

CHAPTER 7

REVISE TAXATION OF BUSINESS PROPERTY AND CAPITAL ASSETS

This Chapter presents the Administration proposals on taxation of investment in business property and capital assets. The proposals would preserve certain investment incentives for businesses and individuals, but would provide such incentives in a relatively neutral manner in order to limit investment distortions created under current law. The proposals would also adjust the tax system for inflation on a relatively comprehensive basis.

The centerpieces of the Administration proposals on capital formation are the proposed Capital Cost Recovery System, retention of favorable tax treatment for capital gains, and the proposal to allow businesses to index inventories. These proposals would stimulate private sector saving and investment and produce a more efficient allocation of capital. These proposals also would facilitate repeal of provisions such as the investment tax credit and selective rapid amortization rules that bias investment toward particular assets.

ADOPT NEW CAPITAL COST RECOVERY SYSTEM (CCRS)

General Explanation

Chapter 7.01

Current Law

The Accelerated Cost Recovery System ("ACRS") was established by the Economic Recovery Tax Act of 1981 and generally governs depreciation allowances for tangible property placed in service after 1980. ACRS assigns all "recovery property" to a class with a specified recovery period and depreciation schedule. In general, recovery property is defined to include all depreciable property placed in service after 1980, except intangible property, property subject to amortization, and property for which the taxpayer properly elects a method of depreciation, such as the units of production method, that is not expressed in terms of years.

The pre-ACRS depreciation rules remain in effect for property placed in service by a taxpayer prior to 1981. In general, these rules require taxpayers to recover an asset's original cost less salvage value over its estimated useful life. Taxpayers can elect among several rates of recovery ranging from straight line to methods that are substantially accelerated. Certain taxpayers can elect to depreciate assets under a system employing prescribed industry-wide class lives, with additional rules for salvage values, retirement, repair deductions, and other matters (the ADR system).

ACRS differs from prior depreciation rules in many important respects. ACRS recovery periods are not based on the useful economic lives of assets, and for most assets are significantly shorter than under prior law. ACRS employs accelerated depreciation schedules and also allows recovery of full original cost without reduction for salvage value. Thus, for most assets, ACRS allows much faster cost recovery and greater present value depreciation deductions than were obtainable under prior law.

ACRS classifies all personal property (other than public utility property) as three-year or five-year property. Automobiles, light trucks and research and experimentation property are the principal three-year property items, while most other personal property, including machinery and equipment, is recovered over five years. Most real property is classified as 18-year property, although some real property, including real property placed in service prior to March 16, 1984, qualifies as 10-year or 15-year property. Low-income housing is classified as 15-year property. Public utility property may be five-year, 10-year or 15-year property depending upon the class life of such property under prior law.

Under ACRS, foreign property (property used predominantly outside the United States during the taxable year) is generally subject to longer recovery periods than comparable domestic property. Generally, foreign personal property is recovered over the pre-ACRS class life of an asset or 12 years and foreign real property is recovered over 35 years.

The ACRS depreciation schedules for three-year, five-year and ten-year property are based on the 150 percent declining-balance method switching to the straight-line method. The schedules reflect a half-year convention which halves the first year's depreciation rate regardless of when during the year the property is placed in service. No depreciation deduction is allowed in the year of disposition of personal property.

The depreciation schedule for 18-year real property, except for special transition rules, is based on the 175 percent declining-balance method switching to the straight-line method. The depreciation schedule for 15-year low-income housing is based on the 200 percent declining balance method switching to the straight-line method. First-year depreciation rates for 15-year and 18-year real property are reduced to reflect the number of months during the first year in which property is held in service. Depreciation deductions for real property are allowed for the year of disposition, based on the number of months during which the property was in service for that year.

Under ACRS, the cost of building components, such as air-conditioning and electrical systems, is not recoverable over periods shorter than the building's recovery period. The recovery period for a component generally begins at the later of the time the component or the building is placed in service. The cost recovery for the component is accounted for separately from the building. Substantial improvements to a building are treated as a separate property item entitled to a separate recovery period and depreciation rate.

A lessee who makes capital improvements to leased ACRS property may recover the cost of such improvements over the remaining lease term, if such term is less than the ACRS recovery period. If the lessor and lessee are related parties, however, leasehold improvements must be recovered over the ACRS recovery period, even if the remaining lease term is shorter.

A taxpayer may elect longer recovery periods than the prescribed ACRS recovery period, but in doing so must use the straight-line method for determining the depreciation allowance. A taxpayer may also elect to use the straight-line method over the ACRS recovery period.

Taxpayers may elect to establish mass asset accounts for assets where separate identification is impractical. Only assets of the same recovery class which are placed in service in the same year may be included in a single mass asset account. Gain or loss is not computed

upon dispositions of items from a mass asset account, and instead all proceeds from sales of items from a mass asset account are treated as ordinary income. Correspondingly, dispositions do not reduce the unadjusted basis of the mass asset account, so that original cost basis can be fully recovered over the class recovery period.

