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A HISTORY OF INVESTMENT TAX CREDIT

by

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Bachelor of Science in Education

Valley City State College 1970

ARCHIVAL COPY

An Independent Study

Submitted to the Faculty

of the

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TABLE OF CONTENTS

Page

Chapter
I. INTRODUCTION.............................. 1

Chapter
II. EARLY DEVELOPMENTS UP THROUGH THE MORATORIUM OF 1966........................ 3

Prior to Accounting Principles Board Opinions No. 2 and No. 4.
Pertaining to Accounting Principles Board Opinions No. 2 and No. 4.
Subsequent to Accounting Principles Board Opinions No. 2 and No. 4.

Chapter
III. THE DEVELOPMENTS SUBSEQUENT TO THE MORATORIUM OF 1966........................ 18

The Investment Credit Provision of the 1969 Revenue Act
The Investment Credit Provision of the 1971 Revenue Act

Chapter
IV. SUMMARY AND CONCLUSIONS................. 31

SOURCES CONSULTED................................... 33

CHAPTER I

INTRODUCTION

Ever since implementation of the federal income tax, man has been searching for a way to decrease or avoid this tax. Some of his methods have been very acceptable such as using an accelerated method of depreciation or averaging his income over a period of years when the income fluctuates a great deal. On the other hand, some of his methods have been illegal such as purposely neglecting to record all of the income or recording too much expense. This search will continue as long as man is faced with the problem of taxation, but from time to time a special type of relief appears on the scene and such was the case with the passage of the 1962 Revenue Act.

One of the most important facets of this new law was a program of tax relief which was designed to offset federal income tax liability. The new tax benefit called Investment Tax Credit was designed to help both the individual and corporate taxpayer.[1]

The purpose of this paper is to trace the history of the investment tax credit from its beginning to the present time. In order to do this various aspects of the credit

will be considered such as: (1) what is it, (2) why was it begun, (3) who benefits from it and, (4) how should the accounting aspect of it be handled.

FOOTNOTES

[1]John J. Raymond, "Comments On The Revenue Act of 1962," Digest of Tax Articles, (April, 1963), pp. 17-19.

CHAPTER II

EARLY DEVELOPMENTS UP THROUGH THE MORATORIUM OF 1966

Events Prior to Accounting Principles Board Opinions No. 2 and No. 4

As previously noted the investment credit began with the Revenue Act of 1962. When President Kennedy signed this law on October 16, 1962 it stated that the tax credit would be retroactive to January 1, 1962. The amount of credit to be allowed would be a given percentage of an investment in qualified property.

Investment credit was begun to stimulate investments in qualified property by taxpayers. Basically, except for investments made by public utilities, the maximum credit was 7 per cent of the investment limited to $25,000 plus 25 per cent of the tax liability in excess of $25,000. The percentage limitation for a public utilities investment was 3 per cent.[1] The $25,000 limitation applied on a joint return or a return filed by a single person. This figure was reduced to $12,500 for a married person filing separately. In an affiliated group, the $25,000 was apportioned among its members. In a partnership, each member was allowed $25,000; the same was true of beneficiaries for trusts and estates plus stockholders of sub-chapter S corporations.[2]

If the amount of credit available exceeded the previously mentioned limitations, the excess could be carried back three years and ahead five. However, the carryback could only be used for a taxable year that ended after December 31, 1961. If there was unused credit as a result of a net operating loss carryback, then the unused credit could only be carried ahead. An additional year would be permitted for carryover if the regular carryback and carryover periods were not adequate to consume all of the available credit.[3]

To determine the amount of investment credit available, qualified property must be defined and its exceptions noted. Its treatment in specific areas namely, new and used property, leased property, property disposed of before the end of its estimated useful life, and property lost through theft or casualty must be considered.

Qualified property consists of section 38 property

> . . . as defined in section 48 (a), (b), (c). In general for property to qualify as section 38 property, it must: (1) be subject to depreciation or amortization in lieu thereof; (2) have a useful life of 4 years or more; and (3) be (a) tangible personal property or (b) other tangible property (not including a building and its structural components) utilized as an integral part of manufacturing, production or extraction, or constituting a research or storage facility used in connection with such activity.[4]

Certain categories of property will not be considered section 38 property even though they meet the above test qualifications. For example, property which is physically

located outside of the United States more than 50 per cent of the taxable year; property used by organizations which are tax exempt (unless it is used mostly in a trade which is unrelated); and property used by international organizations.

