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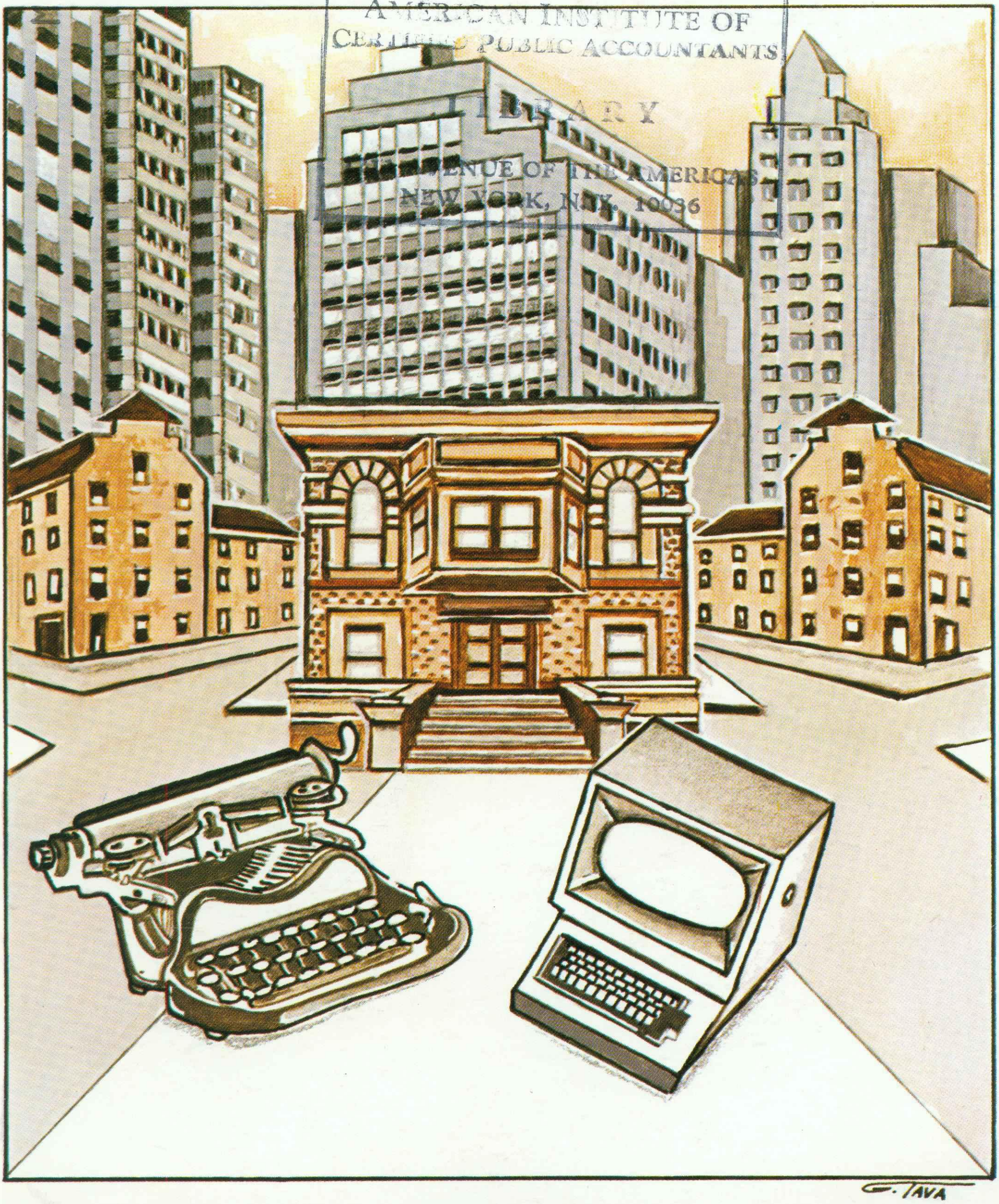
Accelerated Cost Recovery System



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Accelerated Cost Recovery System

Contents

Introduction

The Economic Recovery Tax Act of 1981 represents a radical break with the past. Historically, our laws applicable to business taxation have relied heavily on principles used to determine a clear reflection of income. Through sweeping changes brought about by the 1981 Act, this principle, as it relates to the recovery of capital costs for business assets, is abandoned to achieve the Nation's economic goals of increasing productivity and competitiveness in world markets.

In the past, the clear reflection of income from capital investment has been achieved by allowing an annual deduction for the exhaustion, wear, tear and obsolescence of business assets. The guiding principle was to measure depreciation as an annual expense that varied with the relative durability of the assets. With the enactment of the Economic Recovery Tax Act of 1981, this "useful life" concept is no longer the criteria of measurement used in determining the return on capital investment in depreciable property. The focus has been reoriented from depreciation of the physical property to recovery of the capital expended. The relevant factor has changed from the actual useful life of the asset to the appropriate period for recovery of the capital expended to acquire the asset. Similarly, the question of who possesses the rights and obligations incident to property ownership is no longer the controlling determination in ascertaining who is to derive the tax benefits of the capital recovery. Instead, it is recognized by the new leasing rules that tax advantages available to a user of capital equipment can be passed on to an investor. This will particularly allow non-taxable businesses to share in the benefits of the new capital recovery system, along with their taxable counterparts.

These major changes in the taxation of returns on capital investment in business assets are the cornerstone of the business portion of the Economic Recovery Tax Act of 1981. A capsule comparison of the basic differences between the old depreciation system and the new capital recovery system is presented in the following chart.

A chapter of this book is also devoted to the new incentives for research and experimentation activities conducted in the United States, another important change intended to foster the Nation's economic goals.

Taxation is not a simple subject. The rules for effecting the current changes are quite complex. Even more important are the implications that might not be so apparent. This book tries to specifically point out many of the nuances and indirect effects under the new law and the planning opportunities made available by its enactment, in addition to giving an explanation of the conceptual rules.

Although this book is a comprehensive analysis of the new law, it does not cover all the rules. Therefore, it should be read in conjunction with the appropriate provisions of the statute and the legislative history, as well as the Treasury's regulations as they are published in the future. We hope it is helpful in assisting you to maximize the intended benefits contained in the new law.

Prior Law Depreciation and Accelerated Cost Recovery System
Comparison of Major Features

Item	*Prior Law Depreciation*	*Accelerated Cost Recovery System*
General Applicability	Option of "facts and circumstances" or guidelines (ADR)	Mandatory for "recovery property."
Recovery periods:		
Tangible personal property	Guidelines allow 2½ to 50 years depending on asset type or activity, with optional 20-percent variance.	Three years (autos, light trucks, and machinery and equipment used for research and development); five years (most machinery and equipment, and furniture and fixtures); 10 years (short-lived public utility property); 15 years (long-lived public utility property). Optional longer lives.
Real Estate	Determined by facts and circumstances or by guidelines ranging from 25 to 60 years depending on the type of building.	15 years. Optional longer lives.
Recovery method:		
Tangible personal property	Straight line; or for new property, declining balance up to 200 percent, or sum-of-years' digits, with certain switches.	1981-84: 150-percent DB, with switch to SL. 1985: 175-percent DB, with switch to SYD. 1986 +: 200-percent DB, with switch to SYD. Or straight line.
Real Estate	For new residential, same as personal property; 150-percent declining balance for new non-residential; 125-percent declining balance for used residential; straight line for used non-residential.	175-percent declining balance (low-income housing at 200 percent) with switch to straight line. Or straight line.

Recapture Provisions:		
Tangible personal property	Ordinary income recapture up to prior allowances (section 1245 of the Code).	Ordinary income recapture up to prior allowances (section 1245 of the Code).
Real Estate	Ordinary income recapture up to excess over straight line (section 1250 of the Code).	Residential: ordinary income recapture up to excess over straight line. Non-residential: full recapture if accelerated method used. No recapture if straight line used.
Asset accounting:		
General	Vintage accounting.	Vintage accounting.
First year	Choice of conventions.	Personal property: half-year convention built into tables. Real property: monthly convention built into tables.
Investment tax credit	3⅓ percent for machinery and equipment held for three-five years, 6⅔ percent for five-seven years, 10 percent if longer.	Six percent for three-year class and 10 percent for five-year, 10-year and 15-year public utility property.
Flexibility in use of deductions	Choice of 20 percent shorter or longer lives; facts and circumstances; straight line; net operating loss can be carried over seven years.	Choice of optional longer lives and straight line; extends net operating loss and investment credit carryover period from seven to 15 years; safe-harbor leasing rules may facilitate transfer or sharing of benefits.

Chapter I — Depreciation

by Raymond F. Gehan

Historical Perspective

Until 1962, depreciation deductions were computed by a system known as "facts and circumstances," under which each taxpayer, regardless of its business activity, was required to prove to the Internal Revenue Service the actual useful lives of its fixed assets. Section 1.167(a)-1(b) of the Income Tax Regulations provides that:

> the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to *his experience with similar property* taking into account present conditions and probable future developments [emphasis added].

For those taxpayers who were just starting out in business or who for whatever reason lacked the required experience that would indicate a useful life, section 1.167(a)-1(b) of the Income Tax Regulations continued: "if the taxpayer's experience is inadequate, the *general experience in the industry* may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination [emphasis added]."

In order to provide guidance to taxpayers as to what might be considered reasonably normal periods of useful life in the various industries, the Internal Revenue Service published "Bulletin F—Tables of Useful Lives of Depreciable Property." Last revised in 1942, this booklet contained 67 pages of separate items of property broken down into more than 50 different industries, ranging from "Agriculture" to "Woodworking." Each industry classification contained a list of the pieces of machinery likely to be used in that industry, together with their useful lives. As an extreme example, the Chemical Industry list consisted of 524 different items with lives ranging from two to 50 years.

The first attempt to liberalize, and at the same time simplify, the depreciation deduction occurred in 1962. In that year the Internal Revenue Service published Rev. Proc. 62-21, "Depreciation Guidelines and Rules," which set forth new guideline lives for machinery and equipment. These were on the average 30 to 40 percent shorter than those previously suggested in Bulletin F. The new, shorter guideline lives applied to about 75 broad classes of assets, rather than to the detailed list of items of property found in Bulletin F. In most cases, a single guideline class covered all the production machinery and equipment typically used in the industry.

All depreciable property was divided into the following four classifications:

Group 1 — Assets Used by Business in General

Example	— Furniture and fixtures	10 years
	— Automobiles	3 years
	— Buildings	40-60 years

Group 2 — Nonmanufacturing Activities

Example	— Mining	10 years
	— Retail	10 years

Group 3 — Manufacturing

Example	— Chemicals	11 years
	— Rubber	14 years
	— Food	12 years
	— Metalworking machinery	12 years

Group 4 — Transportation, Communication, Public Utilities

Example	— Electric utilities	20-50 years
	— Gas utilities	14-35 years
	— Airlines	6 years

The procedure provided for a three-year "honeymoon period" from 1962 to 1964, during which a taxpayer could adopt the guideline lives without the possibility of challenge on audit by the Internal Revenue Service. However, starting in 1965, a "reserve ratio test" was applied in order to check whether taxpayers through their replacement policies were actually reducing their actual useful lives down to the guideline life. Failure of the reserve ratio test resulted in an upward adjustment of the guideline life on audit by the IRS.

In 1971, the Treasury Department promulgated section 1.167(a)-11 of the Income Tax Regulations, the Asset Depreciation Range (ADR) System, which was a further step in the liberalization process. ADR was basically a continuation of the Rev. Proc. 62-21 Depreciation Guidelines in that it preserved the concept of only one useful life for all the assets in a single industry class. However, ADR made two very important changes. First, taxpayers were allowed to elect a useful life from a range that was up to 20 percent shorter or longer than the former guideline life. Second, for the first time, the useful life selected by the taxpayer could not be challenged by the Internal Revenue Service on audit.

Now the Accelerated Cost Recovery System (ACRS) is a further step toward liberalization. While preserving the ADR concept that depreciable lives cannot be challenged on audit, ACRS greatly simplifies ADR by providing for a system under which there are now only five classes of property.

In summary, looking at capital recovery in its historical perspective, since 1961 we have evolved from a concept of depreciation under which each item of property was depreciated using a useful life that had to be proven appropriate for the taxpayer to a new system under which there are only five classes of property written off over predetermined periods, generally shorter than the useful life, and not subject to Internal Revenue Service challenge.

General Purpose of ACRS

The purpose of ACRS is to stimulate capital formation, increase productivity, improve the nation's competitiveness in international trade and encourage economic expansion. The prior rules had depressed the real value of the depreciation deduction because of high rates of inflation and diminishing profitability of investment, and discouraged replacement of old or obsolete equipment and structures with more modern assets that reflect recent technology. Additionally, the prior rules were complex and frequently resulted in disagreements between taxpayers and the IRS over useful lives and salvage values. Elections and exceptions provided were often difficult and expensive to apply.

In contrast, ACRS attempts to be simpler and emphasizes capital formation and productivity through the economic advantage of a more rapid recovery of capital costs.

ACRS generally applies to property placed in service after December 31, 1980.

Seven Important Basic Changes Made by ACRS

- The ADR System and "facts-and-circumstances" depreciation are repealed for *recovery* property placed in service after December 31, 1980.
- The ADR repair allowance does not apply to recovery property.
- ACRS is mandatory.

- Write-off periods are substantially reduced, especially for buildings and long-lived public utility property.
- The use of different recovery periods for components of a building is no longer allowed.
- Salvage value is no longer taken into account.
- New and used property is written off using the same schedule.

Eligible and Ineligible Property

Property eligible for ACRS includes all tangible depreciable property, both real and personal. This is a change from the ADR System under which most real property was not eligible. No distinction is made under ACRS between new and used property. Thus, property will be eligible for a specific recovery period regardless of its age or condition. Unlike ADR, ACRS does not provide for an election to exclude used property from the system and depreciate it under facts and circumstances.

The following property is ineligible for ACRS:

- Property depreciated under a method that is not expressed in terms of years, for example, the unit-of-production method, the machine-hour method or the income-forecast method
- Property for which amortization is elected in lieu of depreciation, such as —
  - Section 167(k) of the Code — low-income rehabilitation expenditures, and
  - Section 178 of the Code — leasehold improvements
- Public utility property if all the benefits of ACRS are not normalized, and
- Property used in 1980 and disqualified by the so-called "anti-churning" rules

Electing to use the unit-of-production method of depreciation, for example, should be considered as a possible way of keeping property out of ACRS.

Personal Property

Classifications. ACRS classifies all tangible personal property into four property classes —

- 3-year property
- 5-year property
- 10-year property
- 15-year public utility property

Three-Year Property. The three-year property class includes autos and light trucks, equipment used in research and experimentation, race-horses more than two years old when placed in service and other horses more than 12 years old when placed in service. Also included in the three-year property category are other assets that had (as of January 1, 1981) an ADR midpoint of four years or less. This property would include assets shown on Schedule 1 at the end of this chapter.

Five-Year Property. The five-year class includes all tangible personal property not specifically assigned to any other class. This class would include most machinery and equipment and furniture and fixtures. Additionally, single-purpose agricultural and horticultural structures and facilities used for the storage of petroleum and its primary products (except petrochemicals) are specifically included in the five-year class. All horses not included in the three-year class and non-public utility pollution control equipment related to coal utilization are also included. Also included in the five-year property class is public utility property with an ADR midpoint (as of January 1, 1981) of 18 years or less that is not included in the three-, 10- or 15-year class. Public utility property is defined in section 167(l)(3)(A) of the Code as follows:

(A) The term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of —

(i) electrical energy, water, or sewage disposal services,

(ii) gas or steam through a local distribution system,

(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962, or

(iv) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public utility commission or other similar body of any State or political subdivision thereof.

The former ADR classes shown on Schedule 2 are included in the five-year category.

10-Year Property. The 10-year property class includes railroad tank cars; burners and boilers using coal or lignite that replace or are conversions of those using oil or gas, if used in a public utility power plant; and residential manufactured homes. Also included are public utility property that had (as of January 1, 1981) an ADR midpoint life of more than 18 years and not more than 25 years, and real property that had (as of January 1, 1981) an ADR midpoint life of 12.5 years or less. This property would include former ADR assets shown on Schedule 3.

15-Year Public Utility Property. The 15-year public utility property class includes qualified pollution control equipment related to coal-utilization property and assets that had (as of January 1, 1981) an ADR midpoint of more than 25 years. Such assets are shown in Schedule 4.

Regular Recovery Percentages. Recovery percentages are provided by statute for each year an asset is in service until the asset is fully depreciated. The statutory methods of depreciation for ACRS property classes are scheduled to be phased in between 1981 and 1986. The method to be used for property depends upon the calendar year the property is placed in service, as follows:

Year Placed in Service	*Approximate Depreciation Methods*
1981-84	150% DB, switch to straight line
1985	175% DB, switch to sum-of-years' digits
1986 and later	200% DB, switch to sum-of-years' digits

Schedules 6, 7 and 8 show the tables of recovery rates for tangible personal property placed in service in 1981 through 1984, in 1985, and in 1986 and later years, respectively. All three tables disregard salvage value and incorporate the half-year convention in the year of acquisition.

The applicable percentage is applied to the unadjusted basis of the property. The Treasury has the authority to promulgate regulations for determining the amount of the deduction when basis must be redetermined, as, for example, when there has been a reduction or an increase in basis under section 1017 of the Code.

The depreciation methods required to be used for the years 1981-1984 (approximately 150-percent declining balance with a switch to straight line) are less favorable than the methods formerly allowable under ADR (200-percent declining balance with a switch to sum-of-the-years' digits). The more favorable ADR combination is not used under ACRS until 1986.

The following table compares the depreciation deductions provided by ACRS for the five-year class with depreciation deductions that were formerly allowed for certain ADR classes using the lower limit, the half-year convention and the double-declining balance method with a switch to the sum-of-the-years' digits method:

	ACRS Five-Year Class			*ADR Lower Limit*			
Year	1981-84	1985	1986	5 yrs.	8 yrs.	11 yrs.	14.5 yrs.
1	15%	18%	20%	20.0%	12.5%	9.1%	6.9%
2	22	33	32	32.0	21.9	16.5	12.8
3	21	25	24	21.0	17.4	14.1	11.5
4	21	16	16	15.0	14.7	12.6	10.6
5	21	8	8	9.0	12.1	11.2	9.7
Total	100%	100%	100%	97.0%	78.6%	63.5%	51.5%

The following observations should be made with respect to the above table:

(1) Property with a former ADR lower limit of five years will actually be depreciated on a less accelerated basis during the 1981-84 period of ACRS. Assets in this category include information systems, data-handling equipment, heavy trucks, trailers, and equipment used in drilling of oil and gas wells, construction, cutting of timber, manufacturing of electronic components, and radio and television broadcasting.

(2) Property with a former ADR lower limit of 14.5 years will be allowed almost twice as much depreciation in the first five years under ACRS, even during the phase-in period. Assets in this class would include equipment used in sugar and vegetable oil manufacturing and substitute natural gas-coal gasification.

Optional Periods With Straight-Line Method. In order to provide a certain amount of flexibility, ACRS allows taxpayers to elect the straight-line method of depreciation in conjunction with the regular recovery period or certain optional longer recovery periods:

Class	*Optional Recovery Periods*
3-year property	3, 5 or 12 years
5-year property	5, 12 or 25 years
10-year property	10, 25 or 35 years
15-year public utility property	15, 35 or 45 years

The election to use an optional longer recovery period applies to all property in the class placed in service in the year. A different election may be made with respect to that class in the following year.

If the straight-line method is elected, a half year of depreciation is allowed in the year placed in service, and if the property is held for the entire period, a half year of depreciation is allowed in the last year. However, if the property is retired or disposed of before the end of the period, no depreciation is allowed in the year of disposition.

As under the ADR System, each member of an affiliated group of corporations may make its own election with respect to the property it places in service. However, the Conference Committee Report states that:

if the affiliated group files a consolidated tax return, the availability of separate elections will depend on the applicable consolidated return regulation prescribed by the Treasury. The provisions of this bill do not curtail Treasury authority to prescribe consolidated return rules, including those relating to cost recovery elections.

This statement appears to imply that the Congress is looking to the Treasury for a consolidated-return rule that would deny separate elections to a group that files a consolidated return.

Treatment of Dispositions. Under ACRS, gain or loss will be recognized on each disposition of an asset, including ordinary or normal retirements, unless other provisions of the Code provide for nonrecognition. The unadjusted basis of the retired property is deducted from the cost account, and, presumably, the appropriate reserve is deducted from the reserve account.

This constitutes a significant change from the ADR treatment of retirements. Under ADR, proceeds from ordinary retirements were added to the reserve account and the cost of the retired asset was not deducted from the cost account. No gain or loss was recognized until the reserve account, as a result of the buildup of depreciation deductions and proceeds from ordinary retirements, reached an amount equal to the cost account. Thus, the recordkeeping requirements are substantially increased under ACRS.

However, a special rule is provided to avoid calculation of gain or loss on the disposition of assets from a mass asset account. In the case of mass assets, gain is recognized to the extent of the full amount of the proceeds realized from the disposition of the asset. The unadjusted basis of the property disposed of is left in the account to be fully recovered through depreciation in future years.

The term "mass assets" is defined in the regulations covering recapture of investment tax credit [section 1.47-1(e)(4) of the Income Tax Regulations] as follows:

> the term "mass assets" means a mass or group of individual items of property (i) not necessarily homogeneous, (ii) each of which is minor in value relative to the total value of such mass or group, (iii) numerous in quantity, (iv) usually accounted for only on a total dollar or quantity basis, and (v) with respect to which separate identification is impracticable. The term includes portable air and electric tools, jigs, dies, railroad ties, overhead conductors, hardware, textile spindles, and minor items of office, plant, and store furniture and fixtures; and returnable containers and other items which are considered subsidiary assets for purposes of computing the allowance for depreciation.

Thus, the current definition of mass assets is very limited, and the special rules relating to the disposition of mass assets under ACRS would not seem to be beneficial to most taxpayers, unless the definition of mass assets is expanded by the Treasury.

Recapture. Depreciation recapture on the disposition of personal property under section 1245 of the Code is generally the same under ACRS as under prior law. However, there are some changes:

1. Section 1245 property now includes:
   - Single-purpose agricultural and horticultural structures,
   - Storage facilities for the distribution of petroleum or its primary products,
   - 15-year domestic non-residential real property depreciated under an accelerated method, and
   - Other real property included in the 10-year class (i.e., theme park structures).
2. If there is an election to expense currently under new section 179 of the Code, gain will not be deferred by installment sales treatment.

15-Year Real Property

Regular Recovery Percentages. Under ACRS, 15-year real property includes buildings and section 1250 property that has an ADR midpoint life of more than 12.5 years as of January 1, 1981. Such property is depreciated using a table prescribed by the Treasury over a 15-year recovery period. The table uses the 175-percent declining-balance method, switching to the straight-line method at the appropriate time so as to maximize depreciation. The Treasury table is reproduced as Schedule 9. The Treasury table takes into account the number of months the property is in service during the year of acquisition. The recovery period begins on the first day of the month in which the property is placed in service.

Low-income housing is depreciated using the 200-percent declining-balance method with a switch to straight line.

The 15-year recovery period is a substantial reduction from the guideline lives in Rev. Proc. 62-21, which provided for the following composite lives for various types of buildings:

Description	*Useful Life (Years)*
Apartments	40
Banks	50
Dwellings	45
Factories	45
Garages	45
Grain elevators	60
Hotels	40
Loft buildings	50
Machine shops	45
Office buildings	45
Stores	50
Theaters	40
Warehouses	60

Treasury Department studies show, however, that, in spite of these guideline lives, most taxpayers, by taking advantage of the component method of depreciation, and by relying on facts and circumstances, were using actual composite lives much shorter than the guidelines.

Under prior law, the method of depreciation was limited depending upon the use of the building and its status as new or used property:

Type of Building	*Maximum Method*
New residential rental	200% DB or SYD
New non-residential	150% DB
Used residential rental with a 20-year remaining life	125% DB
Used non-residential and other residential	straight line

Thus the 175-percent declining-balance method allowed under ACRS provides a faster depreciation method for all real property except new residential rental property.

The following table compares the depreciation deduction provided in the first 10 years for real property under ACRS with the depreciation deductions allowable for new non-residential property under prior law, using a composite life of 35 years, and the 150-percent declining-balance method. Both methods use the half-year convention.

Year	***ACRS*** *15 years, 175% DB—SL*		***Prior Law*** *35 years, 150% DB—SL*	
	Annual	*Cumulative*	*Annual*	*Cumulative*
1	6%	6%	2.1%	2.1%
2	11	17	4.2	6.3
3	10	27	4.0	10.3
4	9	36	3.8	14.1
5	8	44	3.7	17.8
6	7	51	3.5	21.3
7	6	57	3.4	24.7
8	5	62	3.2	27.9
9	5	67	3.1	31.0
10	5	72	3.0	34.0

The table indicates that ACRS allows a recovery of 51 percent of cost after the first six years versus only 21.3 percent under the prior methods. After 10 years the recovery under ACRS is 72 percent versus 34 percent.

Optional Lives and Methods. Under ACRS, an election can be made to depreciate 15-year real property under the straight-line method using a 15-, 35- or 45-year period. Depreciation under this election also begins on the first day of the month the property is placed in service. The election may be made on a property-by-property basis, e.g., one building can be depreciated using the accelerated 175-percent declining-balance method and a 15-year period, and another building placed in service the same year may be depreciated using the straight-line method and a 15-, 35- or 45-year period.

Dispositions and Recapture. When residential real property is disposed of, the gain is treated as ordinary income under section 1250 of the Code only to the extent of excess depreciation, i.e., the amount by which accelerated depreciation exceeds depreciation under the straight-line method. The balance of the gain, if any, is capital gain. If the straight-line method was used, there is no excess depreciation and all gain is capital gain. Also, recapture for subsidized low-income housing is phased out at one percent per month after the property has been held for 100 months. This is the same recapture rule as under prior law.

When *non-residential* real property is disposed of, there is no section 1250 recapture if the straight-line method is used. All gain is capital gain. This also is the same rule as under prior law. However, the recapture rules pertaining to *non-residential* property depreciated under an accelerated method have been changed. Under prior law, the gain was treated as ordinary income to the extent that accelerated depreciation exceeded straight-line depreciation. Under ACRS, if non-residential real property in the 15-year class is depreciated under "the prescribed accelerated method," the gain will be ordinary income to the extent of *all* prior depreciation claimed, not just the excess over the straight-line method. The "prescribed accelerated method" is the 175-percent declining-balance method with a switch to the straight-line method at the time that will maximize the deduction. Therefore, even the straight-line portion of the depreciation claimed will be subject to full recapture.

An election to use the accelerated method or the straight-line method should be made on the basis of a cash-flow projection, taking into account the payment of full recapture on disposition of the property if the accelerated method is adopted but no recapture if the straight-line method is used. This cash-flow study should consider:

- The present value of money
- The expected year of disposition
- The expected sales price and gain

Component Depreciation. Under prior law, a taxpayer was allowed to use the component method of depreciation for new or used buildings in lieu of using the composite method with one life for the entire structure. Under the component method, the shell of the building could be assigned a separate life (for example, 40 years) and each of the components, such as electrical, plumbing, heating, roof, etc., could be assigned a shorter life (for example, 15 to 25 years). This procedure accelerated depreciation in the early years.