A special exception to ACRS allows taxpayers to expense a small amount of property used in a trade or business. For taxable years beginning before 1988, a taxpayer may elect to expense a maximum of \$5,000 per year. The limit on expensing increases to \$7,500 for taxable years beginning in 1988 and 1989 and to \$10,000 thereafter. No investment tax credit may be taken on expensed property.

Generally, ACRS depreciation schedules apply to the unadjusted cost basis of an asset. However, if an investment tax credit is taken, the cost basis of an asset must be reduced by 50 percent of the amount of the credit before applying the depreciation rate. Gain or loss is generally recognized on the disposition (including retirement) of ACRS property. Gain or loss is computed with respect to the adjusted basis of property which reflects previously taken depreciation.

ACRS deductions are subject to recapture upon an asset's disposition. For all personal and most real property, gain recognized upon sale is recharacterized as ordinary income to the extent of previously allowable depreciation. There is no depreciation recapture on property for which a straight-line method has been elected. Only the excess of ACRS deductions over the straight-line method is recaptured on residential rental property, low-income housing and property used predominantly outside the United States.

ACRS does not apply to intangible assets. Amortization allowances are available under current law for intangible assets of limited useful life that are used in a business or held for the production of income. Generally, amortization allowances are computed using a straight-line method. Certain income-producing properties, such as motion picture and television films, may be amortized under the income forecast method which allocates costs proportionately to income expected to be produced.

Reasons for Change

Disregard of Economic Depreciation. Depreciation allowances should reflect the economic fact that, on average, the values of assets decline over time due to a variety of factors, including declining productivity, wear and tear, and obsolescence. If depreciation allowances understate real economic depreciation of a particular asset, income from the investment is overtaxed and a tax disincentive is created which impairs capital formation and retards the economy's productive capacity. Similarly, if depreciation allowances exceed real economic depreciation, incentives are created for investment in depreciable property.

The pre-ACRS depreciation system required capital costs to be recovered over the useful economic life of particular property. Generally, useful lives for particular types of property were significantly longer than the recovery periods introduced with ACRS. The rate of recovery over the useful life was often determined by election of the taxpayer. The pre-ACRS depreciation system did not take account of inflation. Thus, pre-ACRS depreciation deductions for many assets understated real economic depreciation and thus resulted in overtaxation of the income from such assets.

The cost recovery system introduced with ACRS addressed the prior overtaxation of capital investment by providing for more rapid acceleration of depreciation deductions. However, at low inflation rates, ACRS reverses the general overtaxation of capital investment. Moreover, ACRS does not differentiate between assets with varying experienced economic depreciation rates. Thus, under the broadly defined class of 5-year ACRS property, the same depreciation allowances are provided for assets with significantly different rates of economic depreciation. In addition, ACRS continues to base depreciation allowances on historic costs rather than current replacement costs; thus, the present value of fixed depreciation deductions varies with the rate of inflation. At recently experienced levels of inflation, ACRS, in combination with investment tax credits, reduces effective tax rates on investment in depreciable assets substantially below statutory tax rates. Under certain assumptions, for certain assets, ACRS, in combination with investment tax credits, is equal to or more favorable than current expensing, which is tantamount to tax exemption of the income from such depreciable assets.

Table 1 displays Treasury Department estimates, based on certain stated assumptions, of average effective tax rates for income derived from assets in the various ACRS classes. Table 1 demonstrates (1) the substantial extent to which ACRS and investment tax credits reduce effective tax rates below statutory tax rates, (2) the variance among ACRS classes in the extent to which ACRS and investment tax credits reduce effective tax rates, and (3) the volatility of effective tax rates in response to different inflation rates.

Non-neutrality of ACRS Investment Incentives. The low effective tax rates on ACRS property at current rates of inflation provide incentives for investment in depreciable property. However, these incentives are not distributed among depreciable assets in a neutral or systematic manner. As Table 1 demonstrates, effective tax rates on machinery and equipment are substantially lower than effective tax rates on structures for all rates of inflation. This substantial variance in effective tax rates is due in part to the application of a one-time, up-front investment tax credit for machinery and equipment and, in part, to the accelerated depreciation schedules for three-year and five-year ACRS property. A more neutral cost recovery system would preserve investment incentives while equalizing effective tax rates across assets.

Table 7.01-1

**Effective Corporate Tax Rates on Income from
Equity Financed Investments
with Various Rates of Inflation
for 46 Percent Taxpayer Under Current Law 1/**

Asset Class (Years)	Inflation Rate (Percent)		
	0	5	10
3	-75	-9	18
5	-47	-4	16
10	-6	19	31
15	8	33	43
18	27	39	45

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1/ Assumptions: Real return after tax is four percent. The investment tax credit selected is the maximum allowable for new equipment (six percent on three-year equipment and ten percent on five-, ten-, and 15-year equipment). Effective tax rates are the difference between the real before-tax rate of return and the real after-tax rate of return divided by the real before-tax rate of return.