Section 38 property is also divided into new and used categories. New property is property on which "construction, reconstruction, or erection" is completed by the taxpayer after December 31, 1961, or which he purchased after December 31, 1961 and of which he is the original user. Used property is property purchased by the taxpayer after December 31, 1961 of which he is not the original user. On new property the investment credit percentage applies to the total basis. For used property, the percentage applies to a maximum cost of $50,000. In other words, that portion of the cost of used property which exceeds $50,000 is not subject to investment credit.[5]

The $50,000 limit on used property applies to a joint return; on the separate return of a married person the limit is $25,000. Affiliated corporations are limited to one $50,000 amount. The $50,000 limit applies at both the partnership and partner levels; at the estate and trust level; and to sub-chapter S corporations and their stockholders.[6]

In the case of either new or used property, the "applicable percentage" depends upon the useful life of the property. For eight years or more 100 per cent of the investment credit is applicable; for at least six years but less than eight, 66 2/3 per cent applies; for at least four years, but less than six, 33 1/3 per cent applies and if the useful life

is less than four years the credit does not apply.

The useful life of the property is determined to start on the date the taxpayer puts the property into service. From the investment credit standpoint, property with a useful life of between four and eight years should always be estimated to have the longest useful life possible. This is contrary to the usual practice of estimating the useful life for depreciation purposes; however, there is a good reason for this. For example, if property is estimated to have a useful life of only six years then only 66 2/3 per cent of the investment credit percentage is available even though the property may actually be used for eight years. On the other hand, if the same property is estimated to have a useful life of eight years and is actually only used six years, then 66 2/3 per cent of the credit has still been used and the extra amount of credit given in the beginning will have to be paid back, but the money will have been used interest free. Also if the property actually is used the full eight years, then 100 per cent of the credit will have been consumed. In the first example only 66 2/3 per cent was available even though it did last eight years. Whichever method is used, the taxpayer must compute the useful life of each asset separately for tax credit purposes.

When section 38 property is leased, the problem arises as to who should claim the tax credit; the lessor or the lessee. The lessor has the option of passing the credit on

to the lessee or retaining it himself. In order to make an economically wise decision it must be determined who will derive the greater economic benefit. Several factors need to be taken into consideration to determine this. First, if the lessor constructed the property, the lessee will usually receive the greater benefit because the basis on which his credit would be figured is the fair market value rather than the lessor's basis. Secondly, the lessor should take the credit when it is felt that the lessee will fail to lease the property for the full period on which the credit is computed (provided the lessor can lease the property again). Thirdly, section 46(a) may impose restrictions on the lessor or lessee so that one could take advantage of the credit immediately and the other could not.

If the lessor elects to pass the credit on to the lessee, the lessor's basis will not be decreased by section 48(g) but the lessee must make an adjustment to his rental deductions as specified in section 162. The computation of credit is determined by reference to the useful life of the property in the hands of the lessor rather than the estimated period of use by the lessee. Apparently this is done to insure the full amount of credit where the lessee leases for a short period of time and then renews his lease upon expiration. If the lessee fails to renew the lease and the credit is not all consumed, then adjustments will need to be made concerning the lessee's carrybacks and carryovers.[7]

In the case of property being disposed of before the end of its estimated useful life, as far as investment tax credit is concerned, the income tax for the year of disposal is increased by the amount of the credit applicable to the unused portion of the estimated useful life. In turn, the basis of the property is increased by the same amount so that gain or loss can be computed on the disposition thereby eliminating any advantage for either the government or the taxpayer upon disposal.[8]

When casualty losses and replacements are considered some problems may arise. For example, section 38 property may be destroyed by casualty in one year and replaced in the next year from insurance proceeds. When this occurs the basis of the property lost, due to the casualty, may need to be adjusted according to section 47(a) of the internal revenue code. In addition the credit may need to be reduced in the year of replacement due to the qualifications imposed by section 46(c) - (4). Section 46(c) - (4) requires that the cost or basis of the replacement property must be reduced by the amount of the insurance proceeds or the adjusted basis of the replaced property whichever is lessor. Presumably "the taxpayer would be entitled to a refund in the later year with respect to the earlier Section 47(a) adjustments. However, the answer is not clear and will have to be resolved by appropriate regulations."[9]

Thus, it is evident that investment credit has been

beneficial to those who made timely investments in qualified property. Actually the tax credit has been used by the federal government in an attempt to stabilize the economy; this is why the credit goes through the on-again, off-again cycle.