Under ACRS, the depreciation deduction for any component of a building placed in service after 1980 must be computed in the same manner as for the entire building. Thus, the recovery period and the method of depreciation must be the same for the building and all its components. However, there is an exception for certain components the taxpayer elects to amortize, for example, low-income rehabilitation expenditures.

Depreciation of a new component begins on the first day of the month in which the component is placed in service, or the first day of the month the building is placed in service, whichever is later.

Under ACRS, it may still be advantageous to separate the cost of buildings into the various components and to depreciate them separately. This would apparently allow the recognition of loss if a component is retired before the expiration of its recovery period.

If a component is added after 1980 to a pre-1981 building, an election can be made with respect to the method and the period to be used to recover the cost of such first component. However, that election is binding on all subsequent components added to the same building in later years. If no election is made, the first component and all subsequent components will presumably be written off over the general 15-year period under the Treasury table. Therefore, careful planning is required when the election is made for the first post-1980 component.

An exception to this rule provides that a substantial improvement will be treated as a separate building and, therefore, eligible for a separate election. A substantial improvement is:

- The addition to the capital account of at least 25 percent of the adjusted basis of the building (disregarding adjustments for depreciation and amortization) over a two-year period, and
- An improvement made at least three years after the building was placed in service.

Under a special recapture rule, if the taxpayer uses an accelerated method for a non-residential building and straight-line for a substantial improvement (or vice versa), or uses an accelerated method for a post-1980 component on a pre-1981 building, *all* the gain on a subsequent disposition of the entire building is first treated as ordinary income to the extent of *all* ACRS accelerated depreciation and excess depreciation attributable to the pre-1981 building, and the balance of the gain, if any, is treated as capital gain.

Earnings and Profits Computation. Whether a payment is a taxable dividend or a nontaxable return of capital depends on the paying corporation's earnings and profits (E&P). Under prior law, E&P was computed using the straight-line method of depreciation and the useful life used to compute the depreciation deduction. If the ADR lower limit was used to compute depreciation, that same useful life would be used to compute E&P.

If corporations were allowed to use the substantially shorter recovery periods provided by ACRS for the computation of E&P, E&P would be substantially reduced, thus increasing the possibility of tax-free dividends. To limit this, special E&P rules are provided.

Under ACRS, taxpayers are required to use the following recovery periods and the straight-line method for purposes of computing E&P:

Class	*E&P Recovery Period*
3-year property	5 years
5-year property	12 years
10-year property	25 years
15-year public utility property	35 years
15-year real property	35 years
Election to expense	5 years

When these E&P recovery periods are compared with the ADR lower limits formerly allowed for E&P purposes, it appears that in many cases the new E&P recovery periods are longer. For example, property now in the five-year class formerly had, for the most part, an ADR lower limit of between five and nine years. Property now in the 10-year class formerly had, for the most part, an ADR lower limit between 10 and 17.5 years. This will mean that corporations can generally expect to produce larger amounts of E&P than under prior law.

If an optional longer life is elected for any class in computing the depreciation deduction, the same period must also be used to determine E&P.

Property Held Outside the United States. Under ACRS, foreign personal property, whether new or used, is depreciated using the ADR midpoint life in effect on January 1, 1981. If there was no ADR midpoint life in effect on January 1, 1981, a 12-year life is used. The applicable recovery percentages will be determined from tables prescribed by the Treasury and will be based on the 200-percent declining-balance method with a switch to straight line, the half-year convention and no salvage value. Depreciation under facts and circumstances is *not* allowed.

An election may be made to use the straight-line method over the following optional recovery periods:

3-year property	ADR midpoint, 5 or 12 years
5-year property	ADR midpoint, 12 or 25 years
10-year property	ADR midpoint, 25 or 35 years
15-year public utility property	ADR midpoint, 35 or 45 years

The period elected may not be shorter than the ADR midpoint. The election must be made for all property with the same ADR midpoint, in the same ACRS class, and placed in service in the same taxable year. This provides somewhat greater flexibility than that allowed for domestic property since, for example, there are within the five-year property category more than 10 different ADR midpoints.

Foreign real property, whether new or used, is depreciated over a 35-year life, using the 150-percent declining-balance method with a switch to straight line, the monthly convention and no salvage value. Depreciation under facts and circumstances is *not* allowed.

An election can be made, on a property-by-property basis, to elect the straight-line method and recovery periods of 35 or 45 years.

Whether an asset is used predominantly outside the United States will be determined under regulations similar to the rules now in effect in section 48(a)(2) of the Code with respect to the investment credit, taking into account all the exceptions listed in section 48(a)(2)(B) of the Code. See Chapter V for a more detailed analysis of the international implications of ACRS.

Normalization Required by Public Utilities. Under prior law, the benefits of using the short ADR lives and accelerated depreciation for tax purposes had to be normalized in most cases. The maximum amount required to be normalized with respect to useful life was the benefit due to the difference between using the ADR midpoint life and the ADR lower limit. The difference between the ADR midpoint and the longer life used for ratemaking purposes could be immediately flowed through to customers.

Under ACRS, *all* the benefits of the new system must be normalized. Such benefits include:

- The total difference between using the ACRS period (10 or 15 years) and the life used for ratemaking purposes (perhaps 30 to 40 years)
- The difference between the accelerated method of depreciation and the straight-line method
- Any difference in computation of salvage value, and
- Any difference in the averaging convention

If all the benefits of ACRS are not normalized, the computation of the depreciation deduction to be used on the tax return must use the same useful life, method, salvage value and averaging convention that is used in the computation of depreciation for ratemaking purposes.

Under prior law, normalization was not required for property placed in service after 1969 that was of the same type as property for which the taxpayer used the flow-through method in 1969. That rule is repealed for property under ACRS. Flow-through is not permitted for such ACRS property, even though it is the same type as 1969 flow-through property.

The new law provides for transitional rules relating to the normalization requirement. If, by the terms of an applicable rate order issued by a regulatory commission before August 13, 1981, a regulated public utility would fail to meet the normalization requirements because, for an accounting period ending after December 31, 1980, the public utility used a method of accounting other than normalization, the public utility will not fail to meet the normalization requirements if by the terms of its first rate order that becomes effective after August 13, 1981 and on or before January 1, 1983, the utility used a normalization method of accounting. This provision does not apply to any rate order that, under prior law, required the utility to use a method of accounting for depreciation that it was not permitted to use under section 167(l) of the Code.

A similar provision applies to the possible failure of the utility to meet the normalization requirements relating to the investment tax credit under section 46(f)(1) or (2) of the Code.

Until Congress acts further, the Treasury may prescribe interim regulations as may be necessary to determine whether the normalization requirements have been met with respect to property placed in service after December 31, 1980.

Railroad Track: Retirement-Replacement-Betterment Method. Under prior law, the railroad industry used what was called the retirement-replacement-betterment (RRB) method of depreciation for rail, ties and other items in the track accounts, such as ballast, fasteners, other material and labor costs. This method was used in lieu of the depreciation methods based on useful life.

Assets were accounted for under the RRB method as follows: when additional new railroad track was laid, the cost of both materials and labor of the line was capitalized. No depreciation was claimed for this capitalized amount, but a deduction for those original costs could be claimed if the line was subsequently retired or abandoned. If the original installation was replaced with new rails, ties and other items of a like kind or quality, the cost of the "replacements," both material and labor, was deducted as a current expense. If the replacement was of improved quality, the costs attributable to the improved portion of the replacement was a "betterment" which was capitalized, and the remainder of the replacement cost was deducted as a current expense.

Upon the retirement or replacement of rail and other track assets, the salvage value (measured by current fair market value) of the recovered materials was treated as ordinary income.

Under sections 48(a)(1)(B)(i) and 48(a)(9) of the Code, the regular investment tax credit was allowed for the cost of railroad track material. The credit was also allowed for costs that were capitalized as additions and betterments, as well as costs that were expensed (i.e., replacements).

Under ACRS, section 167(r) of the Code, which permits the use of the RRB method of depreciation, is repealed as of January 1, 1981. Property placed in service after 1980 that would have been RRB property under prior law will be treated as five-year property. Costs of property that would have been capitalized under RRB as additions and betterments are treated the same as other five-year property.

Replacement property that would have been expensed under RRB is phased in to ACRS over five years. Replacement property placed in service in 1981 will be expensed. Replacement property placed in service in 1982 will have a two-year life; 1983, a three-year life; and 1984, a four-year life. The depreciation method is the 200-percent declining-balance method with a switch to the sum-of-the-years' digits method.

Replacement property placed in service in 1985, 1986 and later years will be treated the same as other five-year property. Thus for 1985, the method is the 175-percent declining-balance method, switching to the sum-of-the-years' digits. For 1986 and later, the method is the 200-percent declining balance with a switch to the sum-of-the-years' digits.

The recovery percentages for such property during the transition period are as follows:

Year	*1981*	*1982*	*1983*	*1984*	*1985*	*1986 & Later*
1	100%	50%	33%	25%	18%	20%
2		50	45	38	33	32
3			22	25	25	24
4				12	16	16
5					8	8
	100%	100%	100%	100%	100%	100%

The adjusted basis of RRB property that is in existence as of December 31, 1980 (the costs that were previously capitalized under the RRB method) may be recovered over a five-year period using the following schedule of deductions which is based on the 200-percent declining-balance method with a switch to the sum-of-the-years' digits method:

Years	*Percent of Basis Deductible*
1981	40%
1982	24
1983	18
1984	12
1985	6
	100%

Alternatively, the taxpayer may elect to recover the unrecovered capitalized costs over a longer period of up to 50 years, using a less accelerated or straight-line schedule of deductions.

All capitalized costs placed in service after 1980 will be allowed the investment tax credit. However, during the transition year 1981, expenditures that would be capitalized if incurred in a later year are considered to have been capitalized, even though they are expensed under the transition recovery rule for 1981.

Election to Expense. Under prior law, section 179 of the Code provided for a bonus first-year depreciation deduction in the amount of 20 percent of the cost of eligible property. Eligible property was tangible personal property with a useful life of six years or more. The cost of such property that could be taken into account could not exceed $10,000 ($20,000 for individuals who filed a joint return). A controlled group of corporations was treated as one taxpayer and therefore was entitled to only $10,000, which had to be apportioned among the members of the group. A partnership also was limited to $10,000 per year. Thus, the maximum additional first-year depreciation was limited to $2,000 ($4,000 in the case of a joint return).

ACRS provides for a new section 179 under which a taxpayer (other than a trust or estate) may elect to treat the cost of qualifying property as an expense and not capital. The costs for which the election is made will be allowed as a deduction for the taxable year in which the qualifying property is placed in service.

The optional expensing provision applies to qualified property placed in service in taxable years *after* 1981. The dollar limitation on the amount that can be expensed is as follows:

Taxable years beginning in	*Dollar Limitation*
1982	$ 5,000
1983	5,000
1984	7,500
1985	7,500
1986 and later	$10,000

In general, the property for which an election may be made is either new or used personal property, eligible to be treated as recovery property, eligible for the investment tax credit, acquired by purchase for use in a trade or business (but not for the production of income).

The requirement that the property be acquired by purchase is the same as the requirement in prior section 179 for property eligible for the additional first-year depreciation. Acquisitions do not qualify if:

- The property is acquired from a person whose relationship to the taxpayer would result in a disallowance of loss on a transaction between the taxpayers.
- The property is acquired by one component member of a controlled group from another component member of the same group, using a more than 50-percent control test.
- The basis of the property in the hands of the person acquiring it is determined in whole or in part:
    - by reference to the adjusted basis of the property in the hands of the person from whom it was acquired, or
    - under the step-up basis rules for property acquired from a decedent.

Prior section 179 is repealed for property placed in service after December 31, 1980. Thus, neither additional first-year depreciation nor the election to expense is allowed in 1981.

A controlled group of corporations is subject to limitations similar to those in prior section 179. Thus, a controlled group of corporations (with a more than 50-percent control test) is treated as one taxpayer and must apportion the annual dollar limitation among the members of the group. Similarly, the same type of dollar limitations will apply in the case of partnerships. As under prior section 179, both the partnership and each partner are subject to the annual dollar limitation.

As under prior law, the cost of property eligible for the new expensing provision does not include the portion of the basis of such property that is determined by reference to the basis of property traded in.

An election to expense property for any taxable year must specify the items of property to which the election applies and the portion of the cost of each of these items to be deducted currently. The election must be made on an original return, including a late-filed original return. In order to provide a degree of certainty, an election to expense property and any specification of items or amounts contained in such an election may not be revoked except with the consent of the Treasury.

If any portion of the basis of an item of property is expensed, the amount expensed is treated as depreciation taken for purposes of the recapture rules of section 1245 of the Code. Thus, gain recognized on disposition of that property is treated as ordinary income to the extent of the amounts expensed and depreciation taken.

In the case of a disposition that is given installment sale treatment under section 453 of the Code, any amounts expensed with respect to the property are immediately recaptured as ordinary income to the extent of the gain realized on the disposition. An amount equal to the amount immediately recaptured under this rule is treated as an addition to the adjusted basis of the property for purposes of determining the gross profit percentage from the installment sale.

Importantly, to the extent that the cost of property is expensed pursuant to this provision, no investment tax credit is allowable.

The following table compares the present value of electing to expense $10,000 currently (with no investment tax credit) with the present value of capitalizing $10,000 with the investment tax credit. It is assumed that tax benefits are realized in the middle of the year.

Present Value of Capital Versus Expense in 1986 and Later Years

			Capitalize plus ITC			
Tax Rate	*Present-Value Rate*	*Currently Expense*	*3-Year Property*	*5-Year Property*	*10-Year Property*	*15-Year Public Utility Property*
%	%		6% ITC	10% ITC	10% ITC	10% ITC
46	10	4,381	4,598	4,725	4,209	3,816
46	12	4,340	4,492	4,580	4,005	3,585
46	15	4,279	4,341	4,376	3,736	3,291
40	10	3,810	4,074	4,232	3,784	3,443
40	12	3,774	3,979	4,106	3,603	3,242
40	15	3,721	3,848	3,926	3,369	2,983
25	10	2,381	2,760	3,002	2,722	2,508
25	12	2,359	2,700	2,919	2,609	2,377
25	15	2,326	2,613	2,802	2,457	2,213

The table illustrates very clearly that, for tax rates between 25 percent and 46 percent and for after-tax present-value rates between 10 percent and 15 percent, it is more beneficial to capitalize and take the investment tax credit on three-year and five-year property. In the case of 10-year property and 15-year public utility property, it may be preferable to expense when both the tax rate and the present-value rate are high. Thus, it appears that the election to expense may provide no benefit to most taxpayers.

Capital Versus Repair. The above comparison of capitalizing new additions versus electing to expense them has broad application where the decision must be made to capitalize an item or to currently deduct it. Under ACRS, it may now be more beneficial to treat items that fall into the gray area between capital and expense as a capital expenditure instead of a deductible repair. Furthermore, the effect of ACRS must be analyzed when a taxpayer considers whether to capitalize taxes and other carrying charges under section 266 of the Code as opposed to currently deducting them. The additional benefit obtained under ACRS, however, must be weighed against the extra recordkeeping costs necessary to reflect differences between financial and tax statements.

Anti-Churning Rules. ACRS provides special rules to prevent a taxpayer from bringing property that it or a related party used during 1980 under ACRS by certain transactions entered into after 1980. Similar rules are provided to prevent a taxpayer from taking advantage of the increased recovery percentages available after 1984 for property used by the taxpayer or a related party before that time.

ACRS will not apply to *personal property* in use during 1980, unless the property is transferred after 1980 in a transaction in which both the owner and user (if different) change. This rule may not be avoided by selling the property more than once after December 31, 1980, unless the user of the property also changes in the same transaction. The requirement that the user must change is designed to prevent lessors of equipment from swapping properties to obtain the benefits of ACRS.

ACRS also does not apply to personal property leased back to a person that owned or used the property during 1980, or to a person related to that person.

ACRS will not apply to *real property* if:

- A taxpayer or a person related to the taxpayer owned the property during 1980.
- The property is leased back to a person that owned the property at any time during 1980 or to a person related to that person.

- The property is acquired in certain like-kind exchanges, "rollovers" of low-income housing, involuntary conversions, or repossessions, for property the taxpayer or a related person owned during 1980. This rule applies only to the extent of the substituted basis of the property received. Thus, ACRS will apply to the extent the taxpayer pays "boot." The taxpayer may not avoid this rule by transferring the property in another like-kind exchange, rollover, involuntary conversion or repossession.

Unlike the personal property anti-churning rules, the user need not change for ACRS to apply to real property. Further, property owned by the taxpayer but under construction during 1980 and placed in service after December 31, 1980 is not subject to the anti-churning rules.

In determining whether the owner or user of the property has changed under these rules, a person will be considered related to the prior owner or user if the person is related within the meaning of section 267(b) or section 707(b)(1) of the Code, substituting 10-percent for the 50-percent ownership test, or section 52(a) or (b) of the Code. A corporation is not considered a related person if:

- The person is a distributing corporation in a transaction described in section 334(b)(2) of the Code and 80 percent of the stock is acquired by purchase after December 31, 1980 by the taxpayer or a person related to the taxpayer, or
- The person is a distributing corporation in a liquidation to which section 331(a) of the Code applies and 80 percent of the stock of that corporation is acquired by purchase by one or more taxpayers or by persons related to the taxpayer after December 31, 1980.

For pre-1981 property acquired in a churning transaction, present law governs depreciation of the asset. Presumably, this means ADR or facts-and-circumstances depreciation.

For real or personal property used during 1980 and transferred to a corporation or partnership in which the basis is determined by reference to its basis to the transferor, ACRS will not apply. Such transfers include the following transactions:

Section 332 — Complete Liquidation of Subsidiaries

Section 351 — Transfer to Corporation Controlled by Transferor

Section 361 — Nonrecognition of Gain or Loss to Corporations

Section 371 — Reorganization in Certain Receivership and Bankruptcy Proceedings

Section 374 — Gain or Loss Not Recognized in Certain Railroad Reorganizations

Section 721 — Nonrecognition of Gain or Loss on Contribution to a Partnership

Section 731 — Extent of Recognition of Gain or Loss on Distribution by a Partnership

In these cases, the Treasury will provide rules similar to those that apply under section 381(c)(6) of the Code. Thus, the transferee, in general, must use the same life and method used by the transferor.

This rule will continue to apply to successive transfers of such property to the extent the basis to the transferee includes an amount representing the basis of property used during 1980. Additions to such basis after 1980, however, such as by the payment of boot, will not be subject to the anti-churning rules.

Broad authority is granted to the Treasury to prescribe regulations to make ACRS unavailable for property that is transferred in a transaction the principal purpose of which is to make the property eligible for the more generous ACRS rules.

Similar anti-churning rules are provided to prevent property placed in service before 1985 or 1986 from getting the benefit of the more accelerated methods of depreciation available after 1984. For this churned property, the transferee must use the same recovery period and method of depreciation as the transferor.

Short Taxable Years. In the case of a taxable year that is less than 12 months, the amount of the depreciation deduction is the amount that bears the same relationship to the amount of the annual deduction as the number of months in the short taxable year bears to 12. In such a case, the amount of the deduction for subsequent taxable years will be adjusted in accordance with regulations prescribed by the Treasury.

The determination of when a taxable year begins will also be made in accordance with regulations. Presumably, the regulations will be similar to those in regulation 1.167(a)—11(c)(2)(iv)(c) of the Income Tax Regulations which provides that

> the taxable year of the person placing such property in service does not include any month before the month in which the person begins engaging in a trade or business or holding depreciable property for the production of income.

These rules do not apply to property for the first taxable year of the lessor who has made an election under the special safe-harbor rules for leases.

Leasehold Improvements. For purposes of determining whether a leasehold improvement that is recovery property should be amortized over the term of the lease, the recovery period (or optional recovery period if elected) is to be used in lieu of its actual useful life. Thus, if the recovery period (or elected longer period) is less than the term of the lease, the leasehold improvements will be depreciated over the recovery period. If the recovery period (or elected longer period) is longer than the term of the lease, the leasehold improvement will be amortized over the term of the lease.

Schedule 1

Three-Year Property

Former ADR Lower Limit	*ADR Asset Guideline Class*	*Description of Assets*
2.5	00.22	automobiles, taxis
3	00.241	light general purpose trucks
3	00.26	tractor units for use over the road
2.5	01.23	hogs, breeding
3	20.5	manufacture of food and beverages—special handling devices
3	30.11	manufacture of rubber products—special tools and devices
3	30.21	manufacture of finished plastic products—special tools
2	32.11	manufacture of glass products—special tools
2.5	34.01	manufacture of fabricated metal products—special tools
2.5	37.12	manufacture of motor vehicles—special tools

Note: Recovery property used in connection with research and experimentation is three-year recovery property even if its former ADR lower limit is greater than four years.

Schedule 2

Five-Year Property

Former ADR Lower Limit	*ADR Guideline Class*	*Description of Assets*
8	00.11	office furniture, fixtures, and equipment
5	00.12	information systems
5	00.13	data-handling equipment
5	00.21	airplanes and helicopters
7	00.23	buses
5	00.242	heavy general-purpose trucks
12	00.25	railroad cars and locomotives
5	00.27	trailers and trailer-mounted containers
14.5	00.28	vessels, barges, tugs
20[1]	00.3	land improvements (section 1245 property)
17.5	00.4	industrial steam and electric generation and/or distribution systems (section 1245 property)
8	01.1	agriculture
9.5	01.11	cotton-ginning assets
5.5	01.21	cattle, breeding or dairy
4	01.24	sheep and goats, breeding
8	10.0	mining
6	13.0	offshore drilling
5	13.1	drilling of oil and gas wells
11	13.2	exploration for and production of petroleum and natural gas deposits
13	13.3	petroleum refining
5	15.0	construction and marine construction
13.5	20.1	manufacture of grain and grain mill products
14.5	20.2	manufacture of sugar and sugar products
14.5	20.3	manufacture of vegetable oils and vegetable oil products

[1] Asset guideline period is 20 years; no lower limit. Section 1250 property is classified as 10-year property.

Schedule 2 (cont.)

Five-Year Property

Former ADR Lower Limit	*ADR Guideline Class*	*Description of Assets*
9.5	20.4	manufacture of other food and kindred products
12	21.0	manufacture of tobacco and tobacco products
6	22.1	manufacture of knitted goods
9	22.2	manufacture of yarn, thread and woven fabric
7	22.3	manufacture of carpets, and dyeing, finishing and packaging of textile products; manufacture of medical and dental supplies
6.5	22.4	manufacture of textured yarns
8	22.5	manufacture of nonwoven fabrics
7	23.0	manufacture of apparel and other finished products
5	24.1	cutting of timber
8	24.2	sawing of dimensional stock from logs (permanent sawmills)
5	24.3	sawing of dimensional stock from logs (temporary sawmills)
8	24.4	manufacture of wood products and furniture
10.5	26.1	manufacture of pulp and paper
8	26.2	manufacture of converted paper, paperboard and pulp products
9	27.0	printing, publishing and allied industries
7.5	28.0	manufacture of chemicals and allied products
11	30.1	manufacture of rubber products
9	30.2	manufacture of finished plastic products
9	31.0	manufacture of leather and leather products

Schedule 2 (cont.)

Five-Year Property

Former ADR Lower Limit	*ADR Guideline Class*	*Description of Assets*
11	32.1	manufacture of glass products
16	32.2	manufacture of cement
12	32.3	manufacture of other stone and clay products
11	33.2	manufacture of primary nonferrous metals
5	33.21	manufacture of primary nonferrous metals—special tools
11	33.3	manufacture of foundry products
12	33.4	manufacture of primary steel mill products
9.5	34.0	manufacture of fabricated metal products
8	35.0	manufacture of electrical and nonelectrical machinery and other mechanical products
5	36.0	manufacture of electronic components, products and systems
9.5	37.11	manufacture of motor vehicles
8	37.2	manufacture of aerospace products
9.5	37.31	ship and boat building machinery and equipment
13	37.32	ship and boat building dry docks and land improvements
5	37.33	ship and boat building—special tools
9	37.41	manufacture of locomotives
9.5	37.42	manufacture of railroad cars
9.5	39.0	manufacture of athletic, jewelry and other goods
11	40.1	railroad machinery and equipment
40	40.51	railroad hydraulic electric generating equipment
16	40.52	railroad nuclear electric generating equipment

Schedule 2 (Cont.)

Five-Year Property

Former ADR Lower Limit	*ADR Guideline Class*	*Description of Assets*
22.5	40.53	railroad steam electric generating equipment
22.5	40.54	railroad steam, compressed air, and other power plant equipment
6.5	41.0	motor transport—passengers
6.5	42.0	motor transport—freight
16	44.0	water transportation
9.5	45.0	air transport
17.5	46.0	pipeline transportation (other than public utility)
14.5[2]	48.12	telephone central office equipment
8	48.13	telephone station equipment
5	48.2	radio and television broadcasting
10.5	48.32	TOCSC—high frequency radio and microwave systems
13	48.34	TOCSC—central office control equipment
8.5	48.35	TOCSC—computerized switching, channeling and associated control equipment
8	48.36	TOCSC—satellite ground segment property
6.5	48.37	TOCSC—satellite space segment property
8	48.38	TOCSC—equipment installed on customers' premises
11	48.39	TOCSC—support and service equipment
9	48.41	CATV—headends
8	48.42	CATV—subscriber connection and distribution systems
7	48.43	CATV—program origination
7	48.44	CATV—service and test

[2]Proposed ADR lower limit.

Schedule 2 (cont.)

Five-Year Property

Former ADR Lower Limit	*ADR Guideline Class*	*Description of Assets*
7.5	48.45	CATV—microwave systems
4	49.121	electric utility nuclear fuel assemblies
11	49.222	gas utility substitute natural gas production plant
14.5	49.223	substitute natural gas—coal gasification
11	49.23	natural gas production plant
8	49.5	waste reduction and resource recovery plants
7	57.0	distributive trades and services
16	57.1	distributive trades and services—billboard, service station buildings and petroleum marketing land improvements (section 1245 property)
8	79.0	recreation

Schedule 3

10-Year Property

Former ADR Lower Limit	*ADR Guideline Class*	*Description of Assets*
17.5	46.0	pipeline transportation (gas or steam)
15	48.31	TOCSC – electric power generating and distribution systems
16	49.12	electric utility nuclear production plant
16	49.15	electric utility combustion turbine production plant
17.5	49.24	gas utility trunk pipelines and related storage facilities
17.5	49.25	liquified natural gas plant
10	80.0	theme and amusement parks

Schedule 4

15-Year Public Utility Property

Former ADR Lower Limit	*ADR Guideline Class*	*Description of Assets*
36	48.11	telephone central office buildings
28	48.14	telephone distribution plant
21	48.33	TOCSC — cable and long-line systems
40	49.11	electric utility hydraulic production plant
22.5	49.13	electric utility steam production plant
24	49.14	electric utility transmission and distribution plant
28	49.21	gas utility distribution facilities
24	49.221	gas utility manufactured gas production plants
40	49.3	water utilities
22.5	49.4	central steam utility production and distribution

Schedule 5

15-Year Real Property

Former ADR Lower Limit	*ADR Guideline Class*	*Description of Assets*
20[3]	00.3	land improvements (section 1250 property)
17.5	00.4	industrial steam and electric generation and/or distribution systems (section 1250 property)
20	01.3	farm buildings
24	40.2	railroad structures and similar improvements
16	40.3	railroad wharves and docks
16	57.1	distributive trades and services—billboard, service station buildings and petroleum marketing land improvements (section 1250 property)

[3] Asset guideline period is 20 years; no lower limit. Section 1245 property is classified as five-year property.