Apart from the operation of the investment tax credit, significant distortions are inherent in the ACRS classification of machinery and equipment. With the limited exceptions of the assets assigned to the three-year ACRS class and assets of regulated public utilities, all types of machinery and equipment are classified as five-year ACRS property and depreciated according to the same schedule. Thus, ships and heavy machinery used in manufacturing receive the same depreciation allowances as computers and trucks. Plainly, these disparate assets experience significantly different rates of real economic depreciation. The effect of a uniform depreciation allowance is that slower depreciating assets, such as ships and heavy machinery, receive a substantially greater investment incentive than do faster depreciating assets. Thus, ACRS, by the very nature of its all-inclusive classification of machinery and equipment in the five-year class, distorts investment decisions across assets and industries.

Investment distortions created by ACRS, investment tax credits and other capital cost recovery provisions hamper economic efficiency. The tax code guides the allocation of capital, overriding private market forces and the individually expressed consumer preferences they represent. Paradoxically, these distortions do not reflect stated government policy to favor particular assets or industries. As a result, ACRS operates as an undeclared government industrial policy which largely escapes public scrutiny and systematic review.

ACRS also fails to provide a systematic level of investment incentives. Since ACRS does not take inflation or real replacement costs into account, the benefits of accelerated depreciation diminish as inflation increases. The variability of inflation over time precludes certainty as to the incentive actually provided for an investment in depreciable property. Such uncertainty acts as a depressant on economic activity. Increasing the certainty of obtaining inflation-proof cost recovery would stimulate risk taking and lead to more efficient allocation of investment funds.

Finally, ACRS has fueled the growth of tax shelters. The low or negative effective tax rates on ACRS property, especially in the early years of acquisition, make possible the sheltering of an investor's unrelated income and the accompanying deferral of tax liability. This encourages taxpayers to make otherwise uneconomic investments in order to obtain tax benefits. Also, the prospect of substantial up-front deductions encourages excessive leveraging and churning of assets. The resulting tax-motivated transactions and divergence from market determined patterns of investment impair economic productivity.

As tax shelter activity has increased due to ACRS and other provisions that mismeasure income, abuses have proliferated, the need for anti-abuse rules has grown, and the Internal Revenue Service has been required to devote additional resources to policing tax shelter investments. Moreover, whether or not abusive, tax shelters invite disrespect for the tax laws from those who perceive, correctly or not, that the laws are unfair and, hence, not worthy of compliance.

Proposal

New capital cost recovery rules would be established that preserve investment incentives while explicitly accounting for inflation and different rates of economic depreciation. The new Capital Cost Recovery System ("CCRS") would modify ACRS in several important respects. First, CCRS would allow cost recovery of the real or inflation-adjusted cost of depreciable assets, rather than only the original, nominal cost. Second, CCRS would assign property among new recovery classes based upon economic depreciation rates. Third, CCRS would prescribe depreciation schedules and recovery periods which produce systematic investment incentives that are neutral across recovery classes.

Under CCRS, all depreciable tangible assets would be assigned to one of six classes, which would replace the present five ACRS recovery classes. Each CCRS class would be assigned a declining-balance depreciation rate, ranging from 55 percent to four percent. The depreciation rate would be applied to an asset's inflation-adjusted basis in a manner described below. Applying a fixed declining-balance depreciation rate of less than 100 percent to the adjusted basis of an asset would never fully recover such basis. To ensure that depreciation accounts close out in a reasonable number of years, each CCRS class would be assigned a recovery period of between four and 28 years. The recovery period is not an estimate of the economic useful life of an asset and hence, is not comparable to recovery periods under pre-ACRS depreciation rules based on economic useful lives.

To avoid bunching of the depreciation allowance in the last year of the recovery period, CCRS depreciation schedules for each class would switch from the declining-balance rate to the straight-line depreciation method in the year in which, assuming a half-year convention, the straight-line method yields a higher allowance than the declining-balance rate. The half-year convention means that, for the CCRS class with a four year recovery period, the straight-line method is applied assuming placement in service on July 1 of the first year and retirement on July 1 of the fifth year. Since a half-year convention is assumed for purposes of determining the year in which the depreciation schedule switches from the declining-balance rate to the straight-line method, depreciation schedules cover one year more than the assigned recovery period.

Under CCRS, the first-year depreciation rate would be prorated based upon the number of months an asset was placed in service. A mid-month convention would be assumed for the month an asset is placed in service. For example, an asset placed in service by a calendar year taxpayer during any part of April would obtain a depreciation rate equal to the full first-year rate multiplied by a percentage equal to $(12-3.5)/12$.