According to an easy analysis of the investment credit the larger businesses gain more in proportion to their total investment than do their smaller counterparts. Apparently the smaller businesses do not possess the flexibility to consume the credit as effectively, so sometimes they are not able to use all their credit.[10]

Events Pertaining to Accounting Principles Board Opinions No. 2 and No. 4

From the accounting standpoint the introduction of investment credit presented a problem. Accountants realized that net income after taxes would be affected but the question was how much and when? Three different approaches were considered by the Accounting Principles Board of the American Institute of Certified Public Accountants. The first approach would involve a contribution to capital. The second approach, called the flow-through method, would permit the credit up to the maximum limitation, to be used as a reduction of the federal income tax liability in the year the credit arose. The third approach, called the deferred credit method, would allocate the credit over the useful life of the asset.[11]

To demonstrate the various methods and their effect on

net income after taxes, assume in each instance that net income before taxes is $60,000; that new equipment with an estimated useful life of ten years has been purchased for $500,000; and that the tax rate is 50 per cent. In the first approach the investment account would be debited for $500,000 and cash or some liability account credited for $500,000. Tax expense would be debited for $30,000 and taxes payable credited for $30,000 to record the tax expense for the period. Then the following entries would be made to record the effects of the investment credit. Taxes payable would be debited for $26,250; donated capital and deferred taxes payable would each be credited for $13,125. This would make a contribution to capital for part of the credit and the rest would be used to adjust income tax expense to income tax liability over the useful life of the asset. (The $26,250 total was arrived at by applying the limitation of $25,000 plus 25 per cent of the tax liability in excess of $25,000.)

In the second approach the two initial entries would be the same as above and the third entry would be as follows: debit taxes payable for $26,250 and credit tax expense for $26,250. This would have the effect of increasing net profit after taxes from $30,000 to $56,250.

In the third approach the initial entry would be the same as in the previous two. The second entry would record the accrued income tax expense by a debit to income tax expense for $30,000 and a credit to income tax liability for

$30,000. Then an entry would be made to recognize the investment credit by debiting income tax liability for $26,250 and crediting deferred investment credit for $26,250. At the end of the year an additional entry would be necessary to record the portion of investment credit earned during the year. In this example it is assumed that the purchase was made at the beginning of the year so an entire years credit would have been earned. Thus, the entry would be a debit to deferred investment credit for $3,281.25 and a credit to tax expense for the same amount. The $3,281.25 was arrived at by apportioning the $26,250 over the estimated useful life of the asset (eight years). This would provide for income after taxes of $33,281.25 instead of the $30,000 had the credit not been available.[12]

After the Accounting Principles Board analyzed the various approaches they issued Opinion No. 2 in December, 1962. In the Opinion the Board indicated their preference for the deferred credit method. They felt that net income should show the effect of the credit over the useful life of the asset instead of just in the year in which the property was placed in service. They had two important reasons for this. First the Board felt income should be the result of the facilities use rather than its acquisition. Secondly, the realization of credit is dependent to a certain degree upon future developments.[13]

The effects of Opinion No. 2 were not as far reaching or generally accepted as the Board had desired. Since the authority of the Board is not absolute, the general acceptability or lack of such regarding their Opinions tends to influence their authority on a particular subject. Since the announced preference for the deferred method in Opinion No. 2 lacked general acceptability, the Board felt compelled to issue the modification contained in Opinion No. 4.[14] Thus, in March, 1964, the Accounting Principles Board issued Opinion No. 4 which amended Opinion No. 2. The basic amendment dealt with the method of handling the investment credit. The Board indicated that they still preferred the deferred credit method, but since it wasn't universally accepted they would also accept the flow-through method.[15] The outside pressure had caused the Board to back away from a firm commitment of only one acceptable method.

Events Subsequent to Accounting Principles Board Opinions No. 2 and No. 4

By late 1966 Congress and President Johnson felt that investment credit should be repealed so on November 8, 1966 the President signed the "Investment Credit and Accelerated Depreciation Suspension Act of 1966." The law was to be effective retroactive to October 10, 1966 and extend through December 31, 1967,[16] but the termination date was later changed to March 9, 1967.[17]

Generally speaking, the suspension applied to otherwise qualified property if the property was acquired during the suspension period, was ordered within the suspension period, or if construction, reconstruction, or erection began during this period.[18]

A number of exceptions should be noted. First, the credit was still available if a binding contract to buy or construct the property was in effect on October 9, 1966. Secondly, the credit was still available if 50 per cent or more of the planned plant or "plant facility" was purchased or contracted for, previous to October 10, 1966. Thirdly, the credit was still available if previous to October 10, 1966 more than 50 per cent of the components or cost of parts for a "piece of machinery" were on hand. Fourthly, a qualified investment of $20,000 or less for a small business (or $10,000 for a married taxpayer filing separately) would still qualify for the credit.