Schedule 6

Property Placed in Service in 1981-84

	Applicable Percentage			
Recovery Year	*3-Year Property*	*5-Year Property*	*10-Year Property*	*15-Year Public Utility Property*
1	25%	15%	8%	5%
2	38	22	14	10
3	37	21	12	9
4		21	10	8
5		21	10	7
6			10	7
7			9	6
8			9	6
9			9	6
10			9	6
11				6
12				6
13				6
14				6
15				6
	100%	100%	100%	100%

Schedule 7

Property Placed in Service in 1985

Recovery Year	3-Year Property	5-Year Property	10-Year Property	15-Year Public Utility Property
		Applicable Percentage		
1	29%	18%	9%	6%
2	47	33	19	12
3	24	25	16	12
4		16	14	11
5		8	12	10
6			10	9
7			8	8
8			6	7
9			4	6
10			2	5
11				4
12				4
13				3
14				2
15				1
	100%	100%	100%	100%

Schedule 8

Property Placed in Service in 1986 and Later Years

Applicable Percentage

Recovery Year	*3-Year Property*	*5-Year Property*	*10-Year Property*	*15-Year Public Utility Property*
1	33%	20%	10%	7%
2	45	32	18	12
3	22	24	16	12
4		16	14	11
5		8	12	10
6			10	9
7			8	8
8			6	7
9			4	6
10			2	5
11				4
12				3
13				3
14				2
15				1
	100%	100%	100%	100%

Schedule 9

ACRS Cost Recovery Tables for Real Estate

1. All Real Estate (Except Low-Income Housing)

The applicable percentage is:

If the Recovery Year Is:	*Month Placed in Service*											
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*
1	12	11	10	9	8	7	6	5	4	3	2	1
2	10	10	11	11	11	11	11	11	11	11	11	12
3	9	9	9	9	10	10	10	10	10	10	10	10
4	8	8	8	8	8	8	9	9	9	9	9	9
5	7	7	7	7	7	7	8	8	8	8	8	8
6	6	6	6	6	7	7	7	7	7	7	7	7
7	6	6	6	6	6	6	6	6	6	6	6	6
8	6	6	6	6	6	6	5	6	6	6	6	6
9	6	6	6	6	5	6	5	5	5	6	6	6
10	5	6	5	6	5	5	5	5	5	5	6	5
11	5	5	5	5	5	5	5	5	5	5	5	5
12	5	5	5	5	5	5	5	5	5	5	5	5
13	5	5	5	5	5	5	5	5	5	5	5	5
14	5	5	5	5	5	5	5	5	5	5	5	5
15	5	5	5	5	5	5	5	5	5	5	5	5
16			1	1	2	2	3	3	4	4	4	5

(*Note*-This table does not apply for short taxable years of less than 12 months.)

2. Low-Income Housing

The applicable percentage is:

If the Recovery Year Is:	*Month Placed in Service*											
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*
1	13	12	11	10	9	8	7	6	4	3	2	1
2	12	12	12	12	12	12	12	13	13	13	13	13
3	10	10	10	10	11	11	11	11	11	11	11	11
4	9	9	9	9	9	9	9	9	10	10	10	10
5	8	8	8	8	8	8	8	8	8	8	8	9
6	7	7	7	7	7	7	7	7	7	7	7	7
7	6	6	6	6	6	6	6	6	6	6	6	6
8	5	5	5	5	5	5	5	5	5	5	6	6
9	5	5	5	5	5	5	5	5	5	5	5	5
10	5	5	5	5	5	5	5	5	5	5	5	5
11	4	5	5	5	5	5	5	5	5	5	5	5
12	4	4	4	5	4	5	5	5	5	5	5	5
13	4	4	4	4	4	4	5	4	5	5	5	5
14	4	4	4	4	4	4	4	4	4	5	4	4
15	4	4	4	4	4	4	4	4	4	4	4	4
16			1	1	2	2	2	3	3	3	4	4

(*Note*-This table does not apply for short taxable years of less than 12 months.)

Chapter II—Investment Tax Credit

by Raymond F. Gehan

New Items Eligible

Under prior law, the investment tax credit applied to storage facilities used in connection with production activities, such as refining, but not in connection with wholesale or distribution facilities. The Accelerated Cost Recovery System (ACRS) extends the investment credit to all facilities used for storage of petroleum or its primary products, even if used in connection with wholesale or distribution activities. Petrochemical storage facilities do not qualify for the credit. Under regulations prescribed by the Treasury, petroleum or its primary products is to have a meaning similar to that given primary products of oil or gas under regulation 1.993-3(g)(3)(i) of the Income Tax Regulations.

ACRS also adds to eligible property railroad rolling stock leased by a U.S. person and used within and without the United States. However, leased railroad property is not eligible if it is leased for more than 12 months in any 24-month period to a foreign person.

Amount of Investment Tax Credit

Under prior law, an investment tax credit of 10 percent was allowed for eligible assets with useful lives of seven years or more. For assets with useful lives of at least five and less than seven years, only two-thirds of the cost was eligible for the investment credit. For assets with useful lives of at least three and less than five years, only one-third of the cost was eligible for the credit. No credit was allowed for assets with useful lives of less than three years.

Under ACRS, the investment tax credit is based on the recovery period classification of the property, as defined in section 168(c) of the Code, as follows:

Recovery Property Class	*Investment Tax Credit*
3-year property	6%
5-year property	10%
10-year property	10%
15-year property	10%

Since section 168(c) of the Code defines the four categories of recovery property without any reference to longer optional periods, an election of a longer optional recovery period (i.e., five or 12 years) for three-year property cannot be used to increase the investment tax credit to 10 percent.

The new law extends the carryover period for investment tax credit from seven to 15 years for unused credit years beginning in 1974.

Recapture of Investment Tax Credit

Under prior law, the investment tax credit was recomputed on an early disposition of property as if the actual useful life had been used to determine the amount of the credit. The difference between the credit previously allowed and the recomputed credit resulted in an increase in tax for the year of recapture. Thus, if property with an estimated seven-year life was disposed of after only five years, the recapture would be 3⅓ percent, i.e., 10 percent (the amount originally claimed) less 6⅔ percent (the amount actually earned). These recapture rules will still apply to property placed in service before 1981.

Under ACRS, for property placed in service after 1980, the investment tax credit is recomputed on early dispositions by allowing a two-percent credit for each year the property is held before disposition. Thus, no recapture is required if five-, 10- or 15-year property is actually held for at least five years, or three-year property is held for at least three years. If three-year property is held only one year, the credit allowed would be two percent (one year at two percent), and the recapture would be four percent. If five-, 10- or 15-year property is held only three years, the allowable credit would be six percent (three years at two percent), and the recapture would be four percent.

The following table indicates how rapidly the credit is earned under the new law as opposed to the prior law:

Years Property Held	*Cumulative % of ITC Earned*	
	Prior Law	*New Law*
1	0	2
2	0	4
3	3⅓	6
4	3⅓	8
5	6⅔	10
6	6⅔	10
7	10	10

Revised Used-Property Limitation

Under prior law, only $100,000 of used property per taxable year qualified for the investment tax credit. ACRS raises that limit in the following steps:

Taxable Year Beginning in	*Used Property Limitation*
1981-84	$125,000
1985	150,000

Qualified Rehabilitation Expenditures

Under prior law, the investment tax credit applied to qualified rehabilitation expenditures for non-residential buildings that were at least 20 years old. A rehabilitation qualified only if a major portion of the building was rehabilitated. At least 20 years must have elapsed since a prior qualifying rehabilitation. At least 75 percent of the existing external walls of the building must have been retained in place as external walls after the rehabilitation. The rehabilitation expenditures must have been made for property with a useful life of five years or more. Accelerated depreciation and the energy tax credit were allowed if the property otherwise qualified.

Property qualifying for the rehabilitation credit included the removal and replacement of structural components such as electrical, plumbing, heating, air conditioning and permanent interior partitions.

The 10-percent investment tax credit, the additional energy credit and the 60-month amortization provision for certified historic rehabilitation expenditures are replaced by the following:

Structure	*% Credit*
Non-residential building: 30-39 years old	15
Non-residential building: 40 or more years old	20
Residential and non-residential: certified historic structures	25

Under the 20-year rule, the 20-year period was computed between the date of the rehabilitation and the latter of the date the building was placed in service or the date of a previous rehabilitation for which the credit was claimed. Thus, a rehabilitation credit was allowed only once every 20 years. Now, the only age requirement is that the building be at least 30 (or 40) years old. There is no reference in the new law to a prior rehabilitation. Therefore, it seems that, as long as the other requirements are met, there can be a qualified rehabilitation of a 30-(or 40-) year-old building every year.

The 15-percent and 20-percent credits are limited to non-residential buildings. The 25-percent credit for certified historic rehabilitation is available for both non-residential and residential buildings.

For rehabilitation credits other than for certified historic structures, the basis of the property must be reduced by the amount of the credit, thus reducing the annual cost recovery allowance. If subsequently the credit is recaptured, the resulting increase in tax is restored to the basis of the building immediately before the event that triggered recapture.

The new rehabilitation expenditure rules apply to expenditures incurred after December 31, 1981. However, if the rehabilitation began before January 1, 1982, a special transitional rule will continue to allow the credit under the prior law for buildings that qualify under the prior law but not under the new law (e.g., a 25-year old building). If the building qualifies under both the prior law and the new law (e.g., a 35-year old building), the prior law applies to expenditures incurred in 1981 and the new law applies to expenditures incurred in 1982 and later years.

Three new limitations now apply to the rehabilitation credit:

- The property must be 15-year property,
- The straight-line method of depreciation must be used, and
- The energy credit is not allowed.

As under prior law, the credit still does not apply to costs for:

- Acquiring a building,
- Acquiring an interest (e.g., leasehold) in a building,
- Facilities related to a building (e.g., parking lot),
- Constructing a new building,
- Completing a new building after it has been placed in service, or
- Enlarging a building.

A further limitation is that expenditures qualify only if made in connection with a "substantial" rehabilitation of a building. A building is substantially rehabilitated if either of two conditions is met:

- Expenditures during the 24-month period ending on the last day of the taxable year exceed the greater of—
    - the adjusted basis of the property as of the first day of the 24-month period, or
    - $5,000.
- Expenditures during the 60-month period, ending on the last day of the taxable year exceed the greater of—
    - the adjusted basis of the property as of the first day of the 60-month period, or
    - $5,000.

Under regulations to be prescribed by the Treasury, this 60-month alternative is available only if a written set of architectural plans and specifications for all phases of the rehabilitation is completed before the rehabilitation begins and there is a reasonable expectation that all phases of the rehabilitation will be completed.

It appears that the minimum expenditure rule (the greater of adjusted basis or $5,000) favors taxpayers who have owned buildings for a long period and thus have a low adjusted basis. They need only to exceed that low adjusted basis (or $5,000) to qualify. On the other hand, the rules do not favor a recent purchaser who presumably would have a high cost basis in the building. To qualify, such a taxpayer must make rehabilitation expenditures greater than the purchase price.

Under prior law, expenditures for a certified historic structure were not eligible for the rehabilitation credit unless the rehabilitation was a certified rehabilitation. The Act extends this rule to all buildings located in registered historic districts unless the taxpayer obtains a certification from the Secretary of the Interior that the building is not of historic significance to the district. No credit is available for a certified historic structure unless approval of the rehabilitation is obtained from the Secretary of the Interior.

A certified historic structure is not subject to the rule requiring the property to have been in service for 30 years at the time the rehabilitation begins. However, there must be a substantial rehabilitation.

The Act repeals the special 60-month amortization provisions for certified historic structures under section 191 of the Code and also repeals the special rule permitting use of accelerated methods for substantially rehabilitated certified historic structures under section 167(o) of the Code.

If a rehabilitation is undertaken by a lessee, the Act provides that the lessee is eligible for the credit for qualified rehabilitation expenditures incurred by the lessee but only if on the date of completion of the rehabilitation the remaining term of the lease is at least 15 years. Because of the requirement that the expenditure must be the greater of adjusted basis or $5,000, the Treasury will prescribe regulations for applying the substantial rehabilitation requirements to lessees.

The Act repeals section 167(n) of the Code which required the use of straight-line depreciation for a building constructed on the site of a demolished certified historic structure.

Under the Act, the prior rule that denies the investment credit for property leased to tax-exempt organizations [section 48(a)(4) of the Code] or governmental units [section 48(a)(5) of the Code] does not apply to the portion of the basis of the building attributable to qualified rehabilitation expenditures.

At-Risk Rules

For a discussion of the new at-risk rules relating to the investment tax credit, see Chapter III—Leasing.

Chapter III—Leasing

by John W. Gilbert

Introduction

One consequence of the Accelerated Cost Recovery System (ACRS) and revision of the investment tax credit is that many companies are not able to use currently all their tax deductions and credits. In considering potential investments, these companies would be at a competitive disadvantage and they could become targets for tax-induced takeovers and mergers.

To alleviate this problem, the Economic Recovery Tax Act of 1981 establishes a broad safe harbor for characterizing transactions as leases for federal income tax purposes. A lease transaction permits the lessee-user of the property to transfer tax benefits to a lessor-investor. The user receives a significant portion of the tax benefits through reduced rental charges and/or cash payments. Under the new leasing rules, almost any type of machinery and equipment is leasable for tax purposes. There is virtually full and complete transferability of the investment tax credit and depreciation deductions within the corporate sector. Also, noncorporate users may transfer investment tax credits and depreciation deductions to corporate investors, using safe-harbor leases.

This is not a "loophole" in the sense that it will provide unintended benefits. On the contrary, it was done by design. A Treasury official has been quoted as saying:

> Two things are important to remember. First, the investment tax credit and accelerated depreciation are *supposed* to lower the cost of capital to firms. Second, leasing made sure that these tax benefits worked for *all* firms, whether or not they could use those benefits themselves.
>
> — Remarks by John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy) before the Tax Society of New York University, October 5, 1981

Lease transactions are not a new technique. The leasing of business property has become widespread over the years for a variety of reasons. Leasing can minimize capital requirements, leasing can be a source of off-balance-sheet financing, or leasing can be simply a matter of convenience.

Of course, leasing was also a means of transferring tax benefits from one taxpayer to another and for this reason the Internal Revenue Service (IRS) developed guidelines for judging whether a so-called lease was really something else (i.e., a sale or a financing arrangement). These IRS guidelines have tended to keep traditional leasing from working to its full potential in allocating tax benefits.

Allocation of Tax Benefits

If a taxpayer owns property used in its trade or business, that taxpayer is entitled to the depreciation and the investment tax credit. If the user of the property cannot utilize the depreciation and/or the investment tax credit, a lease arrangement can be structured to allow some other taxpayer to take advantage of the tax benefits.

A leasing arrangement contemplated by the law will allow the transfer of tax benefits to the lessor-investor from the lessee-user of the property. A lease with a pass-through of the investment tax credit will leave the lessor-investor with the depreciation while giving the investment tax credit to the lessee-user. In cases where the user has purchased the property, the transfer of tax benefits can be achieved by a sale and leaseback arrangement.

In order to transfer the investment tax credit to the investor while the depreciation stays with the user of the property, an arrangement known as the "ITC strip" might be used. In this arrangement the user would purchase the property, lease it to an investor with a pass-through of the ITC, and then sublease the property back. The Treasury has not sanctioned the ITC strip transaction and for practical purposes has restricted its use by specifically reserving judgement as to the qualification of such transactions as safe-harbor leases in Temporary Income Tax Regulations issued on October 20, 1981. In a summary accompanying these regulations the Treasury states:

> Section 5c.168(f)(8)-9 reserves the issue whether section 168(f)(8) leases may be used to transfer only the investment tax credit.

Apparently, the Treasury's concern about the ITC strip is that this transaction would artificially generate taxable losses for the investor and taxable income for the user. The investor presumably can use the tax loss to reduce taxes on other income, but the user may be able to avoid paying tax on the additional taxable income by using net operating losses or investment tax credits.

The Impact of the Economic Recovery Tax Act of 1981 on the Qualification of a Transaction as a Lease

Alternatives which were considered to alleviate the problem of loss companies not being able to use the benefits of ACRS and the investment tax credit included refundability or transferability of the investment tax credit and more extreme flexibility in the utilization of ACRS deductions. Congress chose transferability, not by sale, but by the use of the lease transaction to transfer the tax benefits between parties. This was accomplished by creating safe-harbor leasing rules which guarantee that a transaction will be characterized as a lease for tax purposes and thus accomplish the desired redistribution of tax benefits.

In order to qualify as a lease under the safe-harbor provisions:

- Both the lessor and the lessee must affirmatively elect to treat the lessor as the owner of the property.
- The lessor must be a corporation (other than a Subchapter S corporation or a personal holding company) or a partnership of which all the partners are eligible corporations.
- The leased property must be new section 38 property (which includes tangible personal property and certain other tangible property, but excludes a building and its structural components) or a qualified mass commuting vehicle which is financed by obligations whose interest is tax exempt.
- The lessor must have and maintain throughout the lease term a minimum "at-risk" investment of not less than 10 percent of the adjusted basis of the property.
- The term of the lease (including extensions) cannot exceed the greater of 150 percent of the asset depreciation range (ADR) midpoint life of the property or 90 percent of the useful life of the property.
- The leased property must be leased within three months after its acquisition.
- In a sale-leaseback, the transaction must occur within three months after the lessee's acquisition of the property at a price not more than the adjusted basis of the property in the hands of the lessee. (For these purposes, the time the property is acquired will be the later of the time the property was acquired or the time the property was placed in service.)
- A transitional rule is provided for property placed in service after December 31, 1980 and before August 14, 1981. In this situation, in order to qualify for the safe-harbor provision, the property must be leased within three months after August 13, 1981, the date of enactment. Accordingly, companies which made purchases of qualified property in 1981, before August 14, 1981, can convert those purchases into safe-harbor lease transactions on or before November 13, 1981.

If a leasing transaction meets the safe-harbor requirements, no other factors will be taken into account in determining whether the transaction is a bona fide lease or whether the lessor is the owner of the property.

The following chart compares the requirements for a transaction to qualify for an IRS ruling characterizing the arrangement as a lease within the new safe-harbor rules for leasing transactions. It should be noted that the IRS ruling guidelines for characterization as a lease are not necessarily those applied by the IRS in audits or by the courts, but rather are those criteria that must be satisfied to obtain an advance letter ruling from the IRS.

IRS Guidelines for Characterization of a Transaction as a Lease	***Safe-Harbor Lease Requirements***
1. Lessor, at all times, must have a minimum at risk investment in the asset of at least 20 percent of its cost.	1. Lessor, at all times must have and maintain a minimum at risk investment of at least 10 percent of the adjusted basis of the property.
2. Lessor must be able to show that the transaction was entered into for profit, apart from the transaction's tax benefits (i.e., without consideration of the tax deductions, credits and other tax attributes arising from the transaction).	2. Lessor's profit from the transaction can be derived solely from the transaction's tax benefits.
3. Lessee must not have a contractual right to purchase the property at less than its fair market value, nor may the lessor have a contractual right to cause any party to purchase the asset.	3. Agreement may include fixed price purchase options at more or less than the property's fair market value.
4. Lessee must not have furnished any part of the purchase price of the asset nor have loaned or guaranteed any indebtedness created in connection with the acquisition of the property by the lessor.	4. Lessee or a related party may finance the property's purchase price or guarantee financing for the transaction.
5. The use of the property at the end of the lease term by a person other than the lessee must be commercially feasible to the lessor.	5. Any person may be able to use the leased property at the end of the lease term.

6. The term of the lease, including extensions, must not exceed the lesser of 80 percent of the original useful life of the property or the original life of the property less one year.
7. Leased property can be either new or used.

6. The term of the lease, including extensions, must not exceed the greater of 90 percent of the useful life of the property or 150 percent of the present ADR midpoint life.
7. Lease property must be new section 38 property (qualifying investment tax credit property).

It is important to note that the safe-harbor election for leasing transactions is not available to noncorporate lessors nor for used property. In these cases, the traditional rules are still applicable.

Analysis of a Safe-Harbor Lease

Firms that currently are unable to use all their tax deductions and credits should consider a safe-harbor lease. What is the magnitude of the benefits from such a lease for the user of the property; that is, the seller of the tax benefits? The question is answered by looking at a simple sale-leaseback transaction permitted under the new safe-harbor rules.

A firm making an investment decision must consider the tax benefits from depreciation deductions and the investment tax credit. These tax benefits reduce the cost of acquiring new machinery and equipment. Consider a firm subject to the 46-percent corporate rate that currently can use all tax deductions and credits. If the firm acquires a $10,000 machine, the tax benefits, assuming a 10-percent discount rate, have a present value of $4,358 as shown in Table 1.

Table 1
Tax Benefits from Purchase of $10,000 Machine

Year	*Investment Tax Credit*	*Depreciation*[a]	*Tax Savings from Depreciation*[b]	*Total Tax Savings*	*Present Value of Tax Savings*[c]
1	$1,000	$ 1,500	$ 690	$1,690	$1,536
2		2,200	1,012	1,012	836
3		2,100	966	966	726
4		2,100	966	966	660
5		2,100	966	966	600
Total	$1,000	$10,000	$4,600	$5,600	$4,358

[a]Assumes machine has five-year ACRS life
[b]Assumes 46-percent corporate tax rate
[c]Assumes 10-percent discount rate

Sale-Leaseback

A firm not able to use the tax benefits may transfer them through a sale-leaseback to an investor who has sufficient tax liability to absorb them. If the investor, that is the purchaser of the tax benefits, also uses a 10-percent discount rate, the following terms might be arranged for the sale-leaseback of a $10,000 machine originally acquired by the user.[1]

1. The user sells property to the investor for $10,000.
2. The investor gives the user $2,388 cash and a note for $7,612 payable in 10 annual installments of $1,347, with interest at 12 percent.
3. The user leases back the property for 10 years with annual lease payments of $1,347.
4. The user can purchase the property at the end of the lease for $1.

Table 2 illustrates the elements of this transaction over the term of the lease:

Table 2
Cash Flow — In (Out)

	Investor	*User*	*Total*
Purchase of property		($10,000)	($10,000)
Sale to the investor:			
Down payment	($ 2,388)	$ 2,388	
Principal of note	(7,612)	7,612	
Interest on note	(5,858)	5,858	
Rental	13,470	(13,470)	
Tax benefits (costs):			
Investment credit	1,000		1,000
ACRS	4,600		4,600
Interest deduction (46 percent of $5,858)	2,695	(2,695)*	
Rent (46 percent of $13,470)	(6,196)	6,196 *	
	($ 289)	($ 4,111)	$ 4,400

*The net tax benefit is only realized by the user if the user generates other income from which the net deductions can be subtracted.

After the initial down payment of $2,388, no cash need change hands since the payments on the note (from the investor to the user) are equal to the rental payments (from the user to the investor).

[1]The appendix outlines a methodology for determining what the investor would be willing to pay for the tax benefits assuming a given rate of return is required on the investment.

Over the term of the lease, however, the user will have $7,612 of tax deductions since only the interest portion of the note payments are included in income, but all the rental payments are deductible. Therefore, the total amount of tax deductions (rental payments less interest income) realized by the user over the term of the lease is equal to the principal amount of the note.

If the tax deductions resulting from the lease are usable currently and assuming the 46-percent corporate tax rate, the resulting tax savings will have a present value of $1,970, as shown in Table 3. When added to the $2,388 of cash paid, the user through a sale-leaseback is able to reduce the cost of acquiring the $10,000 machine by $4,358. This is exactly the same reduction the user would have been able to realize if he could currently use all the tax deductions and credits as shown in Table 1.[2]

Table 3
User Cash Flow Analysis in Sale-Leaseback

Year	*Tax Deduction*[a]	*Tax Savings*[b]	*Present Value of Tax Savings*[c]
1	$ 434	$ 200	$ 182
2	486	224	185
3	544	250	188
4	609	280	191
5	682	314	195
6	764	351	198
7	857	394	202
8	959	441	206
9	1,074	494	210
10	1,203	553	213
			1,970
Plus Cash Payment			2,388
Total	$7,612	$3,501	$4,358

[a]The tax deduction is equal to the rental payment less the interest income. Given the assumptions of the lease, the tax deduction for each year is equal to the amortization on a level-payment 12-percent note with a principal amount of $7,612.

[b]Assumes 46-percent corporate tax rate.

[c]Assumes 10-percent discount rate.

Obviously, if the user can never use the $7,612 of tax deductions, the sale-leaseback nets him only the up-front cash payment of $2,388. However, a firm that is temporarily unprofitable and not able to use all the ACRS deductions as they accrue may be able to use the deductions resulting from the sale-leaseback since these deductions are deferred by being spread over 10 years.

[2] The investor must pay taxes on the difference between rental income and interest deductions. The present value of these tax payments is $1,970, assuming the investor's discount rate is 10 percent. Thus the investor, in effect, purchases $4,358 worth of ACRS deduc-

Table 4 compares the user's tax deductions assuming the tax benefits are not transferred with a sale-leaseback.

Table 4
Comparison of Tax Deductions under ACRS and Sale-leaseback

Year	*ACRS Deductions (1)*	*Sale-Leaseback Deductions (2)*	*Difference (2) − (1)*
1	$ 1,500	$ 434	$1,066
2	2,200	486	1,714
3	2,100	544	1,556
4	2,100	609	1,491
5	2,100	682	1,418
6		764	(764)
7		857	(857)
8		959	(959)
9		1,074	(1,074)
10		1,203	(1,203)
	$10,000	$7,612	$2,388

In the first year of the lease, the user's taxable income is increased (or net operating loss reduced) by $1,066, and over the first five years of the lease, the user's taxable income is increased (or net operating loss reduced) by $7,245.

This aspect of the sale-leaseback, the creation of taxable income during the early years of the lease, may be quite valuable for a firm with a need for current taxable income. Examples of situations where firms may want to arrange a leaseback include:

1. Firms with net operating loss or investment tax credit carryforwards close to expiration. Carryforwards would be used sooner and therefore are more valuable.

2. Firms with large long-term capital gains offset by current net operating losses. Increased ordinary income would reduce the undesirable use of net operating losses against capital gain income.

3. Mineral firms subject to the net income limitation for percentage depletion. By leasing mining equipment these firms would increase

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tions and tax credits by making a cash payment of $2,388 and paying future taxes with a present value of $1,970 on the difference between rental income and interest deductions. Over the term of the sale-leaseback, the investor earns 10 percent on the amount of money invested.

the gross income from the mineral property and thereby would increase the percentage depletion deduction.

4. Firms with domestic net operating losses offsetting foreign source income. Increased ordinary income from a sale-leaseback would facilitate the current use of foreign tax credits.

To summarize, a firm, by arranging a safe-harbor lease, can reduce the cost of acquiring a $10,000 machine by:

$2,388	if the firm can never use the tax deductions resulting from the lease,
$4,358	if the firm currently can use all the tax deductions from the lease,[3]

Additional Comments and Qualifications

Difference in discount rates. In the sale-leaseback example used above both the user of the property and the purchaser of the tax benefits have the same discount rates. In the real world this generally is not true and some sale-leasebacks are attractive simply because of a difference in discount rates. In these situations the tax benefits are worth more to the purchaser than they are to the user even if the user currently could use the tax credit and all the depreciation deductions.[4]

Lease Term. A longer lease term (and, therefore, a longer term for the note) will further defer income recognition to the lessor. An investor would therefore be willing to make a higher initial cash payment, all other things being equal. The safe-harbor legislation, however, limits the maximum term of the lease to the greater of 90 percent of the useful life or 150 percent of the present class life of the leased property.

