was both consistently applied and did not exceed twice the straight-line rate of depreciation. Congress believed that the pre-1954 depreciation system acted as a barrier to investment. It also believed that the pre-1954 "tax depreciation methods might depress business capital expenditures below the level needed to keep the economy operating at high levels of output and employment" [U.S. Congress, House, Committee on Ways and Means, 1954, p. 22]. Thus, the 1954 tax changes were designed to provide incentives for investment.

At the same time, however, Congress was also concerned about the effect these changes would have on income determination. The new methods of depreciation would:

> ...concentrate deductions in the early years of service and [would result] in a timing of allowances more in accord with the actual pattern of loss of economic usefulness. With the rate limited to twice the corresponding straight-line rate and based on a realistic estimate of useful life, the proposed system [would conform] to sound accounting principles [U.S. Congress, House, Committee on Ways and Means, 1954, p. 23].

Thus, Congress wanted to stimulate investment while remaining within economic and accounting principles. With the 1954 law, Congress sanctioned the use of the double-declining balance method. This was the first time Congress opted to decide what depreciation methods should be allowed. Up until this time, depreciation was handled administratively through the Treasury Department.

In 1958, the Small Business Tax Revision Act of 1958 introduced first-year depreciation for the first time. This allowed small businesses to deduct up to 20% of the cost of tangible personal property.[4] The purpose of this provision was to assist small business by increasing the amount of funds available to them via a reduction in tax liability [*Congressional Record*, 1958, pp. 17,085, 17,090]. A variation of this election, known as the immediate expense election, remains today.[5]

THE 1960s AND THE INVESTMENT TAX CREDIT

Investment Tax Credit Enacted (1962): The Revenue Act of 1962 (RA62) represents a landmark in terms of tax incentives for investment. ITC was first introduced in RA62.[6] President Kennedy advocated enacting the credit to stimulate capital formation. He believed higher levels of capital formation would raise productivity, keep people employed, and alleviate a serious balance of pay-

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[4]The maximum eligible cost was $10,000 for unmarried taxpayers ($20,000 for married taxpayers) for a maximum deduction of $2,000 and $4,000 respectively.

[5]The deduction is no longer a percentage of allowable cost, but is an election to deduct the full cost of property up to $20,000 in the year 2000 (increasing to $25,000 for the years 2003 and thereafter).

[6]A credit, as opposed to a deduction, is a dollar for dollar reduction of a taxpayer's tax liability. The first ITC was 7% of the cost of personalty in the year of acquisition.

ments problem [U.S. Congress, House, 1961, p. 3]. Congress echoed his sentiments by stating that the objective of the credit was "to encourage modernization and expansion of the Nation's productive facilities and thereby improve the economic potential of the country, with resultant increase in job opportunities and betterment of our competitive position in the world economy" [U.S. Congress, Senate, Committee on Finance, 1962, p. 11].

Stimulating investment was to be accomplished through two major tax revisions. These were the Treasury's revision of depreciation guidelines and ITC. Congress believed that realistic depreciation rules did not provide sufficient incentive to spur economic growth. An additional incentive in the form of an ITC would stimulate investment in two ways. First, it would reduce the net cost of acquiring depreciable assets. Second, it would increase the cash flow available for investment[7] [U.S. Congress, Senate, Committee on Finance, 1962, p. 11].

Congress also considered the possibility of using more accelerated methods of depreciation in lieu of a credit. This idea was discarded, however. Congress believed the credit was "preferable to higher depreciation charges because the latter tends to distort income accounting" [U.S. Congress, Senate, Committee on Finance, 1962, p. 12]. It seems clear that Congress did not wish to deviate materially from accounting and economic concepts of income in order to stimulate investment.

ITC Suspension (1966-1967): In 1966, the U.S. faced problems with inflation. Therefore, President Johnson initiated a comprehensive plan which called for reducing government expenditures for low-priority programs and temporarily suspending tax incentives for investment [U.S. Congress, House, 1966, pp. 4-7]. Congress noted that the bill was:

> ...part of an overall program designed to moderate the pace of the economy to a level more compatible with the rate of increase in our physical capacity to produce, to begin the return to price stability and to relieve distortions among various sectors of the economy which arise from widely different

[7]The reasoning behind this argument is that a firm would have a pool of available funds for investment. The 7% credit for new investment would augment this pool so that more investment could be made.