The "construction-in-process" exceptions mentioned in the second and third exceptions above have special significance. They were devised with the purpose of exempting certain equipment or projects which essentially were committed to construction or acquisition before October 10, 1966, but no formal contract had been signed. Three projects were included in this special exemption, namely, "equipped buildings," "plant facility," and a "piece of machinery or equipment." The "equipped building" exception applied only

if a building was involved and a definite and specific plan was in evidence for the project before October 10, 1966 and no "substantial" modifications were made thereafter. The "plant facility" exception applied if there weren't any significant building structures involved and more than 50 per cent of the "facility" was under construction or contract before October 10, 1966. Under the "piece of machinery or equipment" exception, the total amount would qualify for the exception if more than 50 per cent of the parts and components were on hand or their cost accounted for prior to October 10, 1966.

The suspension did not disqualify property in the hands of a transferee if it was qualified in the hands of the transferor on October 9, 1966 provided the transfer was made by one of the four following methods.

> By reason of death; in a tax-free exchange in which basis carries over, such as on an incorporation or in a merger; by sale and leaseback or sale subject to a lease in a transaction where the lessor is treated as the purchaser for investment credit purposes or where a long-term lease is involved;" or "from one member to another of an affiliated group.[19]

If a binding lease or contract to lease was in effect prior to October 10, 1966, the property involved would qualify for the credit regardless of when it is acquired or constructed. Also if the lease constituted at least 25 per cent of a large project, then a special rule applied whereby the other property for the project would qualify for the tax credit even though it was not under lease on

October 9, 1966. Consequently, there were many exceptions to the moratorium.

Two more important changes were the result of the suspension law of 1966. The first one increased the maximum limit on the credit allowed. The old limit was $25,000 plus 25 per cent of the tax liability in excess of $25,000. The new rule set the limit at $25,000 plus 50 per cent of the tax liability in excess of $25,000 to become effective January 1, 1968. The second change increased the carryover period for investment credit from five to seven years.[20]

The brief moratorium caused many managers to review their replacement needs in regard to property that previously qualified for the credit. The question they had to answer was, will it be more economical to replace old property now during the suspension period due to the high cost of maintenance or would it be better to wait until the suspension is lifted and thus obtain the tax benefit. Each manager had to answer this for himself based upon his needs and financial capabilities.[21]

An attempt was made to measure the effects of the investment credit suspension by mailing a questionnaire to 163 of the largest industrial corporations in the United States. The 163 were selected from the Fortune Directory of the 500 Largest Industrial Corporations in America. They were asked three questions. The first was, "did the suspension of the tax credit affect your capital expenditures for the calendar year 1967?" One hundred twenty-two replied and of those

75.5 per cent said no and the rest replied yes. The second question was, "How much was your capital expenditure budget affected by the suspension of the investment tax credit?" The replies varied from no effect to as high as 50 per cent depending upon what type of business they were in. Some felt they could not respond because of the short duration of the suspension and their expenditure commitments were from two to three years in length. The third question was, "did this repeal of the investment tax credit require you to seek additional external financing of capital expenditures?" Of the firms that replied, 94.3 per cent said no. So based on the survey, it appeared that the suspension was not very effective in dampening the economy, but it did create some ill will because of the off-again, on-again feature.[22]

FOOTNOTES

[1]John J. Raymond, "Comments on the Revenue Act of 1962," Digest of Tax Articles, XIII (April, 1963), pp. 17-19.

[2]Kenneth B. Berg and Fred J. Mueller, "Accounting For Investment Credits," The Accounting Review, XXXVIII (July, 1963), p. 555.

[3]Raymond, Digest of Tax Articles, pp. 17-19.

[4]John C. Baity and Wayne E. Chapman, "Investment Credit Offers New Concepts in Tax Planning: An Extended Analysis," Digest of Tax Articles, XIII (February, 1963), p. 50.

[5]Baity and Chapman, Digest of Tax Articles, pp. 50-51.

[6]Berg and Mueller, Accounting Review, p. 555.

[7]Baity and Chapman, Digest of Tax Articles, pp. 50-58.

[8]Raymond, Digest of Tax Articles, p. 19.

[9]Baity and Chapman, Digest of Tax Articles, pp. 58-59.

[10]Donald L. Richard, "An Analysis of Early Investment Credits," Digest of Tax Articles, XIX (December, 1968), pp. 2-7.

[11]Accounting Principles Board, "Accounting For the Investment Credit," Opinion No. 2, (666 Fifth Avenue, New York, N. Y. 10019: American Institute of Certified Public Accountants, December, 1962), p. 5, paragraph 3.

[12]Kenneth B. Berg and Fred J. Mueller, "Accounting for Investment Credits," The Accounting Review, XXXVIII (July, 1963), pp. 556-559.

[13]Accounting Principles Board, Opinion No. 2, p. 7, paragraph 12.