Interest rate on the note. Similarly, the higher the interest rate on the note, the lower the present value of the amortization payments for any given discount rate used by the investor. This, in turn, will increase the

[3]In this situation the user is in the same position as a user that currently can use the investment tax credit and all the ACRS deductions.

[4]In the basic sale-leaseback example used above both the tax credit and the first-year depreciation deductions were discounted one year since it was assumed that the investment is made January 1 and the tax benefits are available on December 31. If the investor has a higher discount rate, the investment tax credit is less valuable but deferral inherent in ACRS deductions is more valuable. The investment tax credit effect tends to dominate. For example, if the investor's discount rate is 15 percent, he would be willing to make an upfront cash payment of only $2,350. However, if the property is purchased and subleased at the end of the tax year so that the tax credit is immediately available, at higher discount rates the investor will be willing to pay more for the tax benefits since the deferral from depreciation is more valuable.

initial cash payment an investor is willing to make. The temporary regulations on the safe-harbor leases, issued on October 20, 1981, require that in the case of a sale-leaseback transaction the note bear a reasonable or an arm's-length rate of interest.

Transfer of only ACRS deductions. A sale-leaseback transaction can also be used to transfer only the depreciation deductions to the buyer of the tax benefits. The cash payment up front will be lower since the investment tax credit is not being transferred.[5] The user's taxable income is increased during the early years of the sale-leaseback just as when the user transfers both the investment tax credit and the ACRS deductions.

Temporary Regulations

Temporary regulations were issued by the Treasury on October 20, 1981 to provide guidance for executing safe-harbor agreements.

As indicated, the temporary regulations do not address the ITC strip issue and specifically state that there should be no implication that the safe-harbor lease rules will apply to a transfer of only the investment tax credit to a party who is not the user.

The new law imposes a maximum term on a lease, but is silent as to a minimum term. The temporary regulations provide that the lease term cannot be shorter than the ACRS life of the property in the hands of the lessee. This is to prevent the lessee from obtaining faster deductions through rent payments than it would have obtained from ACRS.

One determinant of the maximum term under the new law is 90 percent of the useful life of the property for purposes of section 167 of the Code. The current Income Tax Regulations under section 167 provide that useful life is the useful life to the taxpayer. To the contrary, the temporary leasing regulations provide that the useful life is that period the property can be reasonably expected to be useful in anyone's business.

The temporary income tax regulations make eminently clear that form will triumph over substance in a safe-harbor lease by disregarding the following factors:

1. Whether the lessor or lessee must take the tax benefits into account in order to determine that a profit is made from the transaction;

[5] The Appendix develops a formula for determining the upfront cash payment an investor would be willing to make, assuming that only the ACRS deductions are transferred.

2. The fact that the lessee is the nominal owner of the property for state or local law purposes (e.g., has legal title to the property) and retains the burdens, benefits, and incidents of ownership (such as payment of taxes and maintenance charges with respect to the property);
3. Whether or not a person other than the lessee may be able to use the property after the lease term;
4. The fact that the property may (or must) be bought or sold at the end of the lease term at a fixed or determinable price that is more or less than its fair market value at that time;
5. The fact that the lessee or related party has provided financing or has guaranteed financing for the transaction (other than for the lessor's minimum 10-percent investment); and
6. The fact that the obligation of any person is subject to any contingency or offset agreement.

The safe-harbor lease may be treated as a lease for federal tax purposes only. The agreements need not comply with state law requirements concerning transfer of title, recording, etc.

The safe-harbor lease agreement must be in writing and must state that all of the parties to the agreement agree to characterize it as a safe-harbor lease. Information returns must be filed by the lessor and lessee including information identifying the property, the taxpayers, and the District Director's offices with which their income tax returns are filed.

A sale or assignment by the lessor of its interest in the lease or in the property in a taxable transaction will disqualify the lease as a safe-harbor lease as of the date of the sale or assignment. By implication, a transfer in a nontaxable transaction will not be a disqualifying event.

A disposition by a lessee of its interest in the safe-harbor lease or the property will terminate the characterization as a safe-harbor lease as of the time of disposition unless the transferee (i.e., the new user) furnishes to the lessor within 60 days the transferee's written consent to take the property subject to the lease and both transferee and lessor make required disclosures of the transaction in their income tax returns.

If, during the term of a safe-harbor lease the lessor becomes a Subchapter S corporation or otherwise ceases to be a qualified lessor, the lease will cease to be a safe-harbor lease at such time. Likewise, the disqualification of any partner in a partnership or other syndicate will disqualify the entire partnership or syndicate as a qualified lessor.

If a disqualifying event occurs so that the lease loses safe-harbor protection and if the lessee would be considered the owner of the property without safe-harbor protection, the disqualifying event will be deemed to be a sale of the property by the lessor to the lessee for the amount of the purchase money debt then outstanding.

In a case where the lessee's interest in the lease or in the property is sold or assigned in a bankruptcy, liquidation, receivership, court-supervised foreclosure, or in any similar proceeding, the temporary regulations have been amended to continue safe-harbor lease protection if certain conditions are met:

- The lessor gives written notice of its federal tax ownership to the body having jurisdiction over the proceeding.
- The lessor files a disclosure statement with its federal income tax returns, and
- The secured lenders of the lessee with interests in the property release in writing the federal tax ownership of the property from their interests.

The last condition may cause potential lessors to require their potential lessees to obtain such releases before the initial lease arrangement is consummated in order to be fully protected from the effects of a disqualifying event.

The temporary regulations also make clear that there can be only one safe-harbor lease with respect to a property. Thus, only one lease in a lease-leaseback arrangement could be a safe-harbor lease.

An agreement between the lessor and the lessee requiring either or both parties to purchase or sell the property at some price at the end of the lease term shall not affect the amount the lessor has at risk. However, an option to sell the property held by the lessor that is exercisable before its "ACRS life" is over shall reduce the amount the lessor is considered to have at risk by the amount of the option price at the time the option becomes exercisable.

If several different pieces of property are the subject of a single lease, the maximum term of such lease will be measured with respect to the shortest-lived property. The minimum term of the lease must be at least equal to the ACRS recovery period and is determined by its characterization in the hands of the user without regard to the safe-harbor lease.

Along this same line, the eligibility of property for investment credit is determined by its status to the user so that a safe-harbor lease arrangement can transfer no more investment tax credit than the user would have been entitled to absent such arrangement.

Transactional costs such as legal and investment banking fees and printing costs which are not currently deductible shall be allocated to the lease agreement and amortized over the term of the lease and are not included in the lessor's adjusted basis with respect to the property. Thus, the requirement that in a sale-leaseback, the lessor's basis be not greater than the lessee's will not be violated.

Investment credits earned during the construction of a project cannot be transferred under a safe-harbor lease until the property is completed and placed in service. The temporary income tax regulations take the position that until the property is placed in service, it does not meet the definition of new section 38 property.

An undivided interest in a property may be the subject of a safe-harbor lease regardless of whether or not such interest is considered separate property under state or local law. An undivided interest in a property may be leased to one lessor, another portion to another lessor, and the remainder retained by the user.

In accounting for the payments of principal, interest, and rent under the lease, the rules set forth in the temporary regulations shall apply regardless of the overall method of accounting otherwise used by the parties to the lease. These rules are designed so that the recognition of expense and income between the lessor and lessee is a mirror image, except that a prepayment of rent shall be included in the lessor's income at the earlier of the time when the rent is paid by the lessee or accrued under the lease. Other provisions of the temporary regulations preclude the use of balloon or similar payments to either accelerate or defer recognition of income and deductions as compared with a ratable payment of rent or level amortization of the lessor's obligation. Further, a reasonable rate of interest must be provided.

Finally, the temporary income tax regulations will remain in effect until superseded by later final income tax regulations. It is expected that the temporary income tax regulations will be revised and proposed in a forthcoming notice of proposed rulemaking concerning ACRS.

The New Depreciation Recapture Rules on Leasing

An important provision enacted with the Act relates to the situation where the lessor has been treated as the owner of property under a safe-harbor lease election and the lessee-user acquires the property at the end of the lease term and subsequently disposes of it. When this occurs, the lessee-user will be subject to the depreciation recapture rules of section 1245 of the Code as if the lessee had been the owner of the property for the entire term of the lease. However, any recapture by the lessor on the sale to the lessee will not be again recaptured by the lessee. This provision was designed to prevent the possible situation where the lessor would sell the leased property to the lessee for a bargain purchase price at the end of the lease term. The lessor would recognize no gain on the transaction since the sales price would be less than his adjusted basis in the leased property. The lessee could then sell the property for its fair market value which could be much greater than the cost to the lessee (the bargain purchase price) and recognize capital gain. Under the new law, the lessee would have to recognize ordinary income to the extent of depreciation taken by the lessor (and not previously recaptured by him) and by the lessee before capital gain could be recognized.

The Increased ACRS Tax Benefits of Leasing

In addition to the modifications made by the Economic Recovery Tax Act of 1981 to the qualifications of a leveraged lease, ACRS, as explained in Chapters I and II of this booklet, will have a major effect on the tax benefits of leasing.

The example presented below compares the discounted after-tax cash flow to the lessor of leasing an asset purchased in 1980 (prior law), 1981 or 1986. It should be expected that these benefits will produce somewhat lower rental costs for leases. The terms and assumptions of the 1980 leveraged lease are as follows:

Cost of leased asset (equipment)	$1,000,000
Lease term	15 years, dating from January 1, 1980
Lease rental payments	$150,000 per year (payable last day of each year)
Financing:	
Equity investment by lessor	$400,000
Long-term nonrecourse debt from a bank	$600,000, bearing interest at 18 percent and repayable in 15 annual installments (on last day of each year) of $117,842
Depreciation allowable to lessor for income tax purposes	Nine-year ADR life using 200-percent declining-balance method for the first five years (with the half-year convention election applied in the first year) and straight-line method for remaining life

Lessor's income tax rate (federal and state)	50.4 percent (assumed to continue in existence throughout the term of the lease)
Investment tax credit	10 percent of equipment cost or $100,000 (realized by the lessor in the first year of the lease)

The terms of the 1981 and 1986 leases are identical to the 1980 lease except that the lease terms begin January 1, 1981 and January 1, 1986, respectively. The only assumption presented in the 1980 lease that changes in 1981 and 1986 is the depreciation allowable to the lessor for income tax purposes. For the lease beginning in 1981, the lessor is allowed, pursuant to ACRS, the maximum depreciation over a five-year life using the table provided which approximates the 150-percent declining-balance method for the first year with a switch to the straight-line method for the remaining life. For the lease beginning in 1986, the lessor's maximum depreciation allowable over a five-year life approximates the benefit of using the 200-percent declining-balance method with a switch to the sum-of-the-year's digits method. For the 1981 and 1986 leases, the use of the half-year convention in the year of acquisition is required. It is important to note that under ACRS, the equipment is classified in the five-year recovery class instead of the nine-year ADR guideline class.

The following tables present the present value of the after-tax cash flows to the lessor under each of the three assumptions computed in each case as if the cash flow and the tax benefits are realized on the last day of each year:

Cash Flow Analysis by Years

1980 Lease

Year	*1* *Gross Lease Rentals and Residual Value*	*2* *Depreciation (for Income Tax Purposes)*	*3* *Loan Interest Payments*	*4* *Taxable Income (Loss) (Col. 1−2−3)*	*5* *Income Tax Credits (Charges) (Col. 4× 50.4%)*	*6* *Loan Principal Payments*	*7* *Investment Tax Credit Realized*	*8* *Annual Cash Flow (Col. 1−3+ 5−6+7)*	*9* *Present Value of Cash Flow @ 10%*
Initial Investment (1/1/80)	—	—	—	—	—	—	—	$(400,000)	($400,000)
1980	$ 150,000	$ 111,110	$ 108,000	$ (69,110)	$ 34,831	$ 9,842	$100,000	166,989	151,808
1981	150,000	197,530	106,229	(153,759)	77,494	11,613	—	109,652	90,621
1982	150,000	153,640	104,138	(107,778)	54,320	13,704	—	86,478	64,972
1983	150,000	119,500	101,671	(71,171)	35,870	16,170	—	68,029	46,465
1984	150,000	92,940	98,761	(41,701)	21,017	19,081	—	53,175	33,017
1985	150,000	72,280	95,326	(17,606)	8,874	22,515	—	41,033	23,162
1986	150,000	72,280	91,274	(13,554)	6,831	26,568	—	38,989	20,007
1987	150,000	72,280	86,491	(8,771)	4,421	31,350	—	36,580	17,064
1988	150,000	72,280	80,848	(3,128)	1,576	36,993	—	33,735	14,307
1989	150,000	36,160	74,189	39,651	(19,984)	43,652	—	12,175	4,694
1990	150,000	—	66,332	83,668	(42,168)	51,510	—	(10,010)	(3,508)
1991	150,000	—	57,060	92,940	(46,842)	60,781	—	(14,683)	(4,678)
1992	150,000	—	46,120	103,880	(52,355)	71,722	—	(20,197)	(5,850)
1993	150,000	—	33,210	116,790	(58,862)	84,632	—	(26,704)	(7,032)
1994	150,000	—	17,976	132,024	(66,540)	99,867	—	(34,383)	(8,231)
Totals	$2,250,000	$1,000,000	$1,167,625	$ 82,375	$(41,517)	$600,000	$100,000	$ 140,858	$ 36,818

Cash Flow Analysis by Years **1981 Lease**

Year	1 Gross Lease Rentals and Residual Value	2 Depreciation (for Income Tax Purposes)	3 Loan Interest Payments	4 Taxable Income (Loss) (Col. 1−2−3)	5 Income Tax Credits (Charges) (Col. 4× 50.4%)	6 Loan Principal Payments	7 Investment Tax Credit Realized	8 Annual Cash Flow (Col. 1−3+ 5−6+7)	9 Present Value of Cash Flow @ 10%
Initial Investment (1/1/81)	—	—	—	—	—	—	—	$(400,000)	($400,000)
1981	$ 150,000	$ 150,000	$ 108,000	$(108,000)	$ 54,432	$ 9,842	$100,000	186,590	169,627
1982	150,000	220,000	106,229	(176,229)	88,819	11,613	—	120,977	99,981
1983	150,000	210,000	104,138	(164,138)	82,726	13,704	—	114,884	86,314
1984	150,000	210,000	101,671	(161,671)	81,482	16,170	—	113,641	77,618
1985	150,000	210,000	98,761	(158,761)	80,016	19,081	—	112,174	69,651
1986	150,000	—	95,326	54,674	(27,556)	22,515	—	4,603	2,598
1987	150,000	—	91,274	58,726	(29,598)	26,568	—	2,560	1,314
1988	150,000	—	86,491	63,509	(32,009)	31,350	—	150	70
1989	150,000	—	80,848	69,152	(34,853)	36,993	—	(2,694)	(1,143)
1990	150,000	—	74,189	75,811	(38,209)	43,652	—	(6,050)	(2,333)
1991	150,000	—	66,332	83,668	(42,168)	51,510	—	(10,010)	(3,508)
1992	150,000	—	57,060	92,940	(46,842)	60,781	—	(14,683)	(4,678)
1993	150,000	—	46,120	103,880	(52,355)	71,722	—	(20,197)	(5,850)
1994	150,000	—	33,210	116,790	(58,862)	84,632	—	(26,704)	(7,032)
1995	150,000	—	17,976	132,024	(66,540)	99,867	—	(34,383)	(8,231)
Totals	$2,250,000	$1,000,000	$1,167,625	$ 82,375	$(41,517)	$600,000	$100,000	$ 140,858	$ 74,398

Cash Flow Analysis by Years

1986 Lease

Year	1 Gross Lease Rentals and Residual Value	2 Depreciation (for Income Tax Purposes)	3 Loan Interest Payments	4 Taxable Income (Loss) (Col. 1−2−3)	5 Income Tax Credits (Charges) (Col. 4× 50.4%)	6 Loan Principal Payments	7 Investment Tax Credit Realized	8 Annual Cash Flow (Col. 1−3+ 5−6+7)	9 Present Value of Cash Flow @ 10%
Initial Investment (1/1/86)	—	—	—	—	—	—	—	$(400,000)	($400,000)
1986	$ 150,000	$ 200,000	$ 108,000	$(158,000)	$ 79,632	$ 9,842	$100,000	211,790	192,536
1987	150,000	320,000	106,229	(276,229)	139,219	11,613	—	171,377	141,634
1988	150,000	240,000	104,138	(194,138)	97,846	13,704	—	130,004	97,674
1989	150,000	160,000	101,671	(111,671)	56,282	16,170	—	88,441	60,406
1990	150,000	80,000	98,761	(28,761)	14,496	19,081	—	46,654	28,968
1991	150,000	—	95,326	54,674	(27,556)	22,515	—	4,603	2,598
1992	150,000	—	91,274	58,726	(29,598)	26,568	—	2,560	1,314
1993	150,000	—	86,491	63,509	(32,009)	31,350	—	150	70
1994	150,000	—	80,848	69,152	(34,853)	36,993	—	(2,694)	(1,143)
1995	150,000	—	74,189	75,811	(38,209)	43,652	—	(6,050)	(2,333)
1996	150,000	—	66,332	83,668	(42,168)	51,510	—	(10,010)	(3,508)
1997	150,000	—	57,060	92,940	(46,842)	60,781	—	(14,683)	(4,678)
1998	150,000	—	46,120	103,880	(52,355)	71,722	—	(20,197)	(5,850)
1999	150,000	—	33,210	116,790	(58,862)	84,632	—	(26,704)	(7,032)
2000	150,000	—	17,976	132,024	(66,540)	99,867	—	(34,383)	(8,231)
Totals	$2,250,000	$1,000,000	$1,167,625	$ 82,375	$(41,517)	$600,000	$100,000	$ 140,858	$ 92,425

The tables indicate that under ACRS, the lessor will recognize greater after-tax cash flow than it did under prior law. During the phase-in period between 1981 and 1985, the ACRS deductions more than double the lessor's after-tax cash flow over the lease term. After ACRS is fully phased in, the lessor realizes approximately two-and-one-half times the present value of the after-tax cash flows over the lease term than it did if the asset had been purchased and leased before 1981.

Therefore, if the results of this example are expanded to encompass the volume of leasing transactions, it is evident that lessors will be receiving a greater economic benefit than under prior law. The competitive nature of leasing should result in the lessors passing most of the additional benefits to the lessees in the form of reduced rentals. Accordingly, the lessee should benefit, as well as the lessor, from ACRS. Market forces can be expected to dictate the allocation of benefits between the parties.

Leasing Tax Shelters

At first glance, it would appear that ACRS benefits those individuals investing in equipment-leasing tax shelters. As explained in Chapter I, the Act provides for an accelerated write-off of capital acquisitions over a shorter period of time than under prior law. This accelerated depreciation is a direct tax benefit to the investor. However, Congress enacted with ACRS a new at-risk limitation relating to the investment tax credit.

The Tax Reform Act of 1976 imposed a limit on the amount of losses from a business or income-producing activity that certain taxpayers, such as individuals, Subchapter S corporations and certain closely held corporations, can deduct currently (section 465 of the Code). This at-risk limitation prevents the taxpayer from offsetting income from other sources with losses generated by tax shelter investments to the extent those losses exceed the actual investment the taxpayer has placed at risk in the shelter activity.

The 1981 Act subjects the allowance of investment tax credit to a similar at-risk limitation. The limitation applies to those business activities that are now subject to section 465 of the Code, engaged in by individuals, Subchapter S corporations and certain closely held corporations. Thus, public corporations and real estate activities are not covered by this limitation.

The Act provides that an investment tax credit will not be allowed with respect to amounts invested in qualifying property to the extent the invested amounts are not at risk. Generally, amounts are not considered at risk if:

1. The taxpayer is protected against the loss of the invested amount,
2. The amount was borrowed and the taxpayer is not personally liable for repayment of the debt,

3. The lender has an interest other than as a creditor, or

4. The lender is a related party to the borrower.

These rules are the same as those used to determine whether amounts are at risk in an activity for purposes of the loss limitation rules of section 465 of the Code.

Amounts at risk with respect to qualifying property are only those amounts considered at risk under section 465 of the Code that are directly attributable to investment in the property. Therefore, cash contributed to the operating expenses of a business or a loan for the operation of a business, even if recourse, would not be considered at risk with respect to property qualifying for the investment tax credit.

The changes in the at-risk rules can be illustrated by the following example:

In 1980, a limited partnership purchased and placed in service a machine for $500,000 by paying $300,000 cash and giving a $200,000 nonrecourse note. Since the machine was placed in service prior to the at-risk rules for investment tax credit, the partners were able to share the full investment tax credit of $50,000 (10 percent × $500,000).

However, if after February 18, 1981 the partnership purchases and places in service a machine for $500,000 by paying $300,000 cash and giving a $200,000 nonrecourse note, the partnership is at risk for only $300,000 and the partners can only realize an investment tax credit of $30,000.

There is an exception to the rules relating to amounts not at risk. If the taxpayer is at risk in an amount equal to at least 20 percent of the basis of the property, such taxpayer would be considered at risk with respect to amounts borrowed from a bank, savings and loan association, insurance company or a federal, state or local agency or other qualified lender that is not a related party to the borrower. The exception does not apply where the governmental agency is merely acting as a conduit with respect to the loan.

Debt that falls within this exception will not be subject to the at-risk rules and will generate basis for the investment tax credit as under current law. Therefore, under the exception, debt of a limited partnership, whether or not recourse, to a qualifying institution will be allocated to the limited partners for these purposes, even if the limited partners are not personally liable on the debt.

The effective date for the implementation of the investment tax credit at-risk limitation is for property placed in service on or after February 19, 1981.

Therefore, individuals investing in non-real estate tax shelters should be aware of the possibility that they may not realize the full benefit of the investment tax credit generated by the acquisition of qualifying property. The benefit realized will be dependent upon the amount of at-risk investment the taxpayer has in the property.

Conclusion

It is apparent that the leasing and other provisions of the Economic Recovery Tax Act of 1981 are likely to have a major effect on the economy. The Act enables most corporations to invest in leveraged leasing to substantially reduce their cost of capital acquisitions or tax liabilities. The safe-harbor lease provisions should successfully distribute the economic benefits of ACRS deductions and investment tax credits throughout the corporate sector to benefit both the profitable taxpayers who are able to utilize the deductions and credits and the non-profitable taxpayers who can reduce their cost of equipment. However, lessors and lessees must be carefully matched to provide the maximum benefits.

Appendix

Consider a sale-leaseback with the following terms:

1. The user purchases the property for price P and sells it to the investor also for price P.
2. The investor gives the user a cash payment of X and an n-year note for P-X, with level payments and interest rate r.
3. The user leases back the property for n years with the annual rental payment just equal to the annual payment on the loan.
4. The user can purchase the property at the end of the lease for $1.

Given the price P, the term of the lease n, and the interest rate on the note r, what cash payment will the investor be willing to make for the tax benefits, assuming he must earn an after-tax rate of return of i percent. From standard investment theory, the present value of the cash flow from the investment must be equal to X, the initial cash outlay. The cash flow from this investment may be broken into three components:

1. The present value of the investment tax credit, plus
2. The present value of the tax savings from the depreciation deductions, minus
3. The present value of the tax on the amortization of the note.[6]

An algebraic expression for the cash payment, therefore, would be:

$$X = PV(ITC) + uPV(D_t) - u(P-X)PV(a_t). \qquad (1)$$

where, $PV(ITC)$ = present value of the investment tax credit, discounted at rate i

u = marginal tax rate of investor

$PV(D_t)$ = present value of the depreciation deductions, discounted at rate i

P = price of the property

$PV(a_t)$ = present value of the amortization payments on a level payment loan of $1 for n years at interest rate r, discounted at rate i.

[6]The investor receives rental income and deducts interest on the note. The difference between these two is the annual amortization of the note, and this difference is included in taxable income.

Solving for X,

$$X = \frac{PV(ITC) + uPV(D_t) - uPPV(a_t)}{1 - uPV(a_t)} \tag{2}$$

For the sale-leaseback example used in the text,

$$i = .10$$
$$PV(ITC) = \$909$$
$$u = .46$$
$$PV(D_t) = \$7498$$
$$P = \$10,000$$
$$PV(a_t) = .5625$$

therefore, X = $2,388.

If the user of the property only transfers the depreciation deductions in the sale-leaseback, then equation (2) can be modified to show that an investor would be willing to make a cash payment of Y.

$$Y = \frac{uPV(D_t) - uPPV(a_t)}{1 - uPV(a_t)} \tag{3}$$

Dropping the investment tax credit from the sale-leaseback assumed in the text, reduces the cash payment to $1,162.

It can also be shown that the longer the term of the lease or the higher the assumed interest rate on the note, the lower will be the present value of the amortization payments and, therefore, the higher the initial cash payment X or Y.

Chapter IV—Impact on Carryovers and Carrybacks

by Donald P. Kipp, Jr.

Overview

The Accelerated Cost Recovery System (ACRS) may affect taxable income so significantly that many companies will generate periodic net operating losses as a result of disproportionately large investments that produce additional depreciation deductions. This is likely to occur in the first few years after significant investments are made. Net operating losses have a concomitant effect on using investment, foreign and other tax credits in the loss year and the years to which the loss is carried back or forward.

Net Operating Losses—Years Ended After December 31, 1975

The law retains the general three-year carryback period and increases the general carryforward period from seven to 15 years for losses incurred in tax years ended after December 31, 1975. The carryforward period for real estate investment trusts, regulated transportation corporations and certain losses of life insurance companies is increased from eight, nine, and seven years, respectively, to 15 years. The law retains the 10-year carryback and five-year carryforward period for financial institutions and for banks for cooperatives, the 10-year carryback period for product liability losses, the 10-year carryforward period for foreign expropriation losses and the 20-year carryforward period for Cuban expropriation losses. Generally, taxpayers can still elect to forego the carryback period and only carry the loss forward. This election must be made by the due date (including extensions) of the return for the loss year and is irrevocable. Unless this election is made, losses must first be carried back to the earliest carryback year and then carried forward to each successive tax year. When a loss is carried back, the tax before credits must be recomputed. The recomputed tax is then used to recompute any credits for that year.

Investment Tax Credit Carryovers—Years Ended After December 31, 1973

The Economic Recovery Tax Act of 1981 extends the general carryforward period from seven to 15 years for credits generated in tax years ended after December 31, 1973. The three-year carryback period is still mandatory.

Investment tax credits are consumed on a first-in, first-out (FIFO) basis. Thus, old credits are used before currently generated credits.

Investment tax credit that becomes a carryback as a result of a net operating loss carryback can be carried back three years from the year to which the loss is carried. The limitation for allowable investment tax credit is the tax as computed before credits, except for the allowable foreign tax credit.

Foreign Tax Credit

The rules applicable to the carryover of foreign tax credits are unchanged by the Act. Foreign tax credits are carried back two years and forward five years. Foreign tax credits generated in the current year are used first, then credits from the oldest year are used.

Other Credits

Prior law provided for a three-year carryback and seven-year carryforward period for work incentive program (WIN) credits and new employee jobs credits and a seven-year carryforward period for the alcohol fuel credit. The Act extends the carryforward periods for these credits to 15 years. The extended WIN credit applies to unused credit from years ended after December 31, 1973. The extended new employee jobs credit applies to unused credits from years ended after December 31, 1976 and the extended alcohol fuel credit applies to unused credits from years ended after September 30, 1980.