> rates of growth. By removing certain tax incentives for investment in machinery, equipment and buildings, the bill will ease inflationary pressures in those sectors where demands for output are straining present productive capacity. The action also will have the effect of reducing pressures tending to raise interest rates and will promote an increased flow of credit into the home mortgage market. Moreover, the bill can be expected to produce a short-run improvement in the Nation's balance-of-payments position as demand for output is brought into balance with the existing capacity to produce the output [U.S. Congress, Senate, Committee on Finance, 1966, p. 4].

Thus, ITC and accelerated depreciation on real property were temporarily suspended from October 10, 1966 to December 31, 1967.

The suspension ended up being short-lived. On June 13, 1967, President Johnson signed H.R. 6950 [P.L. 90-26], lifting the suspension effective March 10, 1967. At the time ITC was reinstated, interest rates were dropping and housing starts were up. It appeared as if the economy was rebounding and the suspension no longer necessary.

ITC Abolished (1969-1971): In 1969, problems with inflation reappeared. Once again, Congress believed that ITC directly contributed to inflationary pressures and wide fluctuations in investment. Eliminating the credit would help reduce inflation and help keep the rate of change in investment on a more steady path [U.S. Congress, House, Committee on Ways and Means, 1969, p. 178].

Although Congress considered suspending the credit as it had done a few years earlier, the idea was rejected on two grounds. First and foremost, Congress believed that during the prior suspension period (1966-1967), businesses had simply postponed their acquisitions until after the suspension was lifted. In the view of Congress, it was "undesirable to repeat that experience" [U.S. Congress, House, Committee on Ways and Means, 1969, p. 179]. Second, suspension and subsequent restoration of the credit were administratively difficult.

Therefore, Congress voted to repeal ITC. At the time the credit was repealed, Congress had no plans for bringing it back any time in the future. In fact, it believed that:

> ...It [might] well be that the normal incentives of potentially greater profits in the context of a stable growth, full employment economy will provide the investment needed without resorting to special devices to stimulate investment which, on occasion, appear to give rise to investment booms [U.S. Congress, House, Committee on Ways and Means, 1969, p. 180].

DEPRECIATION FROM THE EARLY 1960s TO THE REVENUE ACT OF 1971

Revenue Procedure 62-21: Although the depreciation rules did not change as frequently during the 1960s as those associated with ITC, depreciation did not escape controversy. In 1962, the next major change with regard to depreciation occurred. That year the Internal Revenue Service (IRS) issued Revenue Procedure 62-21, 1962-2 CB 418 (Revenue Procedure 62-21). Bulletin F had defined useful lives on an asset-by-asset basis. Revenue Procedure 62-21 took a different approach by grouping assets by industry of use. The guideline lives were based on statistical data and assessment of technological trends for each industry in the U.S. [Revenue Procedure 62-21, p. 463]. The new guideline lives placed a greater emphasis on the economic life of an asset rather than its physical life [Revenue Procedure 62-21, p. 464]. As a result, write-off periods for assets could be reduced 30 to 40%. A taxpayer could only use the new guideline lives, however, if they were consistent with the actual retirements and replacement practices of his business. This could be demonstrated by a reserve ratio test.[8]

The reserve ratio test was used to form ranges of depreciable lives based on a taxpayer's actual usage. Taxpayers could only continue to use the generous guideline lives under Revenue Procedure 62-21 if they conformed to actual service lives as determined by the reserve ratio test. This test effectively obligated taxpayers to retire property within the guideline life periods in order to continue to use guideline lives.

Although the IRS initially expected that the guideline lives

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[8]The reserve ratio was calculated by dividing accumulated depreciation by the gross (undepreciated) basis of an asset within a class. This ratio was then used to form a range for depreciable lives no greater than 20% or no less than 10% of a benchmark life based on actual usage of the firm's assets.

under Revenue Procedure 62-21 [p. 464] would alleviate controversy, implementation of the reserve ratio test proved controversial. Announcement 71-76, 1971-2 CB 503 (Announcement 71-76) criticized the reserve ratio test on the basis that one could not determine if guideline lives had been violated until an asset was disposed [Announcement 71-76, pp. 503, 511]. In addition, a survey indicated that 87% of IRS agents found the test unworkable and impractical [Announcement 71-76, p. 512]. The reserve ratio test was abandoned with the enactment of the Revenue Act of 1971.