[14]Accounting Principles Board, "Accounting for the Investment Credit," Opinion No. 4, (666 Fifth Avenue, New York, N. Y. 10019: American Institute of Certified Public Accountants, March, 1964), pp. 22, paragraph 6, 9, 10.

[15]Accounting Principles Board, Opinion No. 4, p. 22, paragraphs 9, 10.

[16]Ernst and Ernst, "Suspension of the Investment Credit and of the Allowances of Accelerated Depreciation on Buildings," The Maryland CPA Quarterly, VII (February, 1967), p. 21.

[17]Prentice-Hall Incorporated, Federal Tax Course, (Englewood Cliffs, N. J.: Prentice-Hall Incorporated, (1971), p. 2011.

[18]Ernst and Ernst, Maryland CPA Quarterly, p. 21.

[19]Gerald J. Holtz, and Harold R. Jenkins, "How to Deal with the Investment Credit and Accelerated Department Suspension," The Journal of Taxation, XXV (December, 1966), pp. 322-324.

[20]Holtz and Jenkins, Journal of Taxation, p. 324.

[21]D. P. Call and P. Kircher, "Investment Credit Moratorium," Journal of Accountancy, CXIII (March, 1967), pp. 49-50.

[21]William R. Parker, "The Impact of Suspension of 7% Investment Credit," Management Accounting, XLIX (February, 1968), pp. 51-52.

CHAPTER III

THE DEVELOPMENTS SUBSEQUENT TO THE MORATORIUM OF 1966

The Investment Credit Provisions of the 1969 Revenue Act

The cycle was continued when the Tax Reform Act of 1969 was signed into law by President Nixon on December 30, 1969. One of the biggest changes the law enacted was the repeal of the investment tax credit. Even though the law was not signed until December 30th, the repeal was retroactive to April 18, 1969. Like its counterpart, the brief moratorium from October 10, 1966 through March 9, 1967, the suspension did not cut off all investment credit immediately. There was a transitional period in which some property still qualified. This property was called "pre-termination property." Property which qualifies for this definition will be eligible for investment credit if placed in service prior to December 31, 1975; after that date all property will be exempt from the credit according to the 1969 law. Many people were affected in one way or another by the repeal and so the following paragraphs will explain, somewhat, who was affected and how.

"Pre-termination property" is property that meets any one of a number of tests. The following types of property

will qualify. Property that was acquired, or on which construction began prior to April 19, 1969; property acquired after April 18, 1969 if it was on order under a binding contract on April 18, 1969.[1] The contract may be oral or written. The price may be open and minor modifications may be permitted in the item to be delivered plus the contract may be conditional on an event to occur subsequent to April 18, 1969, which in essence is controlled by a third party.[2]

Other instances where eligibility will be met for the exception are under the "equipped building rule," and the "plant facility rule." Under the first rule the property will qualify the same as before the repeal if construction was begun before April 18, 1969 and more than 50 per cent of the total anticipated cost has been incurred either through construction or by ordering the necessary components. If the 50 per cent clause is not met, then each item of equipment and machinery is treated separately to determine if it qualifies. The second rule is very similar in that when more than 50 per cent of the facility was started or under contract on April 18, 1969 the whole facility will be eligible the same as before the repeal.

In a leaseback situation the previous commitments control the eligibility factor. If a binding contract was entered into before April 18, 1969 and the property was transfered to a third party the credit is still available despite the repeal. If a lease contract was signed prior to

April 19, 1969 requiring either the lessor or the lessee to construct or acquire property as specified in the lease, the property will be eligible for the credit. If the lessor changes his manner of doing business just to obtain the benefit of the credit he will not be eligible.

Another example of the exception for the repeal concerns barges. If barges are specifically designed or constructed to be used with ocean going vessels which qualify for the credit, then the barges will be eligible too.[3]

In certain types of property transfers, the repeal date does not cancel the credit. So in those situations the transferee is eligible for the credit if the transferor qualified before the transfer. The following transfers fall within this category. First, transfer because of death. Secondly, a tax-free exchange where the basis carries over as in a merger or incorporation. Thirdly, corporate acquisition of assets within two years after the stock acquisition if a contract for the transaction was signed prior to April 19, 1969. Fourthly, a sale or leaseback when the lessor is treated as the purchaser for investment credit purposes. Fifthly, a transfer between members of an affiliated group.