Table 2 lists the CCRS depreciation schedules for each of the six recovery classes. The schedules for each class prescribe the depreciation rate which would be applied to the adjusted basis of an asset in each year. Table 2 identifies the year in which the depreciation schedule switches from the declining-balance rate to the straight-line method. The apparent increase in depreciation rates after the switch-over to the straight-line method does not mean that CCRS would be a back-loaded depreciation system. Relative to inflation-adjusted original cost, the straight-line method produces constant depreciation rates. It is only with respect to adjusted basis that straight-line method depreciation rates increase over time. Thus, under the straight-line method, in the close-out year, the applicable depreciation rate is always 100 percent and the remaining adjusted basis of an asset is fully recovered.

Table 3 converts the CCRS depreciation schedules from Table 2 to a different format. Table 3 presents CCRS depreciation rates as a percentage of inflation-adjusted original cost for each recovery class over the term of its recovery period. Table 3 demonstrates that CCRS would not be a back-loaded depreciation system. For each recovery class, 100 percent of the inflation-adjusted original cost would be recovered over the recovery period. For each recovery class, a greater proportion of inflation-adjusted original cost would be recovered in early years than in later years. The percentages of cost recovery in each year that are given in Table 3 reflect assumptions that property is placed in service on July 1 and that the mid-month convention is ignored. If actual depreciation allowances in the first year differ from those computed under the assumptions in Table 3, the percentage of cost recovery in subsequent years would differ accordingly.

CCRS would adjust depreciation allowances for inflation by means of a basis adjustment. Under ACRS, only the unadjusted original cost basis of an asset is recovered over the class recovery period. Under CCRS, after adjustment for allowable depreciation in the prior year, an asset's unrecovered basis would be adjusted for inflation during the current year using an appropriate government price index. The applicable depreciation rate would be applied to the resulting adjusted basis. There would be no inflation adjustment in the year in which an asset is placed in service; inflation adjustments would begin with the second year in which the asset is in service. Thus, the scheduled depreciation rate in Table 2 would be applied as of the end of a taxable year to an asset's basis which had been adjusted first for the prior year's depreciation and then for the current year's inflation. An asset's unrecovered basis would continue to be indexed for inflation after the switch-over to the straight-line method. The year in which the switch-over occurs would be dependent only on the class depreciation rate and recovery period, and not on the inflation rate.

Table 7.01-2

Capital Cost Recovery System Depreciation Schedule
 (as a Percent of Inflation-Adjusted Basis) 1/

Year	Class					
	1	2	3	4	5	6
1 <u>2/</u>	27.5	22	16.5	11	8.5	2.00
2	55	44	33	22	17	4.00
3	55	44	33	22	17	4.00
4	67	44	33	22	17	4.00
5	100	67	40	29	17	4.08
6		100	67	40	18	4.26
7			100	67	22	4.44
8				100	29	4.65
9					40	4.88
10					67	5.13
11					100	5.41
12						5.71
13						6.06
14						6.45
15						6.90
16						7.41
17						8.00
18						8.70
19						9.53
20						10.53
21						11.76
22						13.33
23						15.38
24						18.18
25						22.22
26						28.57
27						40.00
28						66.67
29						100.00

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1/ A half-year convention is assumed for purposes of determining the year in which the depreciation schedule switches from the declining-balance rate to the straight-line method. Consequently, the depreciation schedules cover one year more than the recovery period for each class.

2/ First-year allowance shown assumes an asset is placed in service by a calendar year taxpayer on July 1, without regard to the mid-month convention. Actual allowance in first year would vary depending on when asset is placed in service.

Table 7.01-3

Capital Cost Recovery System Depreciation Schedule
(as a Percent of Inflation-Adjusted Original Cost) 1/

Year	Class					
	1	2	3	4	5	6
1	27.5	22.0	16.5	11.0	8.5	2.0
2	39.9	34.3	27.6	19.6	15.6	3.9
3	17.9	19.2	18.5	15.3	12.9	3.8
4	8.1	10.8	12.4	12.0	10.7	3.6
5	6.6	9.1	10.0	12.0	8.9	3.5
6		4.6	10.0	12.0	7.9	3.5
7			5.0	12.0	7.9	3.5
8				6.0	7.9	3.5
9					7.9	3.5
10					7.9	3.5
11					3.9	3.5
12						3.5
13						3.5
14						3.5
15						3.5
16						3.5
17						3.5
18						3.5
19						3.5
20						3.5
21						3.5
22						3.5
23						3.5
24						3.5
25						3.5
26						3.5
27						3.5
28						3.5
29						1.8

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1/ Depreciation allowances are computed assuming an asset is placed in service by a calendar year taxpayer on July 1, without regard to the mid-month convention.

Although there would be no inflation adjustment to basis for purposes of determining depreciation in the year in which an asset is placed in service, there would be a full year's inflation adjustment in the close-out year if property is retained in service to the end of the close-out year. Retirement of an asset prior to the end of the close-out year would be treated as a disposition, upon which a taxpayer would obtain full recovery of an asset's remaining adjusted basis and recognize gain or loss. For retirements and other taxable dispositions, such as sales, there would be a pro-rata inflation adjustment to basis in the year of disposition for purposes of computing gain or loss. Such pro-rata adjustment would be based on the number of full months the asset was held during the year of disposition.