Along with the controversy surrounding the IRS's implementation of Revenue Procedure 62-21 during the 1960s, Congress also made a few innovations to tax law associated with depreciation. With the Revenue Act of 1962, Section 1245 depreciation recapture was introduced for the first time. This provision converts the character of a gain from the sale of personalty that is attributable to prior depreciation into ordinary income. Congress wished to prevent using depreciation to convert ordinary income into capital gains [U.S. Congress, Senate, Committee on Finance, 1962]. The Revenue Act of 1964 extended depreciation recapture to buildings with Section 1250 recapture, subsequently made more stringent with the Tax Reform Act of 1969.

The Revenue Act of 1971: In the early 1970s, the U.S. faced high unemployment, inflation, and little growth in GNP and investment. The business tax incentives that were enacted in 1971 were designed to be "large enough to stimulate the economy and yet not so large that they [would] create a new wave of inflationary pressure" [U.S. Congress, Senate, Committee on Finance, 1971, p. 7]. The major business tax incentives were a revision of the depreciation rules and a reinstatement of ITC.

The Revenue Act of 1971 introduced the Class Life Asset Depreciation Range System (ADR). ADR provided new guidelines for defining an asset's useful life. These guidelines effectively replaced the Revenue Procedure 62-21 guidelines that had been used until that time. Like Revenue Procedure 62-21, an asset's useful life was defined by its industry of use rather than by type of asset.[9] The number of asset classes, however, was increased from 75 to 132.

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[9]The Treasury Department was given authority to prescribe depreciable lives based on anticipated industry norms [U.S. Congress, House, Committee on Ways and Means, 1971].

ADR provided an additional feature not present in Revenue Procedure 62-21. Taxpayers were able to select an asset's useful life from a range of lives. The range was 20% less than to 20% greater than those provided by Revenue Procedure 62-21. The Revenue Act of 1971 still allowed taxpayers to define useful lives using the "facts and circumstances" method. Congress expected, however, that the ranges of lives provided by ADR would make administering the depreciation rules simpler. They believed that ADR would reduce the number of disputes which were likely to arise because of the particular facts and circumstances of the taxpayer's situation [U.S. Congress, Senate, Committee on Finance, 1971, p. 48].

ITC also reappeared under the guise of a jobs development investment credit.[10] The credit was reinstated for several reasons. First, the credit was expected to improve the economy by creating additional jobs through increased expenditures in machinery and equipment. Second, Congress expected the credit to reduce inflation this time because "an increased flow of goods into the market is the best long run assurance we can have of keeping prices down." Third, new investment in productive facilities would help make them more efficient. Therefore, the U.S. would be more competitive in foreign markets and the balance of payments would be improved [U.S. Congress, House, Committee on Ways and Means, 1971, pp. 5-6].

TAX REDUCTION ACT OF 1975

In 1975, the U.S. faced its highest levels of unemployment since 1941. The Tax Reduction Act of 1975 was designed to restore economic growth and to move toward full employment. A key component of the Act was a temporary increase in ITC.

The Tax Reduction Act of 1975 increased ITC from 7% to 10% for qualified property acquired before January 1, 1977. Congress expected the tax revisions "would help revive the economy and increase employment without adding significantly to inflationary pressures." Once again, Congress believed that the increase in the tax credit would create more jobs, increase productivity, reduce inflation, and improve the U.S. balance of payments [U.S. Congress, House, Committee on Ways and Means, 1975, pp. 7-11].

[10]The form of the "jobs development investment credit" was similar to ITC that was abolished in 1969. It allowed a credit of 7% of the cost of personalty in the year of acquisition.

The Tax Reform Act of 1976 extended the "temporary" increase in ITC until December 31, 1980. The Revenue Act of 1978 made the "temporary" increase permanent, effective January 1, 1981.

THE BEGINNING OF THE ACCELERATED COST RECOVERY SYSTEM (ACRS): 1981-1985

ACRS: The Economic Recovery Tax Act of 1981 (ERTA) represents a major turning point in the evolution of depreciation and tax policy with the first appearance of the Accelerated Cost Recovery System (ACRS). Until ERTA, Congress was concerned that tax depreciation rules conformed to sound accounting and economic principles. Under ERTA, this function of the depreciation deduction no longer seemed important. In fact, ACRS was so different from what accountants and economists typically referred to as depreciation that the deductions were called "cost recovery" instead of depreciation. With ERTA, simplifying tax rules and encouraging investment seemed far more important than conforming to accounting practice for financial reporting.