Capital Loss Carryback

The Act provides for a capital loss carryback election for regulated futures contracts. Under this election, net commodity futures capital losses may be carried back three years and applied against net commodities futures capital gains in the three prior years. This provision applies to property acquired and positions established by the taxpayer after June 23, 1981. Losses may be carried back to taxable years no earlier than those ending in 1981.

Credit for Research and Experimentation Expenditures

Under prior law, only a deduction and not a credit was specifically available for research and experimentation expenditures. The newly enacted legislation allows for a nonrefundable credit for certain types of research and experimentation expenditures to the extent they exceed that of the base period. This credit is in addition to the deduction that a taxpayer can claim for research expenditures. The amount of allowable credit is limited to the taxpayer's income tax liability for that year reduced by certain other nonrefundable credits. If the amount of allowable credit exceeds the limitation, the excess credit can be carried back three years (including carrybacks to years before enactment of the credit) and carried forward 15 years. This provision applies to research expenditures paid or incurred after June 30, 1981. See Chapter VII, page 103 for a detailed explanation of the new provisions regarding the research and experimentation credit.

Further Limitations

Acquisition. In certain tax free transactions, a corporation's attributes, such as its net operating loss carryovers, will continue in a new combined company. However, there are restrictions which may reduce or eliminate certain of those attributes.

One of those restrictions is imposed if there is a substantial change in ownership. Presently, this restriction will not apply if 20 percent or more of the fair market value of the stock of the combined company is owned by the shareholders of the company which had the attributes. The 20-percent ownership requirement must arise as a result of the ownership of stock in the company which had the attributes. For each percentage point below 20 percent that those shareholders own in the combined company, the attributes are reduced by five percent.

These rules were changed by the Tax Reform Act of 1976, but their application has been postponed until January 1, 1982. Unless Congress acts, after December 31, 1981 the present 20-percent ownership requirement will be raised to 40 percent. In addition, if the ownership requirement is not met, the computation of the amount of the reduction will be changed. The attributes will be reduced by 3.5 percent for each ownership percentage point below 40 percent but not below 20 percent and 1.5 percent for each ownership percentage point below 20 percent.

Currently, certain corporate attributes may be eliminated if the corporation's stock is acquired in a taxable transaction where there is a 50-percentage-point change in ownership and a change in business of the acquired corporation.

The change in stock ownership is measured by the 10 largest shareholders over a period of two taxable years.

Again, unless changed by Congress, after June 30, 1982 changes in the ownership of a corporation's stock may result in the reduction or elimination of certain of a corporation's attributes.

In order for the attributes to be reduced or eliminated, a greater than 60-percentage-point change in the ownership of the corporation's stock will be required. The change in ownership which may result from either a taxable or a nontaxable stock acquisition will be measured by the 15 largest shareholders and can take place over a period of three taxable years.

It will no longer be required that the corporation also change its business.

The reduction which will be required is 3.5 percent for each percentage-point change between 60 and 80 percent and 1.5 for each percentage-point change above 80 percent.

Groups Filing Consolidated Returns. When a corporation joins an existing consolidated group, carryovers generally are limited to the separate taxable income and income tax attributable to the separate corporation joining the group. Similarly, when there is a more than 50-percent change in the 15 largest shareholders of the common parent of a consolidated group of corporations, then, in general, the carryovers are limited to taxable income and income tax attributable to that consolidated group.

Tax Planning for Carryovers

With the extension of the net operating loss carryforward period to 15 years, it would be extremely rare for an advantage to be gained by accelerating income to use expiring net operating losses. To a lesser extent, the same would hold true for investment tax credit carryforwards which have also been extended to 15 years. In capital intensive industries, it may be better to "sell" the tax benefits by use of the safe-harbor lease provisions than to build up carryovers which will not be used until the distant future. These leasing provisions are covered in Chapter III, at page 49.

The most sensitive area for tax planning will be to maximize foreign tax credits. This is so because of the short carryback and carryforward periods (two years and five years, respectively). Planning for foreign taxes is also important because a foreign tax credit produces a dollar-for-dollar offset to U. S. taxes, whereas foreign taxes as a deduction normally yields a maximum U.S. tax benefit of only 46 cents for each dollar of foreign taxes paid.

Because of the above, companies will have to project taxable income for many years in the future and consider alternative courses of action to maximize the utilization of the various tax benefits available. For example, if a company builds a new plant this year it may mean that a plant expansion planned for two years from now should be leased instead of purchased. This would be true if investment credits generated by the second plant expansion will not be utilized until the distant future because of increased depreciation deductions generated by the first plant expansion. Conversely, it might be appropriate under certain circumstances to lease the plant being constructed this year, realize the present value of tax benefits currently and retain tax ownership of the plant to be built in two years. Because of the number of years involved, effective tax planning will only be possible by gathering information for several years and analyzing the likelihood of many alternatives.

Carryover and Carryback Periods
Present Law Contrasted With Prior Law

	Carryover and Carryback Periods	
Net Operating Losses	*Prior Law*	*Present Law*
General—Losses after 12/31/75	3 years back 7 years forward	3 years back 15 years forward
Regulated Transportation Corporations	3 years back 9 years forward	3 years back 15 years forward
Foreign Expropriation Losses	no carryback 10 years forward	no carryback 10 years forward
Real Estate Investment Trusts	no carryback 8 years forward	no carryback 15 years forward
Financial Institutions	10 years back 5 years forward	10 years back 5 years forward
Bank for Cooperatives	10 years back 5 years forward	10 years back 5 years forward
Certain Losses of Life Insurance Companies	3 years back 7 years forward	3 years back 15 years forward
Credits		
Foreign Tax Credit[1]	2 years back 5 years forward	2 years back 5 years forward
Investment Tax Credit[2] — Credits generated after 12/31/73	3 years back 7 years forward	3 years back 15 years forward
WIN Credit [3]	3 years back 7 years forward	3 years back 15 years forward
Alcohol Fuel Credit[3]	no carryback 7 years forward	no carryback 15 years forward
Credit for Research and Experimental Wage Expenditures[3]	no credit available under prior law	3 years back 15 years forward
Other		
Capital Losses—Corporations in General	3 years back 5 years forward	3 years back 5 years forward
Product Liability Losses	10 years back 7 years forward	10 years back 7 years forward

NOTES:

[1]Foreign tax credits generated in the current year are used first; then credits from the earliest year are used. In addition, a taxpayer may elect to take foreign taxes as a deduction instead of as a credit at any time before the statute of limitations expires for the year the credit or deduction is generated.

[2]For taxable years after 1975, investment tax credits generated in the earliest year are used first.

[3]Credits generated in the current year are used first; then credits from the earliest year are used.

Chapter V—International Aspects

by Eli H. Fink

General Rules

Personal Property. The changes made by the Economic Recovery Tax Act of 1981 in the depreciation of foreign assets differ significantly from the sweeping revisions brought about in the domestic area. Under prior law, the cost of personal property used predominantly outside the United States was depreciated by many taxpayers over a period equal to the Asset Depreciation Range (ADR) midpoint life. The taxpayer, however, was not bound by the prescribed ADR recovery period; the useful life selected for a particular asset could be based on facts and circumstances, which in many cases corresponded to the book life. Regardless of which method was chosen to determine useful life, the taxpayer was still free to choose either an accelerated or a straight-line method of depreciation.

Under the new law, however, the taxpayer's choices are severely limited. If the taxpayer opts for accelerated depreciation, the cost of the foreign assets must be depreciated using a recovery period equal to the ADR midpoint life in effect on January 1, 1981. The Treasury has been authorized to issue tables setting forth the appropriate recovery percentage to be used in calculating depreciation. The tables are to be designed to duplicate the result that would be obtained from the use of the 200-percent declining-balance method in the early years, followed by a switch to the straight-line method in later years. The percentages provided in the tables will reflect the use of the half-year convention in the year such assets are placed in service and will disregard salvage value. For personal property for which there was no corresponding guideline class as of January 1, 1981, the Act provides a 12-year recovery period. Reliance on facts and circumstances to justify the use of a recovery period other than the ADR midpoint life will no longer be permitted.

In lieu of the foregoing method, the taxpayer may elect to use the straight-line method over one of the following three periods:

In the Case of:	*Periods Available:*
3-year property	ADR Class, 5 or 12 years
5-year property	ADR Class, 12 or 25 years
10-year property	ADR Class, 25 or 35 years
15-year public utility property	ADR Class, 35 or 45 years

Under no circumstance may the recovery period corresponding to the second or third alternative be shorter than the ADR midpoint life. Accordingly, the only flexibility built into the modified system of depreciating foreign assets is the ability to employ the straight-line method over a longer period of time than that permitted under ADR. The primary beneficiary of this added flexibility would appear to be the taxpayer who finds himself in a loss position. As is true under the prescribed accelerated method, the half-year convention will apply if the straight-line method is elected.

Since there are more than 100 classes of assets under ADR, it will continue to be important to ascertain properly the appropriate ADR class for the foreign asset involved.

Assets placed in service in the same tax year that share the same midpoint life and ACRS class will be grouped together, and elections with respect to recovery period and method will be made on a class-by-class basis.

Schedule 1 below provides examples of these rules with respect to certain assets.

A foreign asset is defined as property used predominantly outside the United States during the taxable year. Property is considered used predominantly outside the United States if the property is physically located outside the United States during more than 50 percent of the taxable year.

In the case of property placed in service after the beginning of the taxable year, only the period of service is considered in determining whether the property was used predominantly outside the United States.

It is not clear how the new rules would apply when the location of use changes from foreign to domestic after the first taxable year.

The following assets represent some of the exceptions to the predominant-use rule and will thus be considered U.S. assets:

1. Aircraft registered by the Federal Aviation Agency and operated to and from the United States or under contract with the United States
2. Rolling stock of a domestic railroad corporation that is used within and without the United States
3. Vessels documented under the laws of the United States and operated in the foreign or domestic commerce of the United States
4. Property owned by U.S. citizens or U.S. corporations (other than section 936 corporations) that is used predominantly in U.S. possessions

5. Property (other than a vessel or an aircraft) of a U.S. person used for the purpose of exploring, developing, removing or transporting resources from the Outer Continental Shelf

Assets of a section 936 corporation used in a possession are considered to be foreign assets and are ineligible for depreciation under the Accelerated Cost Recovery System (ACRS). Accordingly, consideration should be given to placing assets to be used in a possession in a domestic corporation that, in turn, leases them to a corporation organized in a possession. Lease rents of the domestic company may then be reduced by depreciation under ACRS, while the local tax benefits will still be available to the company operating in the possession.

Real Property. The rules with respect to real property located abroad parallel the changes made in the personal-property area. The accelerated method calls for a recovery period of 35 years and a rate based on the use of the 150-percent declining-balance method for early years and the straight-line method in later years. In the computation of depreciation expense, both salvage value and facts and circumstances in support of a shorter useful life will be disregarded.

The taxpayer has the same flexibility in connection with the election to use the straight-line method. The recovery periods that correspond with this method are 35 and 45 years. However, unlike the treatment of personal property, the elections with respect to method and recovery period may be made on a property-by-property basis. Furthermore, the half-year averaging convention is not permitted in calculating depreciation of realty. Basis recovery in the year of acquisition and disposition will be determined by reference to the number of months the property is in service. (To contrast the new U.S. rules with the depreciation rules in various European countries, see page 90.)

Foreign Subsidiaries' Earnings and Profit Changes. The adjustment of earnings and profits relating to depreciation will vary, depending on whether the asset is owned by a foreign corporation or a branch. For the former, the charge to earnings and profits will be computed in accordance with the rules prescribed for calculating foreign-asset depreciation expense. Where, however, the asset is used by a foreign branch, the charge to earnings and profits will be determined in accordance with the rules provided for assets used predominantly within the United States. Accordingly, in the case of a branch, the adjustment of earnings and profits for depreciation in any taxable year will be the amount determined under the straight-line method, using a recovery period of five, 12, 25 or 35 years, depending on the class of property involved.

Effect on Foreign Branches

The taxpayers who will be most affected by the changes implemented in the area of foreign-asset depreciation by the Economic Recovery Tax Act of 1981 are those with a history of depreciating fixed assets over a period shorter than the ADR midpoint life—in other words, those who selected useful lives using the facts-and-circumstances test.

It is not uncommon for taxpayers to conduct their operations outside the United States in the form of a branch rather than as a subsidiary. Although the income generated by the foreign branch is subject to tax in both the U.S. and the foreign jurisdictions, the foreign tax credit mechanism operates so that the taxes paid or accrued in the foreign country that are equal to the U.S. effective tax rate are creditable against the U.S. tax liability. Any excess is available for carryback or carryforward to other taxable years. Taxpayers often preferred the branch to the subsidiary because the subsequent distribution of profits did not attract a dividend withholding tax. Such an add-on tax would only have compounded the problem created by the section 904 limitation on current foreign tax credit utilization.

With the loss of the taxpayer's right to use the facts-and-circumstances test in selecting useful lives for foreign assets, the foreign source component of taxable income is likely to increase, because there will be a lower depreciation charge on these assets. Consequently the U.S. tax on this income will be increased unless the taxpayer has excess foreign tax credits.

The additional U.S. tax on foreign branch income may in certain instances cause reevaluation of the decision to operate abroad in branch form. The additional withholding tax on dividends payable, if the operations were conducted in subsidiary form, may no longer drive the effective foreign rate above the U.S. rate, and all of the foreign taxes could now be offset against the U.S. tax liability. Operating abroad through a foreign subsidiary has the advantage of allowing the taxpayer to time the recognition of foreign income to its maximum advantage.

Effect on Foreign Subsidiaries

The changes occasioned by the new Act may prompt taxpayers who conduct their foreign operations through a subsidiary to repatriate accumulated foreign earnings and profits immediately if the earnings and profit lives used were shorter than the newly prescribed rules. The incentive for immediate dividend distribution would be the avoidance of the adverse impact that the increase in earnings and profits resulting from the reduction in the annual depreciation charge will have on the deemed-paid foreign tax credit (section 902 credit). The formula provided for computing the amount of underlying foreign taxes deemed to have been paid by the U.S. shareholder upon receipt of dividends is as follows:

$$\frac{\text{Dividends received}}{\text{After-tax earnings and profits}} \times \begin{array}{c}\text{Creditable}\\ \text{foreign taxes}\end{array} = \begin{array}{c}\text{Deemed-paid}\\ \text{credit}\end{array}$$

With the advent of the new law, the important number that would change in the above formula would be the denominator of the first term (after-tax earnings and profits). An increase in this component of the formula impairs the ability of the shareholder to utilize all the foreign taxes paid by the foreign corporation with respect to the earnings that are the subject of the distribution. The following example will serve to illustrate this point more clearly.

Y Corp., a controlled foreign corporation, has the following earnings and profits account:

Year	*Pre-tax Earnings and Profits*	*Taxes Paid (40% Effective Rate)*	*After-tax Earnings and Profits*
1980	$ 3,500	$1,400	$2,100
1979	2,500	1,000	1,500
1978	1,000	400	600
1977	2,500	1,000	1,500
1976	2,500	1,000	1,500
1975	700	280	420
Total	$12,700	$5,080	$7,620

In 1981, Y Corp. realized the same economic income as in the preceding year. However, because of the extension of the fixed-asset recovery period required by the new Act, pre-tax earnings and profits amounted to $4,500, an increase of $1,000 over the previous year. The tax liability to the foreign country was computed on the basis of taxable income as determined by the laws of the foreign country and thus amounted to $1,400, the same as was determined on the preceding year's income. Consequently, after-tax earnings and profits totaled $3,100.

At the end of 1981, Y Corp. declared and paid a dividend of $8,000. That dividend will be deemed to be paid first out of current earnings and profits ($3,100), with the remainder ($4,900) coming from years 1980 back through 1978 ($4,200) and a portion ($700) from 1977. The U.S. shareholder will be entitled to a section 902 credit equal to 100 percent of the foreign taxes paid in years 1978 through 1981 and 46.67 percent (700/1,500) of the taxes paid in 1977, for a total credit of $4,667 ($1,400 + $1,400 + $1,000 + $400 + $467). The shareholder will include in gross income the amount of the dividend ($8,000) plus the section 78 gross-up ($4,667) for a total of $12,667. U.S. federal income tax thereon amounts to $5,827 ($12,667 × 46 percent) and, barring any section 904 limitation on the utilization of credits, the shareholder may offset this liability with a foreign tax credit of $4,667. The total added tax cost of receiving this dividend is $1,160 ($5,827 additional tax less $4,667 foreign tax credit.)

If, however, the new legislation were not in effect in 1981, pre-tax earnings and profits for that year would be $3,500 and after-tax earnings and profits would be $2,100. Because of the reduction in accumulated profits, the same $8,000 dividend would have been deemed paid out of earnings and profits all the way back to 1976, so that instead of a foreign tax credit of $4,667, the shareholder would have been entitled to $5,333. The U.S. tax liability on the gross-up dividend of $13,333 ($8,000 + $5,333) would have been $6,133 ($13,333 × 46 percent) against which the $5,333 credit would be applied. The added tax cost of the dividend under the old law would have been $800 ($6,133-$5,333), as compared with $1,160, a saving of $360 ($1,160-$800).

What is illustrated in the above example is that the effective tax rate in the foreign country, already below that of the United States, is being further reduced as a function of the increase in earnings and profits prescribed by the new tax law. Upon distribution of dividends, the amount of taxes creditable under section 902 of the Code is only the amount that represents the modified effective rate multiplied by the gross-up dividend. As the spread between the U.S. and foreign effective tax rates increases, the added U.S. tax cost also increases. Delay on the part of a foreign corporation in making distributions only decreases the likelihood that they will be deemed to come from a year in which earnings and profits were taxed at a greater effective rate.

The example provided above assumed a foreign tax rate below that imposed by the United States. Where, however, the foreign rate is such that the shareholder finds itself with expiring excess foreign tax credit carryovers, the enactment of the new law is not likely to have an adverse impact. The increased U.S. tax liability resulting from the larger dividend would be offset by the application of the expiring foreign tax credit carryovers.

In addition, because the new provisions will probably reduce overall U.S. tax liability, increased attention must be given to foreign tax credit planning in order to avoid excess foreign tax credits. This would include identifying additional items of foreign source income and reduction of expenses allocable to foreign income. Increased attention should also be given to minimizing the foreign taxes paid abroad.

Other Ramifications

The significance of the depreciation provisions of the Economic Recovery Tax Act of 1981 is not limited to the computation of the foreign tax credit limitation; they have an impact on many other areas as well. The discussion that follows highlights some of these.

Allocation of Interest Expense Under Section 1.861-8(e)(2)(v) of the Income Tax Regulations. The concept that money is fungible and that interest expense is attributable to all activities is the premise behind the regulations that require the allocation of interest expense to foreign and U.S. source income. The taxpayer is given the option of allocating interest expense in accordance with either the asset-allocation or the gross-income method. With respect to the former, the taxpayer categorizes its gross assets as either foreign or domestic. The average tax book value or fair market value, if determinable to the satisfaction of the Internal Revenue Service, of foreign assets expressed as a percentage of the average tax book value or fair market value of all assets is the amount that when multiplied by interest expense is allocated to foreign source income.

The effect that the changes in the depreciation area will have on the allocation of interest expense is uncertain at this time. The rapid write-off of domestic-use assets under ACRS is certain to accelerate the reduction in adjusted basis. On the foreign-use side, the elimination of facts and circumstances as a basis for determining useful lives is likely to retard the reduction in adjusted basis. These two factors operating in concert support the contention that more interest expense is likely to be allocated to foreign source income under the asset-allocation method as a result of the enactment of the new law. Counterbalancing this contention, however, is the expectation that the incentive on the U.S. side and the disincentives on the foreign side will prompt U.S. corporations to invest in domestic-use as compared with foreign-use assets to such an extent that, even after factoring in the accelerated reduction in basis, the ratio of U.S. to total assets will not change dramatically.

Allocation of Interest Expense Under Section 1.882-5 of the Income Tax Regulations. In computing the taxable income of a foreign corporation that is effectively connected with the conduct of a trade or business in the United States, the amount of interest expense allowed as a deduction is calculated in accordance with the aforecited regulation. In determining interest expense in this instance, the average value of assets that contribute or could reasonably be expected to contribute to the realization of income effectively connected with a U.S. trade or business as a function of the worldwide assets is a relevant factor. As asset values for purposes of the allocation percentages are to be determined in accordance with U.S. tax principles, the introduction of ACRS and the depreciation changes in the foreign area will affect the calculation of interest expense. Since most foreign corporations doing business in the United States are likely to have more of their assets located abroad, it is reasonable to expect the U.S. asset values to decrease at a faster rate than total asset values. This in turn may lead to less interest expense being deductible by the foreign corporation in the United States.

Effect of Depreciation Changes on Losses. As was mentioned earlier, the principal beneficiary of the flexibility built into the new system is the taxpayer that finds itself in a loss position. By electing the straight-line method of depreciation over one of the three periods provided for under this election, the taxpayer can effectively reduce the loss. The significance of this loss-minimization approach will now be discussed in greater detail.

Revenue Ruling 74-550. In this revenue ruling, the taxpayer, a foreign corporation, declared a dividend to its U.S. parent which, by virtue of section 902 of the Code, was entitled to a credit for the underlying foreign taxes paid by the subsidiary. The subsidiary had sustained losses in certain of the preceding taxable years; however, the foreign country to whose taxing jurisdiction the subsidiary was subject did not provide a mechanism for the utilization of such losses. As the amount of the distribution was in excess of the subsidiary's current earnings and profits, it was necessary to go back to earlier years for purposes of determining whether the distribution was in fact a dividend and, if so, the amount of the deemed-paid credit. The ruling referred to the ordering rule prescribed by section 1.243-4(a)(6) of the Income Tax Regulations, which provides that a deficit in earnings and profits shall reduce the most recently accumulated earnings and profits for a prior taxable year. In so doing, the loss carryback eliminated the earnings and profits of prior years, and the benefit of the taxes paid with respect to those earnings was lost.

To date the authority of Rev. Rul. 74-550 has not been challenged in the courts. In light of the ruling's continued vitality, taxpayers should be advised to minimize losses for foreign subsidiaries, because failure to do so will adversely affect the utilization of prior years' foreign tax credits. They should consider electing the straight-line method of depreciation and, if necessary, selecting the longest recovery period available. It should be noted that it is unclear whether an election to use a longer depreciable life may be limited to one subsidiary or whether it must apply to all subsidiaries. If the latter is correct, careful consideration of the total impact on all subsidiaries is necessary before making the election.

Effect of New Law on Investment in the United States. The comprehensive change in the tax treatment of depreciable assets may entice certain foreign businesses to transfer their capital-intensive operations, presently conducted in some other tax haven, to the newest of tax havens, the United States. The veritable tax holiday granted taxpayers through the introduction of ACRS and the modification of the leasing provisions would be particularly attractive to those foreign producers whose goods are intended for ultimate consumption in the United States. Production in the United States would both eliminate a large portion of the expense of transporting such merchandise and shield the producer from the imposition of protectionist import tariffs. However, the rules with respect to the determination of earnings and profits should be considered. While the assets could be depreciated over the short recovery period on an accelerated basis, the earnings-and-profits charge for depreciation is computed on a straight line over longer lives (12 years for five-year recovery property). Earnings and profits determinations govern whether distributions are subject to the U.S. withholding tax. Therefore while there may be a significant reduction in the U.S. income tax imposed on the earnings there could still be a withholding tax imposed upon repatriation of those earnings to the foreign investor.

Effect of Legislation on Real Property Investments in the United States. The overall liberalization of the depreciation rules with respect to real property situated in the United States is bound to attract even more foreign investment than in the near recent past. The Act introduces the 15-year recovery period coupled with the right to use accelerated recovery percentages. Taxpayers also have the option of using the straight-line method over recovery periods of 15, 35 or 45 years.

The rules governing dispositions of real property have also been modified. Whereas, under the old law, gain was treated as ordinary income only to the extent that the depreciation deducted exceeded the amount that would have been allowed had the straight-line method been used, the new law distinguishes between residential and non-residential property in the recharacterization of gain on disposition. With respect to non-residential realty, if the prescribed accelerated recovery method is employed, all gain will be ordinary income to the extent of recovery allowances previously taken. However, if the straight-line method is chosen, all gain will be capital in nature. In connection with residential real property, depreciation will be recaptured only to the extent that the amount so taken exceeds the amount that would have been allowed had the straight-line method been used over a 15-year period. No recapture results from the disposition of residential realty that has been depreciated under the straight-line method.

The law also makes a number of technical changes in U.S. taxation of foreign persons disposing of U.S. real estate. These amendments are designed to eliminate certain loopholes under the Foreign Investment in Real Property Tax Act of 1980.

Allocation of Research and Development Expenses. The new law provides a two-year suspension of the rules for allocating and apportioning research and development expenses under section 1.861-8 of the Income Tax Regulations. The suspension applies to the first two taxable years beginning within two years after August 13, 1981.

During the taxable years in which section 1.861-8 of the Income Tax Regulations is suspended, research and development expenses for research activities conducted within the United States will be allocated and apportioned to sources within the United States. This provision will be of significant benefit to taxpayers with extensive research and development expenses and foreign source income. The expenses for research and development will therefore not affect the ability of the taxpayer to utilize the foreign tax credit.

Gains or Losses from Certain Forward Sale Terminations. Many companies enter into forward sale contracts of foreign currency to protect against foreign-exchange fluctuations. In closing out contracts in which a loss is expected, the holder may have attempted to obtain ordinary loss treatment by canceling the contract, since there was no "sale or exchange." This option is now foreclosed by a one-sentence amendment to the Code which treats the cancellation as a sale or exchange. New section 1234A of the Code states that gain or loss attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to personal property that is (or on acquisition would be) a capital asset in the hands of the taxpayers shall be treated as a gain or loss from the sale of a capital asset. The new rules under sections 1092 and 1256 of the Code should also be considered in reviewing the tax impact of hedging foreign assets.

International Leases. There has been much publicity surrounding the so-called "double dip" lease. Because of the differences in the tax treatment of leases in various countries, potential exists for enjoyment of accelerated depreciation deductions and credits by more than one party to the lease. The typical transaction involved the purchase by a U.K. lessor of equipment for use by a U.S. lessee. As the rules for determining what constitutes a valid lease for U.K. purposes are more liberal than those of the United States, the British lessor would be entitled to the tax benefits of ownership in the United Kingdom. Because the arrangement failed to satisfy the stricter U.S. standards, the parties believed that they could recast the transaction as a financed sale between the U.K. lessor and the U.S. lessee. Thus, the U.S. party would be entitled to all the tax benefits ordinarily enjoyed by bona fide owner-lessors. This kind of transaction raised a number of difficulties and was not entirely to the liking of U.K. authorities.

The safe-harbor leases introduced by the Act (see page 49) would appear to be available to foreign lessors provided they are deemed engaged in a trade or business in the United States and the leasing income is effectively connected income.

Miscellaneous. ***Section 956 of the Code.*** A U.S. shareholder of a controlled foreign corporation (CFC) may have to include an amount in income if the CFC's increases in earnings are invested in U.S. property. The amount of an investment in U.S. property is measured by reference to the property's adjusted basis decreased by any liabilities to which it is subject. The ACRS provisions for U.S. assets will affect the amount of U.S. property for purposes of section 956 of the Code.