An asset's adjusted basis for depreciation purposes would be used for purposes of computing gain or loss upon disposition of a depreciable asset. The Administration is proposing to tax all real gains on sales or dispositions of depreciable property as ordinary income. There would be no preferential tax rate applied to long-term gains on depreciable assets. Losses from sales or dispositions of depreciable property would not offset capital gains but would be fully deductible against ordinary income. See Ch. 7.03.

Intangible assets would not be subject to CCRS and would be amortized generally under current law rules. For example, assets that are depreciable under the income forecast method or other method not measured in terms of years, such as motion pictures, would continue to be depreciable under rules similar to current law. The basis of depreciable property not subject to CCRS would be indexed for inflation beginning with the second year of amortization. Similarly, gains from sales or dispositions of amortized property which is indexed for inflation would be taxed at ordinary income rates.

Assets that are eligible for cost depletion, such as timber, oil and coal, would not be subject to CCRS. Depletable assets would be indexed for inflation, by means of an inflation adjustment to an asset's cost depletion basis used for purposes of determining ordinary income realized upon sale of the asset.

Foreign property would be recovered under a system of real economic depreciation that would not contain the investment incentives available to domestic property under CCRS. That is, for foreign property, the CCRS depreciation rates and recovery periods would be adjusted along the lines of the real economic depreciation system contained in the Treasury Department's Report to the President, Tax Reform For Fairness, Simplicity and Economic Growth, published in November 1984. The classification of foreign property would be on the same basis as the CCRS recovery classes. Indexing of foreign property would use the inflation rate of the taxpayer's functional currency.

Earnings and profits of domestic and foreign corporations would be computed on the same basis as depreciation deductions are allowed for foreign property.

The current law provision permitting taxpayers to elect to expense the aggregate cost of personal property not in excess of \$5,000 would be retained. The scheduled increases in the ceiling to \$10,000 would be repealed. See Ch. 7.05. Vintaged mass asset accounts would also be retained for property qualifying for such treatment under current law. CCRS would retain the current law distinction between deductible repairs and expenditures that appreciably prolong an asset's useful life or materially add to its value, and thus, must be capitalized. Capitalized costs would generally be added to the adjusted basis of the underlying asset or, in some cases, depreciated separately. Each CCRS class would be assigned a safe-harbor repair allowance factor. The safe-harbor would permit expenses incurred after the asset is placed in service to be deducted without challenge, if such expenses are allocable to the asset and do not exceed the product of the asset's remaining inflation-adjusted basis and the repair allowance factor.

Under CCRS, the cost of leasehold improvements that may be deducted by a lessee would be recovered under the general rules applicable to such property, regardless of the term of the lease. However, in the event leasehold improvements are reasonably expected to have no residual value upon expiration of the lease term, special rules would be provided to permit different depreciation rates to be applied to such improvements, taking into account the term of the lease (including any renewal options and reasonably expected renewal periods). In the case of leasehold improvements depreciated by a lessee under the general rules, a lessee would treat the termination of a lease as a disposition of the leasehold improvements and would compute gain or loss upon the adjusted basis in such improvements.

The scope of each CCRS class would be defined by reference to existing ACRS classes in the following manner. All three-year ACRS property would be classified in CCRS Class 1. All 18-year ACRS property and low-income housing, which is 15-year ACRS property, would be classified in CCRS Class 6.

ACRS five-year, 10-year, and 15-year public utility property would be classified in CCRS Classes 2 through 5. Class 2 would encompass trucks (other than light purpose trucks which are three-year ACRS property), buses, and office, computing and accounting equipment. Class 3 would cover construction machinery, tractors, aircraft, mining and oil field machinery, service industry machinery and equipment and instruments. Class 5 would include railroad structures, ships and boats, engines and turbines, plant and equipment for the generation, transmission and distribution of electricity, gas and other power, and distribution plant for communications services. All other ACRS

five-year, 10-year and 15-year public utility property would be grouped in Class 4. If an item of machinery, equipment or other property is not described by the asset-types listed in Classes 2, 3 and 5, and is not reclassified specifically under the procedure described below, such item would be assigned to Class 4.

Table 4 summarizes the classification of ACRS assets among the six CCRS classes.

CCRS would not prescribe a special class exclusively for property of regulated public utilities. Thus, unregulated companies generating their own electricity or providing communications services would depreciate assets on the same basis as regulated companies. For example, computers of regulated utilities would be in Class 2, while co-generation electric power plants of unregulated companies would be in Class 5. Furthermore, in recognition of the historic practice of requiring normalization of investment incentives for regulated public utilities, CCRS would contain normalization rules for regulated utilities comparable to those under ACRS.