Under ACRS, personalty was categorized into one of four "recovery classes." Assets were grouped according to the number of years over which their original cost was recovered. Of the four personalty recovery classes, only the three-year and five-year classes were frequently used. The ten-year and fifteen-year classes were reserved for a relatively few specialized assets. Under ERTA, all depreciable realty had a 15-year recovery period.

There were several reasons for enacting ACRS. First, Congress concluded that prior depreciation and ITC provisions required revisions because they did not provide the investment stimulus that was considered essential for economic expansion. Second, Congress believed that the prior law was unnecessarily complicated. Third, the real value of depreciation deductions had declined because of inflation. It was hoped that ACRS would compensate for this problem by giving assets shorter lives [Staff of the Joint Committee on Taxation, 1981, p. 73]. A fourth reason mentioned in several hearings was to help the U.S.'s balance of payments problem by increasing the nation's competitiveness in international trade via increased productivity from investment in more modern equipment. In addition to major revisions in depreciation, ERTA modified ITC making it more compatible with ACRS.

Post-ERTA Modifications: 1982 to 1985: During the four years following ERTA, a series of three different pieces of legislation gradually rolled back some of ERTA's generosity. First, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) required either a reduction in depreciable basis or a reduced ITC.[11] In addition, when ERTA was originally enacted, more accelerated cost recovery schedules were planned to begin in 1985 and 1986.[12] TEFRA repealed the planned accelerations in depreciation deductions. Second, the Deficit Reduction Act of 1984 lengthened the recovery period for realty from 15 to 18 years. In addition, special limitations for passenger cars were enacted.[13] Finally, the Imputed Interest Act of 1985 further lengthened the realty recovery period from 18 to 19 years.

All three pieces of legislation were enacted during a time when cutting federal budget deficits was a primary concern [U.S. Congress, House, 1982; U.S. Congress, Senate, Committee on Finance, 1985]. The modifications in TEFRA were based on a concern that the combined effect of ITC and the accelerated depreciation in ACRS had been too generous [U.S. Congress, Senate, Committee on Finance, 1982, p. 126]. In 1984, Congress was concerned that real-estate depreciation had led to excessive tax shel-

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[11]TEFRA required a taxpayer to reduce the depreciable basis of property by one-half of ITC taken. Taxpayers could elect to depreciate the full depreciable basis of property if they reduced ITC taken. Under this election, property eligible for the 10% ITC only received an 8% credit. Property eligible for a 6% ITC received a 4% credit.

[12]The ACRS schedules, as enacted in 1981, were developed to approximate 150% declining balance in the early years of an asset's life with a switch to straight-line for later recovery years. Under ERTA, the schedules were to change in 1985 to approximate 175% declining balance in the early years of an asset's life with a switch to sum-of-the-years' digits for later years. In 1986, the schedules were to change once more reflecting the use of 200% declining balance with a switch to sum-of-the-years' digits.

[13]The Deficit Reduction Act of 1984 limited ACRS deductions to $4,000 for the first year and $6,000 each year thereafter for passenger automobiles. In addition, ITC was limited to $1,000 ($667 if the taxpayer elected to reduce ITC to be able to depreciate the full cost of the asset rather than reducing the depreciable basis by one-half of ITC). Congress believed that ITC and ACRS should be used to stimulate capital formation rather than to subsidize what it perceived to be "the element of personal consumption associated with the use of very expensive automobiles" [U.S. Congress, House, Committee on Ways and Means, 1984, p. 1387]. In addition, there was a perception that taxpayers tended to overstate the proportion of business use of automobiles. It was Congress' belief that the ACRS and ITC limits would assist with compliance in this regard [U.S. Congress, House, Committee on Ways and Means, 1984, p. 1387].

ters to the detriment of more productive investments [U.S. Congress, Senate, Committee on Finance, 1984]. When ERTA was enacted in 1981, the role of depreciation in income measurement was not a concern. By 1985, this concern had resurfaced when the Senate Finance Committee felt that "the useful life of most real property exceeds 18 years and that an increase in the cost recovery period for real property would more correctly measure the income from real property" [U.S. Congress, Senate, Committee on Finance, 1985, p. 15].