One of the more important transitional rules dealt with the mitigation of a credit loss due to recapture when property acquired or constructed before April 18, 1969 is replaced by similar property following April 18, 1969. The "investment credit recapture is reduced on retired property

to the extent it is replaced within six months by property that would have qualified for the credit except for the repeal. Where the retirement occurred because of casualty or theft, the six month rule is waived."[4]

The House Ways and Means Committee determined that unused investment credit totaled about $2 billion on December 31, 1968. The Committee felt that this reserve was too large and should be phased out so the 1969 Revenue Act imposed a limitation on the amount of carryover available after December 31, 1968. The restriction limited the amount of the carryover to 20 per cent of the higher of (1) the total of investment credit carrybacks and carryovers to the taxable year or, (2) the highest total carrybacks and carryovers for any other year which began since 1968. This 20 per cent limitation is in addition to the prior limit of $25,000 plus 50 per cent of the tax liability in excess of $25,000. If the credit is unused solely because of this 20 per cent limitation then an additional three years will be granted in which to use the credit beginning January 1, 1969.

Before the repeal was enacted it was estimated that such action would cost corporations about $2.7 billion annually. In anticipation of the repeal many managers made large scale commitments in March and early April. Those who benefited the most from the credit were people whose equipment expenditures were relatively high in comparison to their current earnings. Conversely, they would suffer the

greatest loss from a repeal.[6]

Due to the retroactive feature of the repeal many people owed extra tax because they had taken the credit and now they weren't entitled to it. However, if they paid the extra tax within 90 days of the date the law was passed, they would not be assessed a penalty or an interest charge.[7]

To get a feeling of the impact of the 1969 repeal of investment credit a questionnaire was sent to 35 of the largest corporations in America. These corporations were selected at random from Fortunes 500 Largest United States Corporations. An analysis of the results showed a minimal effect. It appeared that the elimination of investment credit and accelerated depreciation would be largely offset by the reduction and eventual elimination of the 10 per cent surcharge.[8]

The author of this paper and his father were affected to quite an extent by the repeal of 1969. During the summer and fall of 1969 they purchased about $20,000 worth of equipment that ordinarily would have been eligible for the credit. However, due to the retroactive feature of the repeal the credit was not available.

In view of the above mentioned facts it is apparent that the investment credit repeal had different effects on various individuals and corporations. The degree of effect depended upon the circumstances surrounding their particular case.

The Investment Credit Provision of the 1971 Revenue Act

The next act in the historical cycle of the investment credit was its restoration by the Revenue Act of 1971. This law was signed by President Nixon on December 10, 1971[9] and restored the investment credit, now called the "Job Development Investment Credit."[10] Under the new law, qualified property will be eligible for the credit if it was ordered on or after April 1, 1971 or was acquired after August 15, 1971, regardless of when it was ordered.[11]

The main objective for the restoration of the credit was to stimulate the economy. Actually the program to accomplish this objective was two-fold in its plan. First, reverse the trend of buying equipment which had lagged badly in the previous 18 months; secondly, increase the industrial and commercial activity by stressing the use of new equipment and methods.

In order to create a more favorable attitude toward the restored credit, the words "job development" were added to the title. The primary reason for this was to counteract organized labor's opposition to the credit. Organized labor felt that the restoration of the credit would ultimately reduce the number of jobs due to increased use of machine power. However, Secretary of the Treasury John B. Connally pointed out that more jobs would be created because the credit would spur buying. This in turn would call for greater productivity and an increased labor force.

Consequently, the government proceeded with the restoration of the credit and called it the "Job Development Investment Credit."[12]

In many respects the new investment credit resembles the previous credit which was repealed in 1969. Most of the modifications are minor, but there are a few significant changes and these will be stressed as they are encountered.

Basically the new credit is 7 per cent, except for investments made by public utilities, of an investment in qualified property, called section 38 property. The percentage limitation for a public utilities investment has been raised from 3 per cent to 4 per cent. The maximum credit is $25,000 plus 50 per cent of the tax liability in excess of $50,000. In the event there is unused credit it may be carried back three years and ahead seven with a few exceptions where the rules may vary for unused credit accumulated prior to 1971.

To obtain the maximum credit the asset must have an expected useful life of at least seven years now, whereas it used to be eight. In order to obtain 66 2/3 per cent credit the expected useful life must be from five to seven years now compared with six to eight years previously. For 33 1/3 per cent credit the expected useful life must be from three to five years in contrast with four to six years before. No credit is available for property with an expected useful life of less than three years.

This credit is available to whoever meets the qualifications but there are special rules for several types of entities that should be noted. When sub-chapter S corporations are the recipient of the credit, the credit is passed directly to the shareholders. In a partnership the credit is allocated at the partnership level and for estates and trusts the credit is apportioned among the trust (or estates) and its beneficiaries the same as income is allocable to each.

In order to determine the amount of investment credit available, section 38 property must be defined and its exceptions noted. Its treatment in specific areas, namely new and used property, property disposed of before the end of its estimated useful life, property lost through theft or casualty, and leased property must be considered.