The principle underlying CCRS classification of assets among the six CCRS recovery classes is that assets should be grouped on the basis of equivalent economic depreciation rates. Treasury Department empirical studies show that a geometric pattern of constant-dollar depreciation is generally an appropriate method to apply to all classes of business assets, even though the geometric pattern may not accurately characterize economic depreciation for all items within a class. Each of the six CCRS classes that resulted from the Treasury Department studies is comprised of a group of asset-types that, on average, have approximately the same present value of economic depreciation. The six CCRS classes are organized so as to minimize the variance in observed economic depreciation rates for assets within a class. (For a published account of Treasury Department commissioned studies, see "The Measurement of Economic Depreciation," by Charles R. Hulten and Frank C. Wykoff in Depreciation, Inflation, and the Taxation of Income from Capital (ed. C. Hulten, 1981.)

Table 7.01-4

CCRS Asset Classes

CCRS Class	Classification of ACRS Property 1/	Depreciation Rate 2/	Recovery Period 3/
Class 1	3-year property	55 %	4
Class 2	Trucks, Buses, and Trailers Office, Computing, and Accounting Equipment	44 %	5
Class 3	Construction Machinery, Tractors, Aircraft, Mining and Oil Field Machinery, Service Industry Machinery, and Instruments	33 %	6
Class 4	5-year, 10-year, and 15-year public utility property not assigned to Class 2, 3, or 5 -- E.g., Metal Working Machinery, Furniture and Fixtures, General Industrial Machinery, Other Electrical Equipment, Communications Equipment, Fabricated Metal Products, and Railroad Track and Equipment	22 %	7
Class 5	Railroad Structures, Ships and Boats, Engines and Turbines, Plant and Equipment for Generation, Transmission and Distribution of Electricity, Gas and Other Power, and Distribution Plant for Communications Services	17 %	10
Class 6	18-year property; 15-year low-income housing	4 %	28

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- 1/ Items of property are assigned to CCRS classes under rules described in the text of the General Explanation.
- 2/ The depreciation method switches from a constant declining-balance rate to the straight-line method in the year of service in which the straight-line method produces greater depreciation allowances than the declining-balance rate would, assuming a half-year convention for computation of the straight-line method.
- 3/ The recovery period is the number of years over which cost recovery is computed under the straight-line method. A consequence of assuming a half-year convention for purposes of computing depreciation rates under the straight-line method is that depreciation schedules cover one year more than the recovery periods.

The CCRS depreciation schedules assigned to each CCRS class in Table 2 build in incentives in excess of the economic depreciation rates used to classify property. The incentive depreciation schedules would reduce the effective tax rates on all CCRS classes. Table 5 contains the effective tax rates on property in each CCRS class, calculated on the basis of specified assumptions.

The proposed CCRS system contemplates that the Treasury Department would establish permanent facilities to conduct empirical studies of economic depreciation. Such studies would gather evidence for all types of assets of changing economic depreciation rates due to such factors as technological obsolescence, changing market conditions or changing utilization rates. In addition, the Treasury Department would develop data that would enable economic depreciation rates to be measured more precisely for specific asset-types within each CCRS class. The Treasury Department would review data on economic depreciation and would promulgate regulations to reclassify asset-types upon evidence that economic depreciation for an asset-type deviates significantly from its class norm. Pending development of an institutionalized process for reviewing economic depreciation rates, ACRS property would be classified among CCRS classes in the manner described above.

Table 7.01-5

**Effective Tax Rates on Equity Financed Investments
in Equipment and Structures 1/**

Class	Paid <u>2/</u>	Held <u>3/</u>
1	16 <u>4/</u>	18
2	16	18
3	17	18
4	17	18
5	17	18
6	23	25

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- 1/ Assumes 33 percent statutory tax rate and 4 percent required return after tax and inflation. The effective tax rate at the entity level may be lower than reported here on leveraged investments, depending on the degree of debt-finance and the relation between the interest rate on debt and the rate of return on the investment. Effective tax rates on different property within a recovery class may vary somewhat depending on experienced economic depreciation rates.
- 2/ Assumes application of a 10 percent dividend paid deduction to a corporation which distributes 100 percent of its earnings derived from depreciable assets.
- 3/ Assumes no distribution of corporate earnings derived from depreciable assets.
- 4/ The differences between the 16 percent effective tax rate for Classes 1 and 2 and the 17 percent effective tax rate for Classes 3 through 5 are due to rounding and are not significant.

Effective Date

CCRS would be effective for property placed in service on or after January 1, 1986. Anti-churning rules, similar to those enacted as part of ACRS, would be provided to prevent a taxpayer from treating property owned prior to January 1, 1986, as being subject to CCRS on or after such date. An asset acquired in a transaction in which the basis of such asset carries over from the transferor to the transferee would not be subject to CCRS if placed in service by the transferor prior to January 1, 1986.