1986 TO PRESENT

Tax Reform Act of 1986: The Tax Reform Act of 1986 (TRA86) is the final major shift in depreciation and tax policy. TRA86 repealed ITC and made additional modifications to ACRS, resulting in MACRS. Cultivating investment as a policy goal was not abandoned, but the means of doing so were considerably changed.

TRA86 was enacted to increase the fairness, efficiency, and simplicity of the tax system [Staff of the Joint Committee on Taxation, 1986, p. 6]. Congress wished to reduce the role taxes play in investment and consumption decisions. Rather than targeting specific forms of investment, Congress believed that the "surest way of encouraging the efficient allocation of all resources and the greatest possible economic growth was by reducing statutory tax rates" [Staff of the Joint Committee on Taxation, 1986, p. 98].

TRA86 repealed ITC. As opposed to the 1969 repeal, the current repeal has been far more long-lived as ITC has not reappeared. See Table 1 for a summary of ITC changes. Congress believed that ITC "discriminated against long-lived investment and was used as a tax shelter device" [Staff of the Joint Committee on Taxation, 1986, p. 10]. Instead of targeting investment for a defined set of assets, capital formation incentives under TRA86 were provided by lower tax rates and accelerated depreciation.

TABLE 1
Changes in the Investment Tax Credit and Rationale for Change

Legislation	Change	Congressional Rationale
Revenue Act of 1962	Investment tax credit enacted	Stimulate capital formation
H.R. 17607 [Public Law 89-800]	Investment tax credit suspended effective 10/10/66 to 12/31/67	Ease inflation and relieve distortions across sectors in the economy
H.R. 6950 [Public Law 90-26]	Investment tax credit suspension lifted effective 3/10/67	Economic pressure appeared to have lifted
Tax Reform Act of 1969	Investment tax credit repealed	Ease inflationary pressures
Revenue Act of 1971	Investment tax credit reinstated	Creating jobs
Tax Reduction Act of 1975	Temporary increase in the investment tax credit from 7% to 10%	Revive economy and increase employment
Tax Reform Act of 1976	Temporary increase extended to 12/31/80	Stimulating investment
Revenue Act of 1978	Temporary increase made permanent effective 1/1/81	Stimulating investment
Tax Equity and Fiscal Responsibility Act of 1982	Reduction in depreciable basis or reduced credit	Combined effect of ACRS and investment tax credit was perceived to be too generous
Tax Reform Act of 1986	Investment tax credit repealed	Enhance neutrality of tax system by repealing a provision that discriminated against investment in longer-lived assets

In addition to repealing ITC, Congress modified ACRS. MACRS was designed to "provide for more neutral depreciation treatment across diverse assets" [Staff of the Joint Committee on Taxation, 1986, p. 10]. Congress once again returned to the notion that recovery periods should more closely reflect the actual useful lives of assets.

Revenue Reconciliation Act of 1993: The Revenue Reconciliation Act of 1993 was enacted during a time when reducing budget deficits was a primary goal. In it, Congress lengthened the nonresidential realty recovery period from 31.5 to 39 years. With this legislation, Congress turned full circle toward having depreciation reflect "proper" income measurement with regard to depreciable real property. It felt that depreciation deductions had been larger than the actual decline in the value of property. In order to measure more accurately the economic income derived from using nonresidential realty, the recovery period was increased to

39 years [U.S. Congress, House, Budget Committee, 1993, pp. 625-626]. With this change the recovery period for buildings returned to an amount close to what it was prior to ERTA. With the use of component depreciation[14] and the facts and circumstances methods of depreciation, depreciable lives for buildings was effectively 36 to 37 years [Staff of the Joint Committee on Taxation, 1981, p. 20]. The changes in the Revenue Reconciliation Act of 1993 are the most recent changes in depreciation. See Table 2 for a summary of depreciation changes over time.