DISCs. The larger depreciation deductions available under ACRS may have the effect of reducing export taxable earnings and thereby reducing the amount of tax deferral available under the Domestic International Sales Corporation (DISC) provisions.

Section 1.861-8 of the Income Tax Regulations must be used in computing the combined taxable income of a DISC and its related supplier. It is not clear how the two-year suspension of the rules for allocating research and development expenses under regulation 1.861-8 will affect the computation of combined taxable income.

Schedule 1
Economic Recovery Tax Act
Example of Prescribed Lives for Assets Used Outside the United States

Description of Assets	*ADR Class Life*	*200% Accelerated*	*Straight Line*		
		Option 1	*Option 1*	*Option 2*	*Option 3*
Heavy general-purpose trucks	6	6	6	12	25
Manufacture of electronic components	6	6	6	12	25
Offshore drilling	7.5	7.5	7.5	12	25
Mining	10	10	10	12	25
Manufacture of paperboard	10	10	10	12	25
Printing industry	11	11	11	12	25
Manufacture of glass products	14	14	14	14	25
Manufacture of cement	20	20	20	20	25
Water transportation	20	20	20	20	25
Liquified natural gas plant	22	22	22	22	25

Note—Earnings and profits charge is the same as depreciation charge above in the case of a qualifying foreign corporation. In the case of a branch, the charge will be computed using the straight-line method and a 12-year recovery period.

Depreciation Rules in European Countries[1]

Austria. Depreciation may be calculated on either the straight-line or the declining-balance method, although the latter may not be used if accelerated first-year depreciation or investment allowances are claimed or if an investment reserve is used for the purchase of an asset. Rates of depreciation depend upon the type of asset and its anticipated life. Examples of straight-line rates include: buildings (five percent); movable assets costing less than AS 2,000 (100 percent first year); and other movable assets (10 percent to 20 percent). Alternative declining-balance rates for movable assets, based on the anticipated life in years, are: five years (44 percent); 10 years (30 percent); 20 years (18 percent); and 25 years (15 percent).

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[1]The depreciation rules are excerpted from the Deloitte Haskins & Sells publication "Corporate Taxation in Europe" (September 1, 1980). Copies of this book may be obtained by writing to:

Distribution Department
Deloitte Haskins & Sells
1114 Avenue of the Americas
New York, N.Y. 10036

If the straight-line method is used, business assets (other than most real property and motor vehicles) are eligible for an additional first-year write-off of 50 percent. Accelerated first-year depreciation at 60 percent of the cost is allowed for environmental-protection assets and for assets used to develop or improve economically important inventions, or for energy production.

As an alternative to additional first-year depreciation allowances, Austria grants an investment allowance of 20 percent of the cost of certain depreciable business assets, provided they remain in the business for at least five years. This allowance reduces taxable income, but does not reduce the depreciable basis of the asset. If these assets are disposed of within the five-year period, the amount of the allowance already granted is included in taxable income.

Intangibles, such as patent rights, that produce income and have a limited life are amortizable.

Belgium. Depreciation is normally calculated on the straight-line method. Rates are usually agreed upon by the taxpayer and the tax authorities, in which case the amounts recorded in the books are allowed for tax purposes. The following depreciation rates are generally acceptable: office buildings (three percent), industrial buildings (five percent), machinery (10 percent), office equipment (12.5 percent to 15 percent), and vehicles (20 percent to 25 percent). Declining-balance depreciation at up to twice the straight-line rate is allowed for tangible and intangible depreciable property acquired after 1976. Previously, only assets with a life of from six to 19 years were eligible.

A temporary provision, which has expired, allowed depreciation at will of up to 110 percent of the cost of assets acquired between March 1, 1977 and June 30, 1978.

Denmark. Commercial buildings must be depreciated on the straight-line method. Depending on the purposes for which a building is used, the depreciation rates are either six percent for the first 10 years and two percent thereafter, or four percent for the first 10 years and one percent thereafter. The higher rates are granted primarily for buildings used for industrial purposes. A temporary increase from six to 10 percent for the first two years can be applied to construction commenced during 1979 and 1980. Office buildings are not depreciable unless they are part of an industrial facility.

Most other depreciable property is grouped together and depreciated on the declining-balance method. Rates are discretionary, but cannot exceed 30 percent (15 percent for assets acquired in the second half of the year). The depreciation rate is applied to the total net book value of depreciable assets at the beginning of the year, less proceeds from disposals, plus the cost of additions.

Depreciation is permitted for certain long-term construction contracts. If the total contract price exceeds DKr. 700,000, 30 percent of the excess can be written off during the years prior to acceptance of the asset. The advance depreciation period cannot exceed four years, and the annual deduction cannot exceed 15 percent of the total contract price.

France. Depreciation may be computed using either the straight-line method or the declining-balance method, except that the latter may not be used for most buildings, short-lived assets, or used property.

Normally, acceptable straight-line rates are for industrial buildings (five percent); office and residential buildings (four percent); machinery, equipment, and tools (10 percent to 20 percent); fixtures, fittings, and installations (10 percent); office equipment (10 percent to 20 percent); and vehicles (15 percent to 25 percent). Declining-balance rates are 1.5 to 2.5 times the straight-line rates, depending on the useful life of the asset.

Buildings acquired for scientific research are eligible for a 50 percent first-year write-off, with the balance being subject to straight-line depreciation.

Germany (Federal Republic of). Depreciation of most assets may be computed using either the straight-line or the declining-balance method. Buildings must be depreciated on the straight-line method.

If declining-balance depreciation is used, rates cannot exceed the higher of 2.5 times the straight-line rate or 25 percent.

Intangibles are usually amortizable if they have a limited life. Patents may be amortized over five years using the straight-line method.

Investments in West Berlin and eastern border regions qualify for accelerated depreciation.

The usual straight-line rates include: buildings (two percent to 3.5 percent), machinery (10 percent), office equipment (20 percent), and vehicles (20 percent to 33.3 percent).

Greece. Depreciation generally may be computed only on the straight-line method at rates fixed by the Ministry of Finance. Examples include: industrial buildings (eight percent), machinery and equipment (10 percent to 15 percent), office equipment (15 percent), furniture and fixtures (20 percent), trucks (20 percent), and other vehicles (12 percent).

Accelerated depreciation is sometimes permitted for industrial property investments in certain regions.

Ireland (Republic of). Tax depreciation need not agree with book depreciation. Tax depreciation for industrial buildings and hotels is computed on the straight-line method, but the declining-balance method is available for machinery and equipment. For all new items (except motor vehicles), initial depreciation may be claimed. The rates are as follows:

	Initial	*Annual Allowances on Balance*
Hotels	10%	10%
Industrial buildings	50%	4%
Motor vehicles	-	20%
Machinery and equipment	100%	10%, 12%, 25%

Investments in hotels, industrial buildings, machinery, and equipment may qualify for "free depreciation," under which all or any portion of the depreciable basis may be written off at will. Used machinery and equipment are not eligible for free depreciation or initial depreciation.

The total of initial and annual allowances cannot exceed cost.

If the investment in new machinery and equipment is for use in designated development areas (mainly Western Ireland), an additional 20 percent of cost may be deducted as a special allowance. This allowance does not reduce the depreciable basis of the assets acquired.

Patents may be amortized over their useful lives, but most other intangibles are not amortizable.

Italy. Depreciation must normally be computed using the straight-line method. The government has established specific rates for assets used in various industries. Typical maximum rates include: buildings (three percent to seven percent), machinery and equipment (six percent to 17 percent), office furniture and fixtures (12 percent), and automobiles (20 percent to 25 percent).

Intangibles may be amortized over their useful lives. If an asset's life is indeterminable, a 20 percent rate may be used.

Accelerated depreciation may be claimed for tangible and certain intangible assets in the first three years. The additional depreciation cannot exceed 15 percent of cost in each year.

Luxembourg. Straight-line depreciation must be used for buildings and intangible assets, such as patents. For other tangible assets, either the straight-line or the declining-balance method may be used. Declining-balance rates may not exceed the lower of twice the straight-line rate or 20 percent.

Typical straight-line depreciation rates include: industrial buildings (four percent), office buildings (two percent), machinery (eight percent to 12 percent), office equipment (10 percent), and vehicles (25 percent).

The Netherlands. Depreciation may be calculated on any reasonable basis. There are no official guidelines, but, in practice, rates are agreed upon by the tax authorities and the taxpayer. Tax depreciation need not correspond to book depreciation. The following straight-line rates are normally used: industrial and commercial buildings (1.5 percent to two percent), machinery (10 percent), office equipment (10 percent), and vehicles (20 percent to 33.3 percent).

Intangible assets are amortizable if they have a limited useful life.

Norway. Depreciation is calculated using the straight-line method. Tax depreciation must be the same as depreciation recorded for book purposes. Published government guidelines are generally used to determine depreciation rates. Examples of these rates are: buildings (two percent to five percent), machinery and equipment (five percent to 15 percent), motor vehicles (10 percent to 20 percent), and office equipment (10 percent).

Additional depreciation is allowed for depreciable assets other than certain commercial buildings (used for offices, shops, hotels, etc.) and motor vehicles. Such additional depreciation may be taken only for the first year of use and the four subsequent years. The maximum additional depreciation in any one year is the lesser of half the regular depreciation or five percent of the asset cost, but the total claimed for the five years cannot exceed 15 percent of cost.

Alternatively, certain assets are eligible for an initial allowance which may be claimed in addition to ordinary depreciation. The initial allowance for a qualified asset may be deducted over a period of five years, but the allowance cannot exceed 50 percent of taxable income in any one year. Certain buildings and facilities for production or storage of goods and drilling platforms or drillships are eligible for the initial allowance of 25 percent of cost in excess of NKr. 500,000. Ships and aircraft are similarly eligible for the 25 percent initial allowance, but the NKr. 500,000 minimum does not apply.

Intangible assets, other than goodwill, may be amortized over their useful lives.

Portugal. The straight-line method is the only approved depreciation method. Maximum rates are set by law for assets in many industries, but, in some cases, the authorities may grant permission to use accelerated rates. Typical depreciation rates are: industrial buildings (four percent), office buildings (two percent), machinery and equipment (10 percent to 25 percent), office equipment (10 percent to 14 percent), vehicles (20 percent), and patents (10 percent).

Spain. Depreciation is generally deductible to the same extent it is recorded as an expense for financial-statement purposes, provided the amounts claimed do not exceed government guidelines. Normally, depreciation is computed on the straight-line method, but permission to use accelerated depreciation is sometimes granted. Guidelines have not been revised to reflect the 1979 Spanish tax changes; however, under prior law, the following straight-line rates were acceptable: industrial buildings (three percent to four percent), machinery and equipment (eight percent to 12 percent), and vehicles (14 percent to 15 percent).

The cost of most intangible assets (except goodwill and trademarks) may be amortized for tax purposes to the same extent as for financial-statement purposes.

Sweden. Buildings must be depreciated by the straight-line method. For other depreciable assets, the taxpayer may claim depreciation computed on the same basis as for financial-statement purposes (book method), or a special tax-depreciation method (tax plan) can be adopted. If the book method is chosen, at the end of each year the taxpayer can deduct either 30 percent of the net book value at the end of that year (declining balance) or 20 percent of original asset cost (straight line).

If a separate tax method of depreciation is adopted, the straight-line method is used with the following representative rates: industrial and commercial buildings (two percent to five percent), machinery and equipment (10 percent), office equipment (10 percent), automobiles (10 percent to 15 percent), and other motor vehicles (20 percent to 25 percent).

Under the tax-plan method, depreciation may be deferred to a later year if the taxpayer currently has no profits.

Intangible assets such as patents, trademarks, and goodwill are subject to the same depreciation rules as machinery.

Switzerland. The most common method of calculating depreciation is the declining-balance method, but the straight-line method is permitted. Official guidelines are published, but are not mandatory. If the depreciation method is approved by the tax authorities, the book depreciation is allowed for tax purposes. Rates vary widely among the various cantons.

The following declining-balance rates are generally acceptable: commercial buildings (four percent), industrial buildings (eight percent), machinery and equipment (30 percent to 40 percent), office equipment (25 percent), and vehicles (40 percent). Straight-line rates are one-half of those rates.

The cost of intangible assets used in a business, such as patents, trade names, goodwill, and licenses, may be amortized at a 40 percent declining-balance rate or 20 percent straight-line rate.

United Kingdom. Depreciation recorded for financial-statement purposes is not allowed for tax purposes; instead, specific capital allowances are provided for certain assets, and these are deductible. Capital allowances are granted for industrial buildings and certain hotels, machinery and equipment, research equipment, mineral deposits, agricultural assets, and industrial technology and patents. No allowance is available for investments in land, nonindustrial buildings, trademarks or goodwill.

For new industrial buildings, a first-year allowance of 50 percent of construction cost may be claimed. The balance is deductible on the straight-line method at an annual rate of four percent. Used industrial buildings are not granted a first-year allowance, but an annual allowance is deductible. The deductible amount is computed by writing off, on a straight-line basis, the lower of purchase price or original construction cost over the unexpired portion of 25 years beginning with the date the building was placed in service.

For machinery and equipment (except automobiles), a first-year allowance is deductible, at the taxpayer's option, for any amount up to 100 percent of asset cost. Any amount not claimed as a first-year allowance is written off on the declining-balance method at a 25 percent rate. Automobiles are depreciated using the declining-balance method at a rate of 25 percent, subject to a maximum of £ 2,000 per vehicle per year.

Industrial know-how costs can be written off over six years using the straight-line method. Patent costs are deductible on a straight-line basis over a 17-year period or, if less, the unexpired term of the patent.

Chapter VI—Impact on Merger and Acquisition Considerations

Stephen B. Bauer

Overview

In the area of mergers and acquisitions, the Economic Recovery Tax Act of 1981 does not present any new or altered tax treatments to be applied to corporate acquisitions, dispositions or reorganizations (other than reorganizations involving certain savings and loan associations). However, since the intended impact of the Act is economic in nature, all merger and acquisition activities must be reviewed to ascertain its effect. The new provisions discussed in this chapter relate to property involved in corporate mergers and acquisitions and placed in service after December 31, 1980.

Taxable versus Tax-Free Transactions. Traditionally, there has always been a trade-off between taxable and tax-free transactions. Taxable transactions generally afford the acquiring corporation write-offs equal to the amount paid for the acquired corporation's depreciable and amortizable property, while subjecting the shareholders of the acquired corporation to an immediate tax. On the other hand, tax-free transactions generally permit the shareholders of the acquired corporation to defer the payment of tax, while denying the acquiring corporation a step-up in basis. With the maximum tax rate for individual long-term capital gains reduced to 20 percent, coupled with the benefits of the Accelerated Cost Recovery System (ACRS), there may be a trend, at least initially, toward selecting the taxable alternative.

Taxable transactions usually take one of two forms:

- The shareholders of the acquired corporation sell their shares directly to the acquiring corporation. The acquired corporation is then liquidated in a section 334(b)(2) transaction or a section 346 transaction (page 100).
- The acquired corporation adopts a plan of liquidation, sells off its assets and subsequently distributes the proceeds of sale to the shareholders within a 12-month period.

The tax consequences of the two forms are essentially identical, except as to who bears the liability for recapture taxes, if any. In the former, the recapture tax liability becomes that of the acquiring corporation; in the latter, it remains with the shareholders of the acquired corporation.

Foreign Investment in the United States. In recent years there has been a trend for foreigners who are concerned with either unfavorable tax laws or the political or economic climate in their home countries to initiate an investment program within the United States. The passage of the Act, with its significantly accelerated write-offs of capital investments, may be viewed as encouraging foreign investment in the United States.

Carryovers in Certain Corporate Acquisitions

In transactions to which section 381 of the Code applies, section 381(c) provides the extent to which an acquiring corporation succeeds to certain tax attributes of a distributor or transferor corporation. Section 381 is generally applicable to nontaxable liquidations of subsidiaries under section 332 of the Code and certain tax-free reorganizations under section 368 of the Code, wherein the acquiring corporation's basis in the acquired assets is determined, in whole or in part, by the basis of such assets in the hands of the distributor or transferor corporation.

Section 381(c)(6) of the Code provides that in a transaction that falls under section 381(a), to the extent that the basis of assets in the hands of the acquiring corporation does not exceed the basis of such assets in the hands of the distributor or transferor corporation, the acquiring corporation is restricted to the depreciation methods and rates of the distributor or transferor corporation.

The Act establishes a new subsection of the Code, section 381(c)(28), which is substantially identical to the present section 381(c)(6). The new subsection restricts the acquiring corporation, under the circumstances described above, to computing its recovery allowance by the same method used by the distributor or transferor corporation. The sole purpose of the new subsection is to incorporate the reference to the new section 168 (recovery allowance) in lieu of the reference to section 167 (depreciation allowance).

Although the substance of section 381 of the Code itself has not been altered by the addition of subsection (c)(28), the interplay of the recovery-allowance provisions creates a change from the previous law in this area. Under section 381(c)(28), if the basis of assets in the hands of the acquiring corporation exceeds the basis in the hands of the distributor or transferor corporation, to the extent of the excess the acquiring corporation would be free to use a new rate and method of depreciation. Under section 167 depreciation rules, such basis would be considered "used property" and thus not subject to the maximum rates of depreciation. Under the Act, however, no distinction is made between new and used property; consequently, maximum rates of recovery could be utilized.

Earnings and Profits

In most merger and acquisition transactions, the calculation of the corporations' respective earnings and profits is crucial for a determination of both immediate and future tax effects of the transactions. Under section 312(k)(1) of the Code, a corporation computes the depreciation to be charged to earnings and profits by the straight-line method, irrespective of the method used under section 167 of the Code for purposes of calculating taxable income.

The Act provides that the computation of the recovery allowance will continue to use the *straight-line method* for determining earnings and profits. However, *extended recovery periods* are to be used as follows:

In the case of:	*The applicable extended recovery period is:*
3-year property	5 years
5-year property	12 years
10-year property	25 years
15-year real property	35 years
15-year public utility property	35 years

If, in computing the recovery allowance, a taxpayer uses a recovery period longer than the extended recovery period indicated above, then in computing earnings and profits a taxpayer *must* use the same longer period.

By a careful analysis of the table above, it becomes apparent that although the periods of asset write-offs have generally been shortened under the Act, and depreciation thus accelerated, the charge-off to earnings and profits will in many cases be over a longer period than under the previous law. The overall effect on specific companies could be, under certain circumstances, a relative increase in earnings and profits, and possibly a triggering of adverse tax consequences, i.e., taxability of dividend payments. However, where consolidated tax returns are filed, a tax *benefit* may result. At the end of each consolidated-return year, any member owning stock of a subsidiary must adjust its basis in such stock. This is accomplished by increasing (or decreasing) the stock basis by the allocable portion of the undistributed earnings and profits (or deficit in earnings and profits) of the subsidiary for the taxable year. To the extent the Act decreases the depreciation charge to the subsidiary's earnings and profits, the stock basis of the subsidiary will be increased, thereby resulting in less potential gain on its ultimate sale or other disposition.

Liquidation of a Subsidiary

In evaluating the decision as to whether a corporation should liquidate a recently acquired subsidiary and thus generate a step-up in basis of the acquired assets under section 334(b)(2) or section 346 of the Code, one of the more important considerations is the initial tax cost versus the present value of the future tax benefit. The various changes made by the Act in the law have significantly altered these computations.

Under section 167 of the Code, upon the distribution of the assets in liquidation to the acquiring corporation, the fixed assets would become "used property" and, as such, would not be available for the maximum accelerated rates of depreciation. New section 168 does not distinguish between new and used property. Accordingly, the stepped-up property will be available for the new beneficial accelerated rates of recovery unless the anti-churning rules apply. (The anti-churning provisions deny the application and benefits of ACRS to corporations acquired before January 1, 1981 and liquidated after that date. In order to avoid this exception, at least 80 percent of the target company must be acquired by *purchase* after December 31, 1980.) Depending upon the magnitude of the depreciable assets and the related step-up in basis, the new law could greatly increase the present value to the corporation of achieving future benefits from depreciation due to the liquidation and step-up.

On the other hand, because of the more rapid depreciation write-off that will be available, the amount subject to depreciation recapture upon disposition of assets (thus converting capital gain into ordinary income) will also be substantially increased. If the acquiring corporation were to acquire assets that had been written off under the new recovery-allowance rules, the additional tax that would be due currently because of the recapture rules will be proportionately increased. In addition, under the former rules if the property disposed of was real property, only the depreciation in excess of straight-line depreciation represented recapture potential. Under the new rules, all depreciation on non-residential real property will be subject to recapture if accelerated depreciation was claimed. However no recapture would be required if the taxpayer had elected to apply the straight-line method in lieu of the accelerated recovery percentages.

The investment credit recapture tax that will be applicable in a section 334(b)(2) liquidation could be dramatically altered if the property involved were placed in service after December 31, 1980. Under the former law, a portion of the investment credit originally taken would be recaptured on the basis of the revised, shorter holding period of the property in the hands of the liquidated company. Under the Act, the credit is recomputed on early dispositions by allowing a two-percent credit for each year the property was held. Accordingly, there would be no recapture on eligible five-year, 10-year, or 15-year property actually held at least five years, or for eligible three-year property held for at least three years. Additionally, there would be only a 20-percent recapture for eligible five-year property held only four years, a 66⅔-percent recapture for three-year property held one year, and so on. As a result, this amendment to the recapture rules could reduce the "up-front" cost of a section 334(b)(2) liquidation by reducing the amount of the credit that would have otherwise been recaptured.

Qualifying property received in a section 334(b)(2) liquidation is eligible for the investment credit as "used property." In the past there was a $100,000 limit on the amount of used property that could qualify for the credit. When the Economic Recovery Tax Act was first proposed, no limit was placed on the amount of used property that could qualify for the investment credit. In its final form, however, the limit was reinstated at the somewhat higher amount of $125,000 commencing in 1981 ($150,000 in 1985 and thereafter). As a result of this reinstated limitation, there is still a risk of significant recapture tax payable upon liquidation, without a corresponding benefit for an increase in investment credit claimed.

As an alternative to a section 334(b)(2) liquidation, a partial liquidation of the acquired corporation under section 346 of the Code might be considered. Except for certain recapture items, a distribution of property by a subsidiary (including a newly acquired subsidiary) in partial liquidation during a consolidated-tax-return year generally results in no gain or loss. However, to the extent that any recapture gain is recognized as a result of the distribution in partial liquidation, such gain is deferred until the occurrence of certain restoration events. For example, if the subsidiary were to defer gain as a result of depreciation recapture, that deferred gain would be triggered as the parent deducts depreciation on the property distributed. With certain limited exceptions, the transfer of investment credit property from the subsidiary to the parent in a partial liquidation is not treated as a disposition, and therefore no investment credits are recaptured. A partial liquidation may therefore be advantageous where there is large investment tax credit recapture or where a present-value computation of the recapture tax is prohibitive.

With the increase in recapture potential as a result of the Act, the partial-liquidation alternative should be considered where a step-up in basis is desirable.

Where the book value of the acquired corporation's assets exceeds the purchase price of its stock, a section 334(b)(2) liquidation would be undesirable, as such assets would be stepped down. Of course, if the acquired corporation were not liquidated and a consolidated tax return were filed, any asset whose basis exceeds its fair market value might, unless the safe-harbor rules apply, be subject to the consolidated-return "built-in deduction" limitations. Generally, a built-in deduction is deemed to occur when a loss is economically accrued by a corporation in a year prior to the year in which the corporation joins in the filing of a consolidated tax return. The consolidated-return regulations limit the use of the built-in deduction solely to the profits of the corporation that generated the loss. Under ACRS, an election is available to depreciate assets by the straight-line method over extended recovery periods. It is therefore possible that an asset whose tax life significantly exceeds its economic life may have a tax basis in excess of its fair market value, thereby triggering the built-in deduction limitations.

Chapter VII—Research and Development

by Seymour F. Bernstein

Overview

To encourage business to initiate or expand research and experimentation programs, the Economic Recovery Tax Act of 1981 has added section 44F to the Code. In general, it provides nonrefundable income tax credits based on incremental research expenditures paid or incurred after June 30, 1981 by the taxpayer in carrying on a trade or business. The credit will be available regardless of the taxpayer's actual election, under the provisions of section 174 of the Code, to expense, amortize or capitalize research expenditures.

Credit Computations and Limitations

The allowable credit for a taxable year is equal to 25 percent of the excess of the qualified research expenses for the taxable year over the average qualified research expenses for the taxpayer's base period. As a minimum, the base-period average can not be less than 50 percent of the taxable year's qualified research expenses. It should be noted that for the taxable year that straddles June 30, 1981, only research expenses paid or incurred after such date (the effective date) are taken into account.

Base Period

As a general rule, the base period includes the three taxable years immediately preceding the credit-determination year. However, as to the first credit-determination year, namely, the first taxable year that ends after June 30, 1981, the base period is reduced to the one year immediately preceding such year. Only a portion of the single base year's qualified research expenses is considered, that portion being determined by the ratio of the number of months in the determination year after June 30, 1981 to the total number of months in such year. As to the second credit-determination year, the base period is increased to the two years immediately preceding such year.

Another transitional rule applies to new business taxpayers. If a taxpayer was not in existence during a base-period year, the taxpayer will be deemed to have no qualified research expenses during that base year. Thus, if a calendar year taxpayer commenced business January 1, 1983 and incurred $60,000 in qualified research expenses in 1983 and $100,000 in 1984, then for the 1984 credit-determination year the average base-period research expenses would amount to $20,000 (base period includes 1981—$0, 1982—$0, and 1983—$60,000), but would be subject to the minimum base-period amount of $50,000 (50 percent of $100,000).

The following example illustrates base period and credit computations:

	Credit-Determination Years			
	1981	*1982*	*1983*	*1984*
a) Research expenses	$12,000[1]	$30,000	$31,000	$60,000
b) Base-period research expenses:				
1980 — $10,000	5,000[2]	10,000	10,000	
1981 — 20,000		20,000	20,000	20,000
1982 — 30,000			30,000	30,000
1983 — 31,000				31,000
c) Total base-period research expenses	5,000	30,000	60,000	81,000
d) Number of base-period years	1	2	3	3
e) Average base-period research expenses (c ÷ d)	6,000[3]	15,000	20,000	30,000[3]
f) Increase in research expenses (a - e)	$ 6,000	$15,000	$11,000	$30,000

[1]$20,000 total paid for year of which $12,000 was paid after June 30, 1981.

[2]Since one-half of computation year is after June 30, 1981, only one-half of 1980 base-period expense amount is considered.

[3]Subject to minimum base-period amount of 50 percent of taxable year's expenses.

Limitations and Unused Credit Carryovers

As a general limitation, the allowable credit is limited to the taxpayer's income tax liability after reduction for all other credits except the credits for earned income, gasoline use and wage withholding. A special limitation applies if an individual owns an interest in an unincorporated trade or business, is a partner in a partnership, is a beneficiary of an estate or a trust, or is a shareholder in a Subchapter S corporation. In each of these situations, the allowable research credit is further limited to the lesser of (1) the general limitation (above) or (2) the income tax attributable to that portion of the individual's taxable income allocable or apportionable to his interest in the particular business. An unused research credit, arising in any year because of the limitation, must be carried back to the three preceding years (including pre-1981 years) and then carried to the following 15 years, in chronological sequence. In applying and consuming unused research credits against tax liabilities, priority is given to the application of current credits and then the earliest year's unused credits.