Analysis

Improvements in Capital Cost Recovery System. The proposed CCRS depreciation system, in conjunction with repeal of the investment tax credit and other capital and business taxation proposals, makes possible a substantial lowering of statutory tax rates for individuals and corporations. This reduction in statutory tax rates is accomplished without sacrificing investment incentives necessary to stimulate continued economic growth for the economy as a whole. The CCRS depreciation rates and recovery periods produce effective tax rates which would stimulate new investment in depreciable assets. The indexing of depreciation allowances for inflation and the classification of assets on the basis of economic depreciation would ensure that the CCRS system provides neutral investment incentives. Thus, CCRS, in conjunction with repeal of the investment tax credit, would correct three principal defects of the capital cost recovery system of current law -- the variance in effective tax rates among different assets and industries; the volatility of effective tax rates in response to fluctuating inflation; and the excessive acceleration or front-loading of capital cost recovery which make possible negative effective tax rates exploited by tax shelters.

CCRS would be less distortive of economic choices among new investments in equipment and structures in different industries. Since CCRS incentive depreciation rates are derived separately for each CCRS class based upon economic depreciation rates, the variance of effective tax rates across different industries and assets would be minor compared to the unsystematic distortions created under current law. Some differences would remain, however, in the effective tax rates on income from depreciable and non-depreciable assets.

CCRS would contribute further to economic neutrality by accounting for the effects of inflation. For each recovery class, CCRS would produce the same real present value of depreciation deductions regardless of inflation rates, while ACRS and unindexed straight-line methods, which recover original cost only, yield real present value deductions which decrease as inflation increases. Moreover, for all six CCRS classes, at an assumed inflation rate of five percent and an

assumed real discount rate of four percent, the incentive depreciation rates under CCRS produce greater present value depreciation benefits than does ACRS without the investment tax credit. At higher assumed inflation rates, the CCRS incentives are even greater relative to ACRS. The CCRS incentives are provided without the front-loaded acceleration of depreciation deductions available under ACRS.

Investment Incentives. CCRS would provide depreciation rates in excess of estimated economic depreciation rates. CCRS recovery periods would be shorter than the recovery periods under a system of real economic depreciation. CCRS depreciation rates and recovery periods would combine to produce approximately equivalent effective tax rates of 18 percent on all types of equipment and machinery, regardless of the inflation rate. The effective tax rate on structures would be higher, although the recovery period would be significantly shorter than under a system with real economic depreciation rates. Moreover, the disparity under current law in effective tax rates for machinery and equipment compared to structures would be substantially narrowed under CCRS. When the effects of debt finance are taken into account, the difference in effective tax rates would likely be reduced further.

For all six CCRS classes, CCRS depreciation allowances would be more valuable than accelerated ACRS depreciation allowances (without regard to the repealed investment tax credit) under most inflation conditions. Tables 6 through 11 illustrate the present values of depreciation deductions available over the entire life of an asset under CCRS, ACRS and unindexed straight-line methods. These tables demonstrate both the incentive advantages of CCRS and the protection afforded from fluctuating and unpredictable inflation.

Comparisons of CCRS with current law should also consider the effects of CCRS in combination with other Administration proposals for taxing capital and business income. Table 12 compares the combined effective tax rates at the corporate and individual levels on equity financed investments under different cost recovery systems. Table 13 similarly compares effective tax rates at the corporate level only under different cost recovery systems. Tables 12 and 13 demonstrate that, under the stated assumptions, CCRS would produce generally lower and more uniform effective tax rates than current law or the system of real economic depreciation proposed by the Treasury Department report in 1984. However, the effective tax rate on equipment would be increased somewhat relative to current law, resulting in more nearly equal effective tax rates on different types of capital.

Neutrality of CCRS Asset Classification. CCRS is designed to provide neutral investment incentives while at the same time preserving the simplicity of a depreciation system based on relatively few classes of property, each of which would have a single depreciation rate to be applied to inflation-adjusted basis. In modifying the ACRS class-based system, CCRS does not revert to prior flawed methods of depreciation which depended upon determining each

asset's useful life, without regard to the pattern of economic depreciation over such life. Rather, CCRS is premised on the theory that a neutral depreciation system is one which produces the same effective tax rate for all depreciable assets. The equivalence of effective tax rates can be accomplished by classifying property on the basis of economic depreciation. Even though CCRS depreciation rates contain incentives in excess of economic depreciation rates, classification of assets on the basis of economic depreciation permits the investment incentives to be of approximately equal effect for all depreciable assets, regardless of inflation.

The asset types classified in Table 4 are obviously broad categorizations of the myriad of depreciable assets. These asset types are much broader than the categorization of assets under the ADR depreciation system which preceded ACRS. The six CCRS classes however, are more differentiated and hence, fairer depreciation rates than are obtained under ACRS. ACRS has a single depreciation rate for assets as diverse as computers and ships. The single ACRS depreciation rate applicable to these diverse assets may be simple in application, but it is neither fair nor conducive of efficient resource allocation.