Section 38 property includes the following: (1) "Tangible personal business property" such as trucks, office equipment, factory machinery and fixtures such as grocery counters, display shelves and refrigerators; (2) "Elevators and escalators;" (3) "Certain tangible real-property-like-assets," for example, bridges, gas lines and telephone poles; (4) "Certain research and storage facilities" used in connection with production, like a farmer's silo and gas storage facilities. In addition the new law specifically includes a facility for bulk storage of fungible commodities; (5) Lodging facilities such as hotels and motels if more than 50 per cent of the living quarters are used by transients with

rental periods of less than 30 days; (6) A nonlodging commercial facility which can be used by the tenant and the general public, examples of which would be drug stores, restaurants and grocery stores; (7) Coin-operated laundry machines; (8) Livestock with the exception of horses and; (9) Motion picture and television films including the production costs which the producer capitalizes. The items under (7), (8) and (9) became eligible for the credit under the new law.[13]

An innovation of the new law was the exclusion of foreign made assets from the eligiblity list unless they qualify for one of the four exceptions. Property is considered foreign if it was completed outside of the United States or at least 50 per cent of its basis is attributable to value from outside of the United States. Puerto Rico and United States possessions are considered part of the United States for this test. The four exceptions are: (1) property that would have been eligible under the previous credit because of a transitional rule; (2) property on which construction, reconstruction or erection was begun by the taxpayer between April 1 and August 15, 1971; (3) property ordered between April 1 and August 15, 1971 and; (4) property specifically excluded by the President.[14]

In addition to the above qualifications section 38 property must be divided into a new and used category. The purpose of this is to establish the basis upon which the given percentage must be applied to determine the credit.

The percentage is applied to the total basis of new property and limited to a maximum basis of $50,000 for used property, the same as under the previous investment credit.

In the event section 38 property is disposed of before the end of its estimated useful life, the unused portion of the credit generally must be paid back to the government as recapture of ordinary income, the same as under the previous credit. However, there is one new exception. If property was purchased prior to August 15, 1971 and is disposed of early, the seven year life as a maximum requirement would be used instead of the eight years. For example, if a machine bought in the fall of 1964 is disposed of in the fall of 1971 there would not be any recapture because the seven year life applies instead of eight.

When property is lost by theft or casualty, a special rule applies for determining the portion of the replacement property which qualifies for the investment credit. This is determined by starting with the basis or cost of the replacement property and then reducing it by the lessor of the insurance proceeds or adjusted basis of the old property.

In the event new section 38 property is leased, the lessor has the option of retaining the credit or passing it on to the lessee the same as under the previous investment tax credit law, except for two new changes. The first change grants a corporate partner in a joint venture the right to its pro rata share of the partnership's credit for

leases entered into after September 22, 1971. The second change provides that the lessor may not pass the full credit through to the lessee unless the lease is for at least 80 per cent of the "Class Life" of the property or the class life is less than 14 years or it is a net lease. This change applies to leases begun after November 8, 1971.[15]

In view of recent developments, the proper accounting methods for the new credit must be considered. Late in the fall of 1971 the Accounting Principles Board issued an Exposure Draft for a proposed APB Opinion on "Accounting for Investment Tax Credits." In this Exposure Draft the Board barred the use of the flow-through method in favor of the deferral method. Shortly thereafter Congress ruled that the taxpayer could use the method he preferred provided he disclosed which method it was and he used it consistently.[16] This Congressional action prompted the Accounting Principles Board to issue a statement on December 9, 1971 in which they voiced their disapproval of that Congressional action. The Board said,

> The APB unanimously deplores Congressional involvement in establishing accounting principles for financial reports to investors, which largely have been the responsibility of the Securities and Exchange Commission and the accounting profession. The APB further deplores Congressional endorsement of alternative accounting methods, especially since there has been strong demand by Congressmen and others for the elimination of alternative methods which confuse investors.[17]

Thus it is evident that the Accounting Principles Board felt Congress had infringed upon their authority. Only time

will reveal the results of this action and how the Board will respond with the content of their next Opinion on accounting for investment tax credit.

Looking back to the early months of 1971 it is easy to see that feelings were already being aroused toward the possibility of restoring the investment credit. Some viewed the possibility with eagerness and some did not. Some of those who favored it were toolmen who had experienced a bad year in 1970. In that year 32 per cent of the toolmen employed by builders of metal cutting tools were laid off; thus they favored a credit restoration.[18] Of those opposed were many businessmen who felt the instability of the credit due to its off-again, on-again feature outweighed the advantages.[19] Consequently there was a diversity of opinion, but the credit was restored and now the economists are endeavoring to measure its overall effectiveness upon the economy.