Qualified Research Expenses

As a general guide, the statute provides that the term *qualified research* has the same meaning as the term *research or experimental* has under section 174 of the Code. However, it specifically excludes research conducted outside the United States, research in the social sciences or humanities, and research to the extent funded by any other person (including any government agency). The section 174 Income Tax Regulations define research expenses in the "experimental or laboratory sense." These would include such expenditures incidental to the development of an experimental or pilot model, plant process, product, formula, invention or similar property, and the improvement of already existing property of the type mentioned. They would also include the cost of obtaining a patent, such as attorneys' fees in making and perfecting a patent application.

The section 174 Income Tax Regulations exclude expenditures for ordinary testing or inspection of products for quality control, or for efficiency studies, management studies, consumer surveys, advertising or promotions. Also excluded are expenditures for the purpose of ascertaining the existence, location, extent or quality of mineral deposits including oil or gas.

The statute classifies qualified research expenses in terms of *in-house research expenses* and *contract research expenses.* The in-house expenses include wages paid or incurred for qualified services, as well as supplies and equipment leasing costs used in conducting qualified research. The term *supplies* excludes land or land improvements as well as the cost of depreciable property. The term *qualified services* as applied to wages is restricted to:

1. The actual conduct of research, such as the laboratory scientist engaged in experimentation,

2. The immediate supervision of persons actually conducting research, such as the research scientist supervising other laboratory scientists, and

3. The direct support of persons actually conducting or supervising the conduct of research.

Examples of the direct support category are the laboratory assistant entering research data into a computer, a secretary typing research reports, a laboratory worker cleaning research equipment, a machinist working a part of an experimental model, or a drilling crew preparing a test well for the purpose of testing a new and innovative method for extracting ores or minerals. General and administrative services or overhead are not considered services performed in conducting research, even though they may qualify for section 174 deduction elections. Examples of such nonqualifying services include services of payroll personnel, accounting personnel and general supervisory officers.

The term *wages* is limited by statute to the same meaning as used in section 3401 of the Code for withholding tax purposes. Thus, various fringe benefits as part of the compensation package are excluded from research wages. The self-employed individual is limited to his *earned income* as defined in section 401(c) of the Code. The amount of research wages of an individual is limited to that portion of compensation attributable to actual services performed in conducting research. However, if at least 80 percent (substantially all test) of an individual's total services during a taxable year are performed in conducting research, then 100 percent of the individual's compensation qualifies as research wages.

The term *contract research expenses* includes 65 percent of amounts paid or incurred to any non-employee for qualified research. This would cover payments to universities, special research firms, and the like, performing qualified research on behalf of the taxpayer. Any prepaid amounts would be deferred until the year the research is actually performed. Contract research expense also includes 65 percent of corporate grants for basic research made to tax-exempt universities, scientific research organizations and electing funds (making grants to universities) pursuant to written agreement. The term "basic research" is defined in section 44 F of the Code as any original investigation for the advancement of scientific knowledge not having a specific commercial objective.

The following is a list of research activities and expenses that generally qualify as section 174 research but may or may not qualify for the research credit as indicated.

Research Activities	**Section 44F Qualified Research**
Foreign research	Excluded
Research in the social sciences and humanities	Excluded
Basic research (no specific commercial objective)	Included only to extent of 65 percent of corporate grants to universities and scientific organizations. In-house basic research can not qualify.
Development of software	Included if it constitutes new and significant improvement of programs or routines.

Expenses or Costs	
Wages	
Direct	Included if in direct conduct, supervision or support of research.
Overhead	Excluded
Gen. and admin.	Excluded
Patent application	Excluded
Fringe Benefits	
Employee pension and similar plans	Excluded (All items exempt from with-holding tax are excluded)
Group life ins.	
Moving expenses (deductible)	
Educational assistance	
Dependent care assistance	
Meal and other allowances	
Supplies	
Direct	Included only if tangible property is used directly in research (as in wages above). Costs and improvements of land and depreciable property are excluded.
Overhead	Excluded
Gen. and admin.	Excluded
Utilities	Excluded
Depreciation on equipment	Excluded
Rental Costs of Personal Property Used in Research	Included only if property is used directly in research.
Contract Research Expenses	Only 65 percent is included provided it is for qualified research.

Aggregation of Expenditures

All members of a controlled group of corporations under section 1563(a) of the Code are treated as a single taxpayer. For this purpose, the more-than-50-percent control test is used in lieu of the 80-percent test. Similarly, all businesses (incorporated or unincorporated) under common control (more-than-50-percent test) are treated as a single taxpayer. Accordingly, both current and base-period qualified research expenses are aggregated. The allocable credit is to be apportioned among the members of the group on the basis of their respective proportionate shares of the group's increase in research expenses giving rise to the credit.

This may best be illustrated by the following:

Corporation	*Average of Base Period*	*Taxable Year*	*Change*	
A	50	35	(15)	
B	20	30	10	35
C	30	50	20	
D	5	10	5	
Totals	105	125	20	

Research and experimental credit = 25% of $20,000 = $5,000.

The credit will be apportioned as follows:

A	=	0
B 10/35 × $5,000	=	$1,429
C 20/35 × $5,000	=	$2,857
D 5/35 × $5,000	=	$ 714
		$5,000

Subchapter S Corporations and Partnerships

Qualified research expenses of a Subchapter S corporation and of a partnership will pass through to the shareholders and partners, respectively, in accordance with regulations to be prescribed by the Treasury.

Base-Period Adjustments upon Transfer of Business

If a taxpayer acquires a major portion of a trade or business after June 30, 1980 from a predecessor, the taxpayer's qualified research expenses for the base-period years prior to the acquisition are to be increased by the amount of research expenses attributable to the portion of the business acquired by the taxpayer.

If the taxpayer disposes of a major portion of a trade or business after June 30, 1980, the taxpayer's qualified research expenses for the base-period years prior to disposition are to be decreased by the amount of the taxpayer's research expenses attributable to the portion of the business that has changed hands. The allowance of the decrease in base-period amounts is conditioned upon the disposing taxpayer furnishing the acquiring person the information needed to enable the acquiring person to increase the base-period amounts.

If during any of the three taxable years following the disposition of a business, the disposing taxpayer reimburses the acquiring person for qualified research expenses incurred on behalf of the taxpayer, then the taxpayer's research expenses for the base period, applicable to the reimbursement year, shall be increased by the lesser of:

a) the amount of the decrease adjustment made upon the business disposition that is allocable to such base period, or

b) the product of the number of years in the base period multiplied by the reimbursement amount.

The object of this provision is to prevent a decrease in base-period qualified research expenses through a sale of a major portion of a business (research department) followed by a research contract with the acquiring entity.

Short Taxable Year

The amount of research expenses in a short taxable year is to be annualized pursuant to regulations to be prescribed by the Treasury.

Planning Considerations

Determining the type of expenditures that would be "qualified research expenses" may, at times, be difficult. A broad indication of the congressional intent is provided in the House Ways and Means Committee Report with respect to this subject, notwithstanding the fact that the Administration's bill was ultimately enacted and not the House bill. It is rather all-inclusive and provides general guidance as to items that may qualify for the research credit.

One item referred to in the House report deals with the costs involved in generating computer software. Under certain conditions, such costs would qualify for the research credit whether or not the software is used in the qualified research activity. In addition, the report concentrates on the necessity of having all research expenses relate to the carrying-on of a trade or business. Apparently, the concept of *carrying-on* is emphasized as distinct from the term *in connection with* a trade or business. Accordingly, expenses incurred before the sale of a product would not be deemed incurred in carrying on a business. Another example is that of a company involved in research activities for the development of an *item* that would then be licensed to third parties to generate royalties. The royalty activity would not qualify as *carrying on a trade or business.* However, if the taxpayer employs the new item in its business as well as licensing the item to third parties, then the credit would be allowable.

A major question arises as to whether the direct costs incurred in the development of certain new products qualify as research expenses, such as a new loan package by a bank or other financial institution; a new insurance program by an insurance company; a new investment package by investment or broker/dealer companies; a new architectural design by an architectural firm and similar "high knowledge" types of products. The answer to this question really depends on the intended congressional scope of the term research and experimental development. The committee reports indicate that such research and development should take on the same meaning as used under section 174 of the Code regarding the deduction of research and development expenses. The only enlightenment on this point is that the qualified deductions should be incurred in experiments in the "laboratory sense."

However, the House Ways and Means Committee Report provides perhaps a more restrictive definition of research as expressed in the explanation of the exclusion of the social sciences and humanities from qualified research activities. This explanation reads as follows:

> First, the credit is not available for any activity in the social sciences or humanities (including the arts), such as research on psychological or sociological topics or management feasibility studies. That is, to be eligible for the credit, the research must be performed in a field of laboratory science (such as physics or biochemistry), engineering, or technology.

From the above-quoted portion of the House report, it is apparent that research must be performed in the field of laboratory sciences such as physics, biochemistry, engineering or technology. In the absence of any research in these technical areas, a project would fail to qualify as a research activity. From this conclusion, all of the above-noted new business items, such as bank loans, insurance packages, investment packages, etc., appear to be excluded.

The statute includes within the term *qualified research expenses* the cost of leasing or renting of equipment used in conducting qualified research. In this regard, there is a prohibition in the definition of the word *supplies* against recognizing the cost of depreciable personal property acquired for use in research. In the latter case, the equivalent of the annual depreciation on allowable equipment and computer equipment would be excluded from qualified research expenses, while the payment of an annual rental (covering such depreciation) for the use of such equipment would qualify. In view of the provisions in the statute, it is recommended that a corporation consider leasing major equipment rather than purchasing such equipment, and thus obtain the 25-percent research credit on the incremental annual or periodic rental payments and other charges. According to temporary regulations, equipment leased under the special Accelerated Cost Recovery System (ACRS) safe-harbor leasing rules would not qualify for the research credit. It should be noted that all research equipment qualifies as three-year property under ACRS.

In an attempt to finesse the problem of laboratory equipment, it has been suggested that one member of an affiliated group of companies should purchase equipment, whereupon it can then be leased to another member of the affiliated group to be used by the latter in its research activities. The Act requires all members of a controlled group to be treated as one entity. Accordingly, the House report provides that any intercompany leasing of laboratory equipment would not qualify as qualified research expenses to the lessee.

In connection with supplies used in the conduct of qualified research, it appears logical to include major utility costs, such as electricity, water and fuel, only if it can be shown that these utilities are directly used and are important ingredients in the type of research being conducted. Of course, electricity and fuel costs related to the heating and lighting of research facilities would not be included as qualified research expenses in the nature of supplies.

In regard to basic research, it appears from the statute that a corporation's own activity in conducting basic research may not qualify for the research credit. Basic research is used in the sense of scientific research in an original investigation for the advancement of scientific knowledge not having a specific objective. Thus, if a company intends to finance or conduct basic research, it should endeavor to make a grant arrangement with a tax-exempt university or scientific research organization to accomplish this objective.

As noted earlier, research performed outside of the United States can not qualify for the research credit. In view of this provision, wherever possible, and if practical, foreign research projects might be transferred to research facilities in the United States so as to generate a research credit and, in addition, increase the ratio of foreign taxable income to total taxable income for foreign tax credit limitation purposes.

In designing or programming accounting records in order to support the research credit, a clear distinction between direct and indirect (overhead and general administration) research expenses should be drawn. As to direct wage expenses, these amounts can easily be drawn from employees' Forms W-2, amounts of compensation subject to income tax withholding, simply because all nontaxable compensation benefits do not qualify as research expenses.

In the last analysis, the potential research credit is based solely on the increase in qualified research expenses. Because of the minimum base-period amount of 50 percent of the determination year's qualified research expenses, the maximum research-credit potential in any year (excluding carryovers) is 12½ percent of the year's total qualified research expenses.

The magnitude of the potential credit in any year can be determined as follows:

- 25 percent of the increase in current expenses over the base-period average, but only up to a 100-percent increase, plus
- 12½ percent of current expenses in excess of twice the base-period average.
- A new business is limited to 12½ percent of current expenses.

The following schedule illustrates the application of these guidelines to a fact pattern with a fixed base-period average of $100 and variable current expenses.

1	2	3	4	5	6	7
Qualified Research Expenses				**Research Credit**		
	Taxable	*Increase over*			*As % of Actual*	
Base	*Year*	*Base Period*			*Research Expenses*	
Period	*Amounts*	*Actual*	*Adjusted*	*Amount*	*Total*	*Increase*
		(2 − $100)	*(2 − 1)*	*(25% of 4)*	*(5 ÷ 2)*	*(5 ÷ 3)*
$100	$100	0	0	0	0	0
100	120	$ 20	$ 20	$ 5	4.2%	25 %
100	140	40	40	10	7.1	25
100	160	60	60	15	9.4	25
100	180	80	80	20	11.1	25
100	200	100	100	25	12.5	25
110*	220	120	110	27.5	12.5	22.9
120*	240	140	120	30	12.5	21.4
130*	260	160	130	32.5	12.5	20.3

*Increased to 50-percent minimum amount.

However, because of the moving three-year average base-period expense amount, the total research expense amount of one year becomes part of the following period's average base-period amount. Accordingly, the credit generated by a current year's research expense is partially or entirely offset in the three subsequent years as a result of the expense becoming part of the average base-period expense amounts for such subsequent years. In view of this relationship, the question arises as to what is the best plan for the spreading or scheduling of projected research expenses.

In answer to the above question, one must realize that in any one year as to any taxpayer, the maximum available credit can not exceed *12½ percent of the total amount of research expenses for such year.* The above schedule illustrates this basic point. In view of this conclusion, the optimum schedule would be one in which the 50-percent minimum base-period rule applies in every taxable year. This can be accomplished by scheduling research expenses on a substantially increasing level each year. The better approach, if otherwise practical, is to maintain a moderately level amount of research expenses in alternate years and no expenses in the intermediate years. Because realism may preclude this objective, one must accept the realization of total credits at less than the 12½-percent maximum level.

Deduction for Charitable Contributions of Scientific Property Used for Research

Generally, a corporation is allowed a deduction for charitable contributions, limited to five percent of taxable income after certain adjustments. (Effective for years beginning after December 31, 1981, the limitation percentage is increased to 10 percent.) If the amount contributed exceeds the limitation, the excess may be carried forward for five years, subject to the same limitation each year.

Under current law, a charitable-contribution deduction is allowed for a donation of appreciated ordinary-income property. However, section 170(e) of the Code provides a reduction rule, namely, that the amount of the deduction otherwise allowable for the value of such property must be reduced by the amount of ordinary income that would have been realized had the property been sold at its fair market value on the date it was contributed to a charitable organization. The new law places a limitation on this reduction rule, which is applicable to a qualified research contribution made after August 13, 1981. The contribution allowable is the lesser of (a) twice the basis of the property or (b) the basis plus 50 percent of the appreciation.

If an item has appreciated more than 200 percent, then the contribution deduction is limited to an amount equal to twice the basis of the property. As an example, if the basis is $100 and the fair market value has increased to $300, then the deduction is limited to $200, which, at the 46-percent tax rate, produces a tax benefit of $92. Accordingly, the corporate donor is out of pocket a minimum contribution cost of $8 (basis or cost of $100 less a tax benefit of $92).

A qualified research contribution is defined as a contribution of tangible personal property by a corporation (excluding Subchapter S, personal holding and service corporations). The donee must be an institution of higher education. The property must be:

1. Stock in trade, inventory, or property held for sale to customers in the ordinary course of business,
2. Constructed by the donor and contributed not later than two years from completion,
3. Originally used by the donee, and
4. Scientific equipment or apparatus for use by the donee in the United States.

For this provision to apply, the donee must not transfer the property in exchange for money, other property, or services and must provide a written statement representing that its use and disposition of the property will conform to the requirements.

Allocation of Research Expenses for Foreign Tax Credit Limitations

Existing law requires that a taxpayer allocate research expenses between U.S. and foreign source gross income before applying the limitation rules on the use of foreign tax credits. This allocation requirement has been suspended for a taxpayer's first two taxable years beginning after August 13, 1981.

Thus, as to a taxpayer with a calendar taxable year, all 1982 and 1983 expenses for research conducted in the United States would be allocated to U.S. source gross income and no such expenses to foreign source gross income. This temporary suspension will help to increase a taxpayer's foreign source taxable income and serve to reduce somewhat the applicability of the foreign tax credit limitation. To capitalize on the suspended allocation rule, as well as to increase its research credits, a multinational corporation may consider, if feasible, temporarily transferring certain research projects from foreign facilities to U.S. facilities.

Chapter VIII—An Economist's Perspective

by Emil M. Sunley

Overview

The Accelerated Cost Recovery System (ACRS) established by the Economic Recovery Tax Act of 1981 provides a new simplified system for writing off the costs of business investments. It is a break with the past. Under ACRS, annual deductions for capital recovery no longer depend on the useful life of the property. There is no attempt to match income and expense. Instead, businesses are permitted to recover the costs of their investments rapidly. Investments are written off according to fixed schedules over cost recovery periods of three, five, 10 or 15 years.

Complementing the new capital recovery rules, the investment tax credit is increased to six percent for cars, light trucks, and other assets in the three-year class. The credit is 10 percent for all other eligible property. Liberalized leasing rules will insure that most firms will benefit either directly or indirectly from the speed up of capital recovery and the higher investment tax credits.

Equipment

In economic terms, ACRS, once fully phased in, amounts to no less than repeal of the federal income tax on returns to investment in machinery and equipment. A project that yields 12 to 15 percent before tax will yield about the same return after tax. If the after-tax and before-tax rates of return are the same, the effective tax rate is zero. Put another way, the present value of the tax savings from the investment tax credit and the ACRS deductions, using a 12-percent discount rate, is about equal to the present value of the future tax payments on the income from the investment.

That ACRS plus the investment tax credit results in a zero effective tax rate on returns to investment in machinery and equipment may not be apparent. This proposition may become clearer if it is broken down into two separate ones. The first is that assuming a 12-percent discount rate and a 46-percent tax rate, ACRS plus the investment tax credit is equivalent to expensing; that is, to full and immediate write-off of investments. The second one is that expensing results in a zero effective tax rate on returns to investment.

To illustrate the first proposition consider a $1,000 investment. A firm would be permitted a $100 investment tax credit in the first year and depreciation deductions, once ACRS is fully phased in, of $200 the first year, $320 the second year, declining to $80 the fifth year as shown in the table below. Assuming the firm is subject to the 46-percent corporate tax rate, the present value of the tax savings, using a 12-percent discount rate, would be $460—which is just equal to the tax savings from immediate write-off of the $1,000 investment.

Year	*Depreciation Deduction*	*Tax Savings (46% Tax Rate)*	*Investment Tax Credit*	*Total Tax Savings*	*Present Value of Savings*[1] *(r = .12)*
1	200	92.00	100.00	192.00	181.13
2	320	147.20		147.20	123.99
3	240	110.40		110.40	83.03
4	160	73.60		73.60	49.42
5	80	36.80		36.80	22.06
Total					459.63

[1]It is assumed that the investment is made in the middle of the year. Therefore, the tax savings at the end of year 1 is discounted ½ year and the tax savings at the end of year 2 is discounted 1½ years, etc.

There are two qualifications that should be made. First, if the tax rate is lower than 46 percent, the investment tax credit plus ACRS is better than expensing. That is, the present value of the tax savings exceeds the tax savings from immediate write-off. The reason for this is that the investment tax credit is equivalent to a larger first-year deduction for the firm in the lower tax bracket. Second, if the appropriate discount rate is lower than 12 percent, ACRS plus the investment tax credit would be better than expensing. Whether 12 percent is the appropriate discount rate is a matter of dispute. Until the recent surge in inflation, a 12-percent discount rate was considered appropriate since it was about equal to the after-tax real rate of return plus the expected inflation rate.

The second proposition is that expensing is equivalent to exempting from taxation the normal returns to investment. Consider first a world without income taxes. Firms will invest in the projects until the discounted cash flow from the project, discounted at say, 12 percent, is just equal to the initial outlay. In this situation the cash flow from the investment will pay for replacement of the capital and provide an annual return of 12 percent. This can be illustrated by the following example:

A firm invests $1,000 at the beginning of year 1 and receives an annual cash flow (gross income less operating costs) of $277 per year for five years. The present value of the cash flow, if discounted at 12 percent, is equal to the $1,000. Put another way, the internal rate of return on the investment is 12 percent.

Now introduce a 40-percent income tax and permit expensing. Expensing provides an immediate $400 tax savings that reduces tax that otherwise would be payable on the income from other assets. The initial outlay is in effect only $600. Since the investment has been expensed there is no depreciation deduction and the $277 of cash flow each year is fully subject to tax. The annual cash flow is reduced 40 percent to $166. But $166 of cash flow for five years provides an internal rate of return of 12 percent on the $600 at risk. Thus the after-tax rate of return is just equal to the before-tax rate of return. The effective tax rate is zero. This is true regardless of the nominal tax rate or the before-tax rate of return.

Structures

With respect to structures the capital recovery is not as generous as that for machinery and equipment. First, most structures, other than special purpose ones, do not qualify for the investment tax credit. Second, the capital recovery period is 15 years, not five years as for machinery and equipment. Third, the ability to reduce the recovery period by the use of component depreciation was eliminated.

The initial 10-5-3 proposal supported by the business community would have provided a 10-year recovery period for commercial and industrial structures. Residential structures were left outside the system. It was generally believed that the tax system tilted too much toward residential structures compared to machinery and equipment or commercial and industrial structures. ACRS, as enacted, includes both residential and nonresidential structures. When account is taken of rate of depreciation and recapture rules, the Act did not alter the relative pecking order for buildings. Low-income residential housing continues to have the more favorable depreciation rates (200-percent declining balance) and the less stringent recapture rules. Other residential housing has the less favorable depreciation rates (175-percent declining balance) but gets the same recapture rules as low-income rental housing. Under ACRS, investors in industrial and commercial structures must use the less favorable depreciation rates (175-percent declining balance) and are subject to the more stringent recapture rules. Alternatively, investors in industrial and commercial structures may use the straight-line method of depreciation, but then they are not subject to recapture at ordinary tax rates.

Leasing

One consequence of accelerated cost recovery and revision of the investment tax credit is that companies are more likely to find that they can not currently use all their tax deductions and credits. This is especially true of companies that are growing very rapidly, are heavily debt financed, or temporarily have fallen on hard times. In considering potential investments these companies are at a competitive disadvantage compared to companies that currently can use all their tax deductions and credits. In addition, basically sound companies that have unused credits or net operating losses are targets for tax-induced takeovers and mergers.

To alleviate these problems, the Act establishes a broad safe harbor for characterizing transactions as leases for federal income tax purposes. It is expected that almost any type of machinery and equipment will be "leasable" for tax purposes. Under the new rules there is virtually full and complete transferability of the investment tax credit and depreciation deductions within the corporate sector.

The liberalization of the leasing rules was a compromise between banking of depreciation deductions and a refundable tax credit. The original 10-5-3 proposal would have permitted banking; that is, businesses would have been allowed to postpone depreciation allowances. Banking would have given businesses considerable flexibility to shift income between periods and to maximize the use of preferential tax rates and investment and foreign tax credits. This would have been achieved at the cost of great complexity. If the investment tax credit had been made refundable, businesses would have been able to claim and use the credit even though they had no current income tax liability. Many in the business community opposed refundable credit since it would give the appearance of backing losers; that is, giving tax subsidies to unprofitable companies.

It should be recognized, however, that most of the companies that will benefit from the new leasing rules (or from refundable investment tax credits) are not losers. Many are high technology companies that are expanding rapidly. Others are highly leveraged public utilities. And still others are temporarily unprofitable possibly because of bad management or sudden economic shifts beyond their control. These companies should not be at a competitive disadvantage when considering investment opportunities. By making the investment credit and depreciation deductions fully transferable within the corporate sector, Congress has made these provisions more efficient and more evenhanded.

Impact on Aggregate Investment

Capital recovery rules that permit more deductions in early years are worth more to a taxpayer because they defer tax liabilities to later years. This lowers the present value of the tax burden and increases the after-tax rate of return on potential investments. Investment demand increases in response to the higher rates of return.

To finance increased investment, firms must acquire more funds, either through higher retained earnings, new equity issues, or increased borrowing. As firms bid for the scarce supply of savings generated in the economy, interest rates rise, improving the return on savings. This encourages an increased flow of savings at any level of income and an increased flow of capital from abroad. It also chokes off some of the potential increase in investment demand. For the rate of capital formation to increase, these increased savings must be forthcoming to match the increase in investment demand.[1]

The net effect on total investment, therefore, depends not only on the stimulus to investment demand but also on the responsiveness of private savings and international capital flows to increased rates of return. It also matters how the revenue cost of the liberalized capital cost recovery rules is financed by the federal government. If it is financed by a larger deficit, the amount of private savings available to finance investment will be reduced. If it is financed by increases in taxes on labor income or consumption or by reduction in government spending on goods and services, there will be an increase in savings relative to current consumption.

Just how much the Act will increase investment is uncertain and a matter of dispute. During the congressional debate over the Act, there was little attempt to quantify the effects of increased stimulus for investment. Data Resources, Inc. (DRI) recently simulated the effects of the Act and concluded that between 1981 and 1986 there would be just under a one percentage point increase in the investment share of Gross National Product (GNP).[2] The DRI estimates assume an accommodating monetary policy. The impact of the Act on investment would be much less if the Federal Reserve pursues a tight monetary policy. The Administration would probably dispute the DRI estimates since the DRI model may understate the increased savings that will be induced by the lower marginal tax rates for individuals.

The tax writing committee in estimating the revenue impact of the legislation assumed that business fixed investment would increase by about one percentage point of GNP. This may seem like a small increase, but over time it would have a very significant effect on the size of the private capital stock, improving both productivity and American competitiveness.

[1] Other provisions in the Act, particularly the reduction in marginal tax rates, will encourage additional savings. To the extent that more private savings are forthcoming as a result of these provisions, the supply of savings can be equated with investment demand without an increase in interest rates.

[2] Data Resources, *U.S. Review,* September 1981.

Allocation Effects

While the effect of increased investment incentives on total capital formation is uncertain, the sectoral impacts may be very strong. By changing the relative rewards to different uses of savings, ACRS (and the other provisions of the Act) will direct investment toward machinery and equipment, particularly longer-lived machinery and equipment other than public utility property. This is consistent with an economy where investors are seeking the highest after-tax return on their dollars and efficient financial markets facilitate movements of funds between different sectors.

In 1980, gross private domestic investment totalled $395.3 billion, broken down as follows:

	($ billions)
Producer's durable equipment	190.1
Non-residential structures	108.8
Residential structures	102.3
Changes in inventories	–5.9
Total	395.3

Source: *Economic Indicators,* August 1981.

Machinery and equipment represented just under half of total investment, while the remaining half was about evenly split between residential and non-residential structures.

Of the major components of investment, the Act puts residential housing in a relatively worse position. First, reducing the top marginal individual income tax rate from 70 to 50 percent will decrease the tax savings from the homeowner deductions, increasing the out-of-pocket cost of owning a home. This should decrease the demand for expensive homes.[3] As a result, housing starts at the upper end of the market will likely decrease. The impact of the Act on total housing starts, however, depends crucially on future interest rates.

Second, the acceleration of tax depreciation for rental housing is less than for machinery and equipment. Also, the reduction in individual marginal tax rates will make real estate shelters less attractive. As a result of all these factors one would expect residential real estate to lose relative to plant and equipment.