TABLE 2
Changes in Depreciation and Rationale for Changes

Legislation or Administrative Action	Change	Congressional Rationale
Corporate Excise Tax Act of 1909	Depreciation first appeared	
Revenue Act of 1913	Depreciation appeared as part of the first income tax under the 16th Amendment	
Bulletin F first issued (1920)	Determination of depreciation expense remained taxpayer determined	(Administrative action)
Bulletin F first revised (1931)	Determination of depreciation expense remained taxpayer determined but an attachment provided examples of useful lives for over 2,700 different assets	(Administrative action)
TD 4422 (1934)	Required taxpayers to furnish a schedule supporting their depreciation deduction; limited depreciation to an asset's useful life; shifted the burden of proof to the taxpayer to demonstrate that depreciation was properly determined	(Administrative action)
Bulletin F 2nd revision (1942)	Treasury Department recommended useful lives for over 5,000 assets based on studies conducted during the Depression	(Administrative action)
Internal Revenue Code of 1954	Congress allowed businesses to use any depreciation method as long as it did not exceed twice the straight-line rate	Stimulate investment while remaining within accepted economic and accounting principles
Small Business Tax Revision Act of 1958	Immediate expense election first introduced	Assistance to small businesses
Revenue Procedure 62-21	Provided guideline lives based on an industry-by-industry basis rather than an asset-by-asset basis	(Administrative action)
Revenue Act of 1962	Section 1245 recapture introduced for the first time	Raising revenue (recapture provisions designed conversion of ordinary income to capital gains)

[14]Component depreciation allowed a taxpayer to depreciate the parts of a building over differing useful lives rather than depreciating the entire over a uniform life.

TABLE 2 (cont.)

Legislation or Administrative Action	Change	Congressional Rationale
Revenue Act of 1964	Recapture (Section 1250) extended to buildings	Raising revenue (recapture provisions designed conversion of ordinary income to capital gains)
Tax Reform Act of 1969	Section 1250 recapture tightened	Revenue raising
Revenue Act of 1971	Class Life Asset Depreciation Range System introduced (ADR)	Encourage investment
Economic Recovery Tax Act of 1981	Accelerated Cost Recovery System (ACRS) introduced	Investment stimulus, simplifying law, and compensating for inflation effects
Tax Equity and Fiscal Responsibility Act of 1982	Depreciable basis reduced if full investment tax credit taken	Perception that 1981 provisions were too generous
Deficit Reduction Act of 1984	Real property lives extended from 15 to 18 years	Deficit reduction
Imputed Interest Act of 1985	Real property lives extended from 18 to 19 years	Deficit reduction and bringing useful lives for realty closer to actual useful lives
Tax Reform Act of 1986	Modified ACRS introduced extending recovery periods for personalty and realty (residential realty lives extended to 27.5 years and nonresidential extended to 31.5 years)	Enhance neutrality in tax system
Revenue Reconciliation Act of 1993	Extended recovery period for nonresidential realty to 39 years	Better measurement of economic income

CONCLUDING REMARKS

In the 90 years since the inception of the modern income tax, tax policy and depreciation have come nearly full circle. Until 1954, depreciation's role was primarily one of proper income determination. In 1954, Congress first entertained the notion that depreciation could be used to further other tax policy goals, specifically encouraging capital formation. From 1954 to 1981, income measurement and economic motivations were the primary tax policy considerations. The investment credit, initially enacted in 1962, was turned off and on during this period, justified entirely on economic grounds. ERTA's enactment in 1981 marked a major turning point in depreciation policy. For the first time, the role of depreciation in income determination was ignored. Encouraging investment and simplifying the tax rules were the primary motivations behind the law. Soon after ERTA's enactment, revenue-raising concerns became important and Congress began to lengthen depreciable lives over a series of legislative acts. The Tax Reform Act of 1986 abandoned the notion of targeting investment in certain types of assets. The neutrality of the tax system became important. ITC was repealed, and ACRS

was modified based on neutrality considerations. By the Revenue Reconciliation Act of 1993, Congress had come full circle with the desire to have better income measurement. Encouraging certain forms of investment was no longer paramount.

Despite Congressional use of depreciation and ITC to further economic goals, the empirical evidence about the effectiveness of these tax policy tools is quite mixed. There is no consensus about the effectiveness of these measures. Since depreciation is based on when an asset is placed in service, taxpayers are left with a hodgepodge of regulations as a complex legacy of Congressional policymaking. For the time being, the current rules for new acquisitions are relatively simple and have returned to useful lives that are closer to what they were before ERTA's enactment. History indicates, however, that as economic pressures change, depreciation and ITC are particularly vulnerable to modifications. Each change adds another layer of complexity for taxpayers. The impact of taxes on investment has been, and is, clearly an important issue that warrants further study to assist policymakers in shaping the law.

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