FOOTNOTES

[1]"The Tax Reform Act of 1969 - Termination of the Investment Credit Tax," The Oklahoma CPA, IX (October, 1970), pp. 5-7.

[2]Gerald J. Holtz and Harold R. Jenkins, "The Investment Credit: Act Five - Repeal," Taxes, XLVIII (1970), p. 146.

[3]Owen T. Smith, "Tax Reform Act of 1969," Digest of Tax Articles, XX (January, 1970), pp. 60-63.

[4]Holtz and Jenkins, Digest of Tax Articles, p. 149.

[5]"The Tax Reform Act of 1969 - Termination of the Investment Credit Tax," The Oklahoma CPA, IX (October, 1970), p. 5.

[6]"End to Investment Credit?" Financial World, CXXXII (September 24, 1969), p. 3.

[7]Holtz and Jenkins, Digest of Tax Articles, p. 151.

[8]L. C. Phillips, "Impact of the New Tax Reform Law Upon Corporate Decisions and Earnings," Financial Analysis Journal, XXVI (May, 1970), pp. 21, 26.

[9]Gilbert Semonetti, Jr., "The Investment Credit," Journal of Accountancy, CXXXIII (February, 1972), p. 75.

[10]Revenue Act of 1971 Contains Many Little Noticed but Far Reaching Provisions, "Taxation For Accountants, VIII (January, 1972), p. 7.

[11]Prentice-Hall, Incorporated, "Concise Explanation of the Revenue Act of 1971," 1972 Federal Tax Course (Student Edition), (December 10, 1971), p. 10.

[12]A. N. Wechsler, "Investment Credit to Spur Equipment Buying Plans," Purchasing, LXXI (September 30, 1971), pp. 11-13.

[13]Prentice-Hall Incorporated, "Concise Explanation of the Revenue Act of 1971," 1972 Federal Tax Course (Student Edition), (December 10, 1971), pp. 9-17.

[14]"Revenue Act of 1971 Contains Many Little Noticed but Far Reaching Provisions," Taxation In Accountants, VIII (January, 1972), p. 7.

[15]Prentice-Hall, Incorporated, "Concise Explanation of the Revenue Act of 1971," 1972 Federal Tax Course (Student Edition), (December 10, 1971), pp. 9-17.

[16]"Revenue Act of 1971 Contains Many Little Noticed but Far Reaching Provisions," Taxation In Accountants, VIII (January, 1972), p. 7.

[17]Semonetti, Journal of Accountancy, pp. 75-77.

[18]R. A. Wilson, "Toolmen Cry Investment Credit Now," Iron Age, CCVII (April 15, 1971), p. 45.

[19]"Business Looks Warily at the Tax Credit," Business Weekly, (October 2, 1971), pp. 78-79.

CHAPTER IV

SUMMARY AND CONCLUSIONS

Tracing the history of investment tax credit is like reading a continued story where another part is added whenever the Federal government so desires. This is due to the fact that the Federal government has used the credit as a tool to either encourage or discourage capital expenditures. When the economy slows down, the investment credit is used as an incentive to increase spending. When the capital outlays become too great and the trend is regarded as inflationary, the investment credit is suspended.[1] A survey conducted of management accountants' attitude toward the investment credit revealed that 68 per cent of those who responded favored keeping the credit as a part of the tax policy. Over 90 per cent of the respondents favored a one basis method of accounting for the credit, and about 75 per cent preferred the flow-through method. If the credit was to be deferred, 52 per cent favored showing it as a liability, but however it was recorded almost everyone felt it should be kept separate from depreciation.[2]

Looking back from a vantage point of ten years, it is evident that the investment tax credit has been used to

influence our nation's economy. No doubt it will continue to be used in that capacity to a greater or lesser degree as time progresses.

In the author's opinion investment credit should be applicable at all times, but at a lower percentage. Thus management would be able to incorporate the credit into their long range plans more easily and accounting for it would be less burdensome. If, on the other hand, the credit continues to be available in cyclical stages, then the Federal government's arbitrary feature of retroactivity should be eliminated. This would remove, at least, one of the features over which the taxpayer has no control. Another item that should be dealt with is the accounting method to be used. There should be one standard method which applies in all circumstances and the Accounting Principles Board should be permitted an influential voice in the decision as to which it should be. Thus it is apparent that investment tax credit needs to be refined in some areas, but perhaps this will be forthcoming in the future.

FOOTNOTES

[1]"End to Investment Credit?" Financial World, CXXXII (September 24, 1969), p. 3.

[2]William W. Ecton and James A. Knoblett, "Attitudes of Management Accounts on the Investment Credit Issue," Management Accounting, LII (September, 1970), pp. 36-37, 43.

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