[3]High-income taxpayers will also have greater after-tax incomes as a result of the marginal rate cuts. This could increase housing demand. But most likely the "price effect" mentioned above will dominate the "income effect."

Commercial and industrial structures, compared to residential structures, are little affected by the elimination of component depreciation or the tighter recapture rules. However, the acceleration of tax depreciation for machinery and equipment is greater than for investments in plant. A greater share of savings is likely to flow into machinery and equipment.

Within the producer's durable equipment sector there are also likely to be significant shifts. By going to a five-year recovery period for almost all machinery and equipment, ACRS will increase the attractiveness of industries with relatively long durability of assets such as cement and steel. A greater share of savings should go into these industries. Also, industries such as airlines, steel, and public utilities that currently have not been able to use all tax credits and deductions should gain relatively since the liberal leasing rules will allow them to compete more aggressively for the available supply of savings.

Another sector that will lose relatively is the state and local sector. The Act will have an adverse effect on state and local governments, raising their borrowing costs. First, the reduction in individual marginal tax rates will decrease the attractiveness of state and local bonds for high-income taxpayers. Second, the liberal leasing rules will pull commercial banks out of the tax-exempt market into leasing. Finally, the All Savers certificates may adversely impact the yield differential between taxable and tax-exempt bonds particularly for bonds with short maturities. As the cost of state and local borrowing increases, state and local governments should borrow less, freeing resources for investment in the private sector.

Chapter IX—Perspective of the Small Businessman

By Norman J. Ginstling

Overview

Small businessmen have recently expressed increasing frustration with government-imposed impediments to the growth and survival of their companies. Common concerns articulated by business owners include difficulties in raising capital, complicated tax laws, and an absence of incentives to improve productivity or to attract and retain good management. The Economic Recovery Tax Act of 1981 contains several provisions designed to address these concerns. Although much of the new legislation has been covered in prior chapters of this booklet, it is useful to summarize in this chapter some of those subjects of particular interest to the small businessman, i.e., the changes affecting depreciation, the investment tax credit, research and development, and carryovers. Where appropriate, planning ideas are incorporated into the discussion. In addition, this chapter analyzes the new rules relating to reduced corporate tax rates, eased Subchapter S qualification, expanded accumulated earnings credits, incentive stock options and simplified LIFO inventory rules, as well as miscellaneous other changes.

Accelerated Cost Recovery System

The Accelerated Cost Recovery System (ACRS) is the cornerstone of the government's policy to encourage capital formation through tax incentives. ACRS generally allows taxpayers larger deductions for depreciation at an earlier point in an asset's life than was possible under prior law. Increased investment tax credits for many new assets also reduce the after-tax cost of capital expenditures. In addition, ACRS offers standardized depreciation rules. Planning and computations of depreciation are simplified by the elimination of such subjective factors as useful life and salvage value.

ACRS deductions are based on specified recovery lives for classes of assets (new or used) placed in service after December 31, 1980. Recovery lives are generally three, five, 10 or 15 years. Three-year property includes automobiles, light trucks, and certain research-related machinery and equipment. Other tangible personal property such as furniture and fixtures, tools, machinery and equipment have five-year recovery periods. The 10-year property has somewhat limited applicability, relating to public utility property, railroad tank cars and theme-park structures. Real property is depreciated over 15 years under ACRS. The newly legislated recovery lives, particularly for the five- and 15-year asset classes are, for many assets, dramatically shorter than the depreciable lives formerly applicable to similar assets. The more rapid write-offs for depreciation under ACRS are subject to a five-year phase-in period from 1981 through 1986. Cost recovery deductions are specified in a schedule and in years 1981-1984 are approximately based on the accelerated 150-percent declining-balance method during the early years of an asset's life, with a change to the straight-line method for the rest of the recovery period. In 1985, the schedule is based on 175-percent declining balance changing to the sum-of-the-years'digits (SYD) method. After 1985, an accelerated cost recovery method using 200-percent declining balance, followed by a switch to the SYD method, is prescribed. However, an election is available under ACRS to depreciate assets on a straight-line basis over the normal recovery period or over extended periods so as to reduce annual depreciation charges, where desired. Planning considerations in connection with slower depreciation are discussed below.

Allowable investment tax credits, like depreciation deductions, are based on the recovery lives of purchased assets. Acquisitions of three-year property entitle the taxpayer to a six-percent credit, up 2⅔ percent from credits available for similar assets under prior law. Credits for five- and 10-year property are 10 percent of the asset's cost. As under prior law, no investment tax credit is available for real property additions. However, investment tax credits are provided for certain real property rehabilitation expenditures.

A provision under ACRS specifically designed to benefit small business owners involves expensing or the immediate write-off of certain qualified capital expenditures. Property acquired for use in a trade or business and eligible for the investment tax credit qualifies for this deduction in the year it is placed in service. The dollar limitations on amounts that can be immediately written off are $5,000 for taxable years beginning in 1982 and 1983, $7,500 for 1984 and 1985 and $10,000 for years beginning thereafter. To the extent that the cost of qualifying property is expensed rather than capitalized, no investment tax credit is allowable with respect to such property. The former allowance for additional first-year depreciation (generally, not in excess of $2,000) is repealed for taxable years beginning in 1981. Therefore, for 1981 neither the additional first-year depreciation nor the new expensing provision is applicable.

ACRS Illustration—The Smallco Case

Proper capital budgeting by business owners requires consideration of the after-tax benefits of depreciation deductions and investment tax credits. These can best be quantified by determining the present value of reinvested cash flow from reduced taxes caused by depreciation and investment tax credit. The example below is designed to quantify the cash flow effects of depreciation and investment tax credits under the ACRS method as compared to prior law.

Smallco's 1982 Capital Spending Plan

Smallco is a regional manufacturer of office furniture. Its $100,000 asset-expansion plans for 1982 include the following:

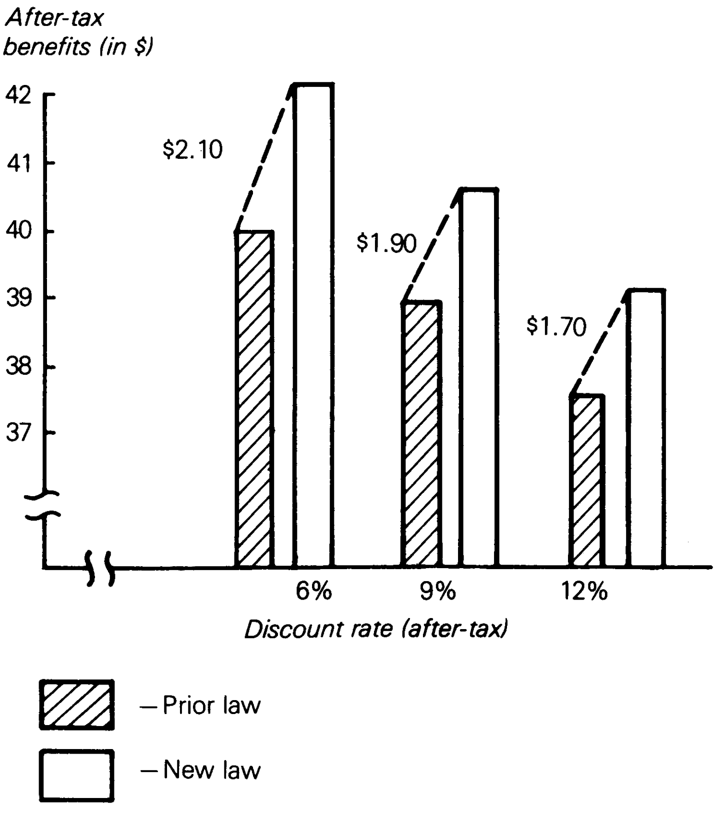
1. Automobile additions for increased sales force—$20,000
2. Replacement machine for staining furniture—$50,000
3. New telephone system—$25,000
4. Miscellaneous office capital expenditures—$5,000

Under prior law, Smallco used the 200-percent declining-balance method of accelerated depreciation for tax purposes on all personal property additions. Automobiles were depreciated over three years. Manufacturing equipment and office furniture and fixtures were depreciated over eight years, in accordance with the shortest allowable life under the Asset Depreciation Range System. Additional first-year depreciation and investment tax credits, to the extent allowed, were claimed.

Three-Year Property. Smallco depreciates automobiles over a three-year recovery life under ACRS. Until the completed phase-in of ACRS in 1986, depreciation using a three-year recovery life is slower than using the 200-percent declining-balance method with a three-year useful life under prior law. However, investment tax credits on auto additions are now six percent of asset cost, increased from 3⅓ percent.

The accompanying bar graph shows the combined effects of slower depreciation and increased investment tax credits for three-year property placed in service from 1981 through 1984. After-tax benefits have been determined from the present value of depreciation deductions and investment tax credits. Smallco's after-tax cost of raising funds has been used in making this persent-value determination, and in the accompanying graphs has been designated the "discount rate." Smallco's marginal tax rate is assumed to be 40 percent, the marginal tax rate for corporations with taxable income from $75,000 to $100,000.

Three-Year Property
Present Value of After-tax Benefits per $100 Invested
(1981—1984)



As interest (i.e., the discount rate) rises, the value of increased investment tax credits under ACRS is offset more by slower depreciation deductions. This is so because the investment tax credit is earned almost immediately, while the delay of depreciation deductions becomes more important as the discount rate rises.

After the phase-in period, the timing of depreciation deductions for three-year property under ACRS will virtually parallel deductions under the prior law. The following table reflects the increased after-tax benefits after the full phase-in of ACRS.

Three-Year Property
Present Value of After-tax Benefits per $100 Invested
(Assuming a 12-percent After-tax Discount Rate)

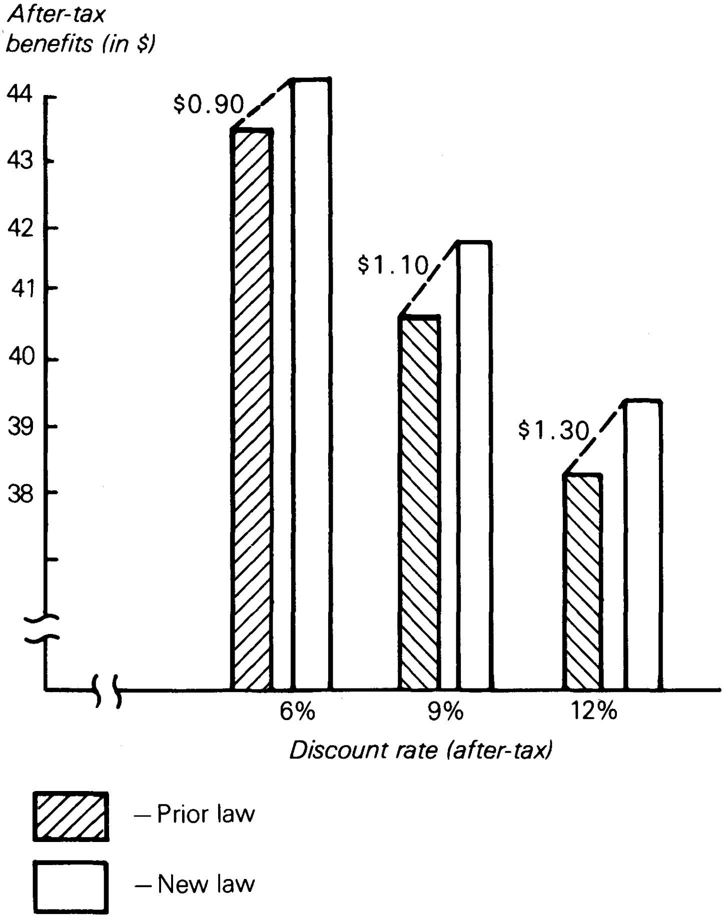
Prior Law	*New Law*		
	1981-1984	*1985*	*1986*
$37.30	$39.00	$39.70	$39.90

It can be seen that if the same $20,000 for automobiles were expended in 1986, the present value of the increase in after-tax benefits to Smallco under ACRS approximates $520 ($2.60 per $100 invested).

Five-Year Property. Smallco's investment in new machinery and a telephone system are recoverable over five years under ACRS. Faster depreciation results from ACRS deductions over five years than from 200-percent declining-balance deductions over a useful life of eight years. Investment tax credits are 10 percent of cost for both property with an eight-year useful life under prior law and property with a current five-year recovery life.

The bar graph displays the increased after-tax benefits of five-year assets acquired under ACRS. Since with five-year property the additional benefit under ACRS results from increased depreciation rather than investment tax credit, the change in the present value of the tax savings increases as the discount rate increases.

Five-Year Property
Present Value of After-tax Benefits per $100 Invested (1981–1984)



On $75,000 of expenditures for machinery and office equipment in 1982, Smallco's increased after-tax benefit under ACRS ranges from $675 ($0.90 per $100 invested at a six-percent discount rate) to $975 ($1.30 per $100 invested at a 12-percent discount rate).

Differences in the timing of depreciation deductions between the prior law and ACRS will be even greater after the phase-in period. The following table shows the increased after-tax benefits on five-year property after the complete phase-in of ACRS.

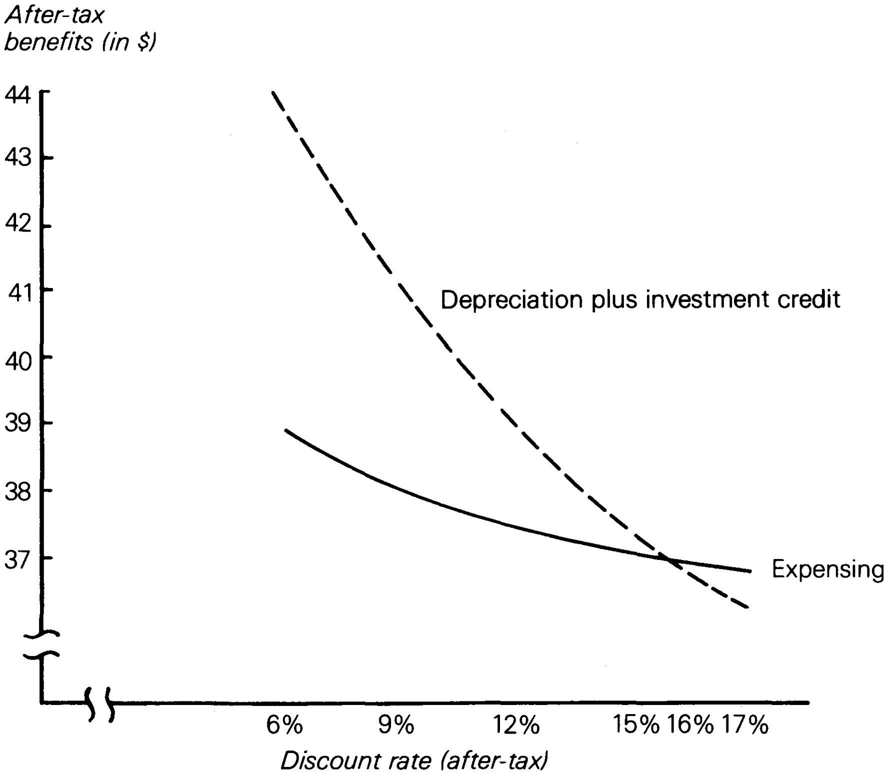
Five-Year Property
Present Value of After-tax Benefits per $100 Invested
(Assuming a 12-percent After-tax Discount Rate)

Prior Law	*New Law*		
	1981-1984	1985	1986
$38.10	$39.40	$41.10	$41.20

If the same $75,000 for machinery and equipment were spent in 1986, the present value of the increase in after-tax benefits to Smallco approximates $2,325 ($3.10 per $100 invested).

Expensed Property. Expensing of a capital outlay obviously produces a faster cost recovery than capitalizing and depreciating such an investment. However, the benefits of immediate expensing are reduced or, in some cases, eliminated by the lost investment tax credit on the expensed portion of an asset. The graph depicts the differences in after-tax benefits between expensing and depreciating (with the benefit of allowable investment tax credit) $5,000 in miscellaneous office capital expenditures (five-year property).

Immediate Expensing Compared to ACRS
Present Value of After-tax Benefits per $100 Invested



As inflation and interest rates decline, and/or the marginal tax rate decreases, the benefits of immediate expensing are reduced significantly. When interest rates decline to a point at which a company's after-tax cost of raising funds is less than 16 percent, companies with a 40-percent tax rate would be better off using ACRS and claiming the investment tax credit. At rates above 16 percent expensing is more attractive.

It should be noted again that as a corporation's marginal tax rate decreases, it becomes more advantageous to forgo the election to expense capital additions immediately, but rather depreciate them and obtain the benefits of accelerated depreciation and investment tax credit. As an example, a corporation in a 30-percent tax bracket will receive more net benefits from expensing an asset only when its after-tax cost of funds exceeds 24 percent.

Although real property additions are not included in Smallco's 1982 capital spending plan, and hence have not been covered in this illustration, the increase in after-tax benefits for real estate under ACRS is significant. As an example, on an investment in a $500,000 new commercial building, the additional after-tax benefits comparing ACRS (15-year recovery period) with prior law (generally a useful life of 35 years) and using a 12-percent discount rate approximate $43,200 ($8.64 per $100 invested).

Other Provisions Under ACRS

Three additional changes introduced under ACRS include expanded investment tax credits for rehabilitation expenditures, increase in the used property limitation for investment tax credits, and the ability to elect longer recovery lives for classes of assets. The first of these topics is discussed in Chapter II of this booklet. The other two are addressed briefly here.

Under prior law, investment tax credits could be claimed on up to $100,000 of qualified used property in any taxable year. Members of a controlled group of corporations (under common ownership) were required to allocate this $100,000 used-property limitation among individual members. Under ACRS, the used-property limitation is increased to $125,000 for property placed in service in taxable years beginning in 1981-1984, and is increased to $150,000 after 1984.

A provision of the ACRS depreciation rules entitles taxpayers to make an irrevocable election to extend the recovery period for all assets of a class that are placed in service in a particular year. For personal property, this election must be made for all assets of a particular class. For real estate, the election is made on a property-by-property basis. The purpose of this election is to give taxpayers greater flexibility in timing depreciation, specifically in situations where the additional deductions available under ACRS are not needed currently. Taxpayers can elect to use straight-line depreciation under the following alternatives:

Recovery Period Alternatives

Asset Class	*Allowable Recovery Periods*
3-year	3, 5, or 12
5-year	5, 12, or 25
10-year	10, 25, or 35
15-year	15, 35, or 45

To illustrate this point, assume that two individuals establish a Subchapter S corporation anticipating large losses in the early years of operation. Each individual currently has significant other income and expects such income to continue. Under regular ACRS, the individual's share of the Subchapter S corporation's loss wipes out any personal taxable income. Yet, as the loss reduces more and more personal income, the marginal value of each additional $100 deduction is reduced to as little as $11. Under an optional recovery period election the loss is reduced so that each individual pays some personal income tax on a small amount of income not covered by the Subchapter S loss. Now, however, the depreciation deductions not taken this year at low marginal tax rates are available for use against income of future periods at higher rates. This strategy would be equally applicable to a corporation that pays income tax in view of the graduated corporate rates on taxable income up to $100,000.

Credit for Research and Experimentation Expenditures

The law now allows a taxpayer a nonrefundable 25-percent credit for certain non-capital research expenses in excess of a base-period average.

Those who operate in research-intensive industries should refer to Chapter VII of this booklet for more detailed coverage of the newly enacted credit for research expenditures.

Extension of Carryover Periods for Tax Credits and Losses

The new law extends from seven to 15 years the carryover period for net operating losses, investment tax credits, new jobs credits, WIN credits and alcohol fuel credits. Effective dates for extension of the carryover period apply as follows to losses and credits:

	Years Ending After:
Net operating losses	December 31, 1975
Investment tax and WIN credits	December 31, 1973
Alcohol fuel credits	September 30, 1980
New jobs credits	Years beginning after December 31, 1976

Taxpayers with years ending in 1981 and 1982 need not be as concerned as before about accelerating income and deferring deductions to take advantage of expiring investment tax or WIN credits from years ended in 1974 and 1975 respectively. Such credits can now be applied as late as years ending in 1989 and 1990. In fact, taxpayers with unused investment tax or WIN credits from tax years ending in 1974 who have changed their year end since 1974 may be able to resurrect what were thought to be lost credits. For, even though seven or more taxable periods have expired since the credit was earned, the fact that it arose in a year ended after December 31, 1973 entitles the taxpayer to a 15-year carryforward.

Lower Corporate Tax Rates

Corporations with less than $50,000 in taxable income benefit from tax rate reductions to be phased in over a two-year period. Present rates of 17 percent on the first $25,000 of taxable income and 20 percent of the next $25,000 are each decreased by one percentage point per year for years beginning in 1982 and 1983. Thus, in 1983 and subsequent years, the tax on the first $50,000 of corporate income declines $1,000 from its current $9,250 to $8,250.

Relaxed Subchapter S Qualification Standards

Subchapter S permits incorporation and operation of small businesses without double taxation of income at the corporate and shareholder levels. Income or losses of electing Subchapter S corporations are passed through to each shareholder in proportion to the shareholder's share of the corporation's total stock. The new rules ease qualification requirements in an attempt to facilitate the use of Subchapter S provisions by more businesses. Certain trusts now can be Subchapter S shareholders, and the maximum number of shareholders in a Subchapter S corporation is increased from 15 to 25. A qualified Subchapter S trust basically is a trust terminating not later than the life of the income beneficiary (who must be a U.S. citizen or resident), all of the income of which is distributable annually to such income beneficiary. The beneficiary of such a trust is deemed to be the owner of the Subchapter S corporation stock held by the trust. Therefore, the income is includible in the benficiary's tax return based on the year end of the Subchapter S corporation rather than on the year end of the trust.

The new maximum individual tax rate of 50 percent will undoubtedly make Subchapter S elections more attractive. The pass-through of Subchapter S taxable income to an individual is considered dividend income previously taxed at rates as high as 70 percent. To avoid this, shareholders often resorted to increased salaries and bonuses to reduce Subchapter S income since such salaries and bonuses were eligible for the 50-percent maximum tax rate on earned income. The possibility always existed, however, for the Internal Revenue Service to deem such compensation as unreasonable, thereby disallowing it as a deduction and increasing Subchapter S income taxable at a rate higher than 50 percent. This potential problem no longer exists for federal tax purposes, since the maximum rate for individuals on all types of income is 50 percent. The distinction still might have some significance, however, in certain state and local taxing jurisdictions.

Increased Minimum Accumulated Earnings Credit

High borrowing costs and lack of access to equity markets often lead small businessmen to rely heavily on internally generated earnings to finance possible future expansion. The tax law imposes a limit, previously $150,000, on the level of earnings that can be retained by a closely held corporation other than for the reasonable needs of the business. Where earnings are accumulated above that limit (without specific growth plans), an onerous accumulated earnings tax is assessed in addition to the regular corporate income tax. The new law raises the "accumulated earnings credit" from $150,000 to $250,000 to adjust for rising costs and to give small businessmen a wider margin for retaining earnings for future contingencies. The increased credit is not available, however, to service corporations in health care, law, engineering, architecture, accounting, actuarial science, the performing arts or consulting.

Incentive Stock Options

Under the new law small businessmen can use "incentive stock options" to encourage management retention and equity participation by employees. An employee who receives an incentive stock option is taxed only when the stock is sold, and the gain on the sale is taxed at favorable capital gains rates. The employee incurs no tax at either the date of grant or the date of exercise of such an option. An employer receives no deduction with respect to an incentive stock option, nor must its earnings be reduced for accounting purposes with respect to the granting or exercise of such options.

A holding period and an employment requirement must be met by an employee to achieve the desirable tax results of an incentive stock option. An option grantee cannot dispose of the stock within two years after the option is granted and must hold the stock itself for at least one year. The option holder must also be an employee continuously from the date of grant of the option until at least three months before the date of exercise.

Option terms must be approved by shareholders and must meet other conditions involving dates of grant, dates of exercise and transferability. Options for no more than $100,000 in value of stock based on the exercise price can be granted to a single employee in any one year. There are, however, carryover provisions if this amount is not used. The most difficult requirement for closely held businesses is that the option price must equal or exceed the fair market value of the stock at the date of grant. If all of the requirements are not met, an employee will recognize ordinary taxable income and the employer receives a comparable deduction. The new incentive stock option rules apply generally to options granted after January 1, 1981. However, under certain circumstances, an election may be made to treat certain options granted prior to 1981 as incentive stock options, if they qualify as such or their terms are amended to so qualify.

Whether incentive stock options turn out to be a useful device for closely held corporations will depend on the ultimate rules for determining "fair market value." An option whose price is less than the fair market value of a company's stock at the date of grant may still qualify as an incentive stock option if the option price is established "in good faith." Perhaps certain approaches will be set forth in regulations, or perhaps the problem can be overcome by the proper use of shareholder buy-sell agreements that will be deemed to establish a market value for closely held stock.

In some cases it might be economically more favorable for a company to grant a nonqualified stock option in a greater amount than an incentive stock option, since the tax deduction available to the corporation can offset the amount of ordinary income recognized by the employee. And, a closely held corporation might not be overly concerned about the charge to its earnings resulting from the issuance of a nonqualifed option.

Simplified LIFO Inventory Rules

The last-in, first-out (LIFO) system is an acceptable tax accounting method for inventories. Adoption of LIFO during inflationary periods is tax beneficial because higher, more recent inventory costs are matched against revenues, thereby leading to lower taxable income. However, inherent complexities in the computation of LIFO inventories limit its use by small businesses. The Economic Recovery Tax Act of 1981 allows certain small businesses with average annual gross receipts of less than $2 million to use a single pool of goods to determine the dollar values of their year-end LIFO inventories. Under prior law, small businesses carrying several types of inventory often had to use more than one pool of goods. This practice added to the complexity of LIFO and often detracted from the benefits.

In addition, the Act provides that taxpayers electing LIFO will have three years, increased from one year under the prior law, to take back into income inventory writedowns for the years prior to the LIFO election. Finally, the use of governmental indexes to compute LIFO inventory will be permitted under regulations to be issued by the Treasury.

Miscellaneous Changes

Increased Corporate Deductions for Charitable Contributions. Corporations may deduct up to 10 percent of taxable income for charitable contributions for taxable years beginning after December 31, 1981. Formerly, deductions for such contributions were limited to five percent of taxable income. Carryovers of past contributions in excess of allowable limits are available for five years, as under prior law.

Expanded Deductions for Employer Gifts to Employees. In general, employers may deduct only $25 per year for business gifts made to an individual. However, certain employee awards are excluded from the $25 limitation. The new legislation increases the ceiling on the deductibility of employee awards from $100 to $400 per person for length of service, productivity, or safety achievement. Three requirements must be met to ensure deductibility of gifts for employee accomplishments. Only items of tangible personal property, not cash, may be distributed. Gifts must be awarded as part of a permanent written plan. Finally, such a plan may not discriminate in favor of shareholders, officers or highly compensated employees as to eligibility or benefits. The employee recipients of such awards are not taxable on their value.

Higher Interest Rates on Deficiencies and Overpayments. Interest on underpayments and overpayments of taxes is 12 percent through January 31, 1982. After that date, interest will be on the basis of the average prime rate in effect for commercial banks in September 1981 (20 percent). Starting in 1983, interest rate adjustments will occur each January 1, based on the average prime rate for the previous September.

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