The classification of assets under CCRS is not more complex than under ACRS. CCRS would be a relatively simple system for taxpayers to comply with and for the Internal Revenue Service to administer. Recordkeeping would be no more involved than under ACRS. Although there would undoubtedly be a need for regulations to refine technical classification of certain items of property, such regulations would not be more complex than existing regulations under ACRS.

CCRS Class 4 would initially serve as a residual class for five-year ACRS property not specifically classified in Classes 2, 3, or 5. Further refinement of property classification would be expected as the Treasury Department conducts ongoing studies of economic depreciation for different assets and industries. These studies would take into account not only inflationary changes in replacement costs but also dynamic factors, such as technological change, capacity utilization and changing market conditions, which determine rates of economic depreciation. For example, economic depreciation of telecommunications equipment and plant may be affected by technical change and deregulation of markets. These factors would have to be studied in reclassifying such property.

Reclassification of assets would also take into account the fact that certain equipment used to manufacture other depreciable property might depreciate at nearly the same rate as the end product. For example, equipment used to produce computer components might be so specialized that it depreciates at the same rate as the computers produced. Further consideration of actual evidence of rates of economic depreciation for types of assets included in the categories of assets listed in Table 4 would be conducted by an institutionalized office of the Treasury Department operating under administrative procedures affording the public an opportunity to participate.

It can be expected that additional items of five-year ACRS property which are classified in CCRS Class 4 could be reclassified among CCRS Classes 2, 3, or 5. Future studies might also justify reclassifying assets in CCRS Classes 1 or 6. For example, long-lived electric power plants initially classified in Class 5 might experience economic depreciation more nearly equivalent to real property in Class 6 than to the other types of property in Class 5. The initial overinclusiveness of Class 4 would be mitigated by the fact that the present value of depreciation deductions for an asset in CCRS Class 4 would exceed the present value of depreciation deductions for 5-year ACRS property for all but de minimus rates of inflation.

Simplification of Other Tax Provisions. CCRS and other proposed reforms of the capital cost recovery system of current law would permit a further simplification of the tax system. Even where existing complex rules are retained, their significance to taxpayers and the Internal Revenue Service would be lessened with a more neutral measure of taxable income. For example, recapture rules could be simplified considerably under CCRS, since all gain upon sale or disposition of depreciable property would be taxed as ordinary income. Consideration would be given to simplifying taxpayer accounting by permitting an election to maintain open accounts for certain classes of CCRS property.

CCRS would apply to mixed-use property which is partially used for personal use and partially for business purposes. For taxpayers whose portion of business use varies over time, indexing of depreciable basis may require more complicated recordkeeping than is customary under current law.

CCRS should reduce the proliferation of tax shelters based on the accelerated capital cost recovery rules of current law. As a consequence, the significance of many anti-tax shelter rules would be lessened, enabling Internal Revenue Service enforcement resources to be committed elsewhere.

Table 7.01-6

**Depreciation Allowances Under Alternative Depreciation Methods
for a Class 1 Asset 1/**

(In Current Dollars Per \$1,000 Investment)

Year	CCRS Depreciation Rate - 55 Percent			ACRS 3 Years	Straight- Line 3 Years
	0 Percent Inflation	5 Percent Inflation	10 Percent Inflation		
1	\$275	\$275	\$275	\$250	\$167
2	399	419	439	380	333
3	179	198	217	370	333
4	81	93	107	0	167
5	66	80	97	0	0
Nominal total <u>2/</u>					
	\$1,000	\$1,065	\$1,135	\$1,000	\$1,000
Inflation adjusted total <u>3/</u>					
	\$1,000	\$1,000	\$1,000	\$948	\$930
Present value <u>4/</u>					
0% inflation	\$953	NA	NA	\$957	\$944
5% inflation	NA	954	NA	908	879
10% inflation	NA	NA	955	865	824

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1/ Depreciation is computed on an asset placed in service by a calendar year taxpayer on July 1 of year 1 without regard to the mid-month convention.

2/ Current dollars.

3/ Assumes 5 percent inflation rate.

4/ Assumes a 4 percent real rate of return.

Table 7.01-7

**Depreciation Allowances Under Alternative Depreciation Methods
for a Class 2 Asset 1/**

(In Current Dollars Per \$1,000 Investment)

Year	CCRS Depreciation Rate - 44 Percent			ACRS 5 Years	Straight- Line 5 Years
	0 Percent Inflation	5 Percent Inflation	10 Percent Inflation		
1	\$220	\$220	\$220	\$150	\$100
2	343	360	378	220	200
3	192	212	233	210	200
4	108	125	143	210	200
5	91	111	134	210	200
6	46	58	74	0	100
Nominal total <u>2/</u>					
	\$1,000	\$1,086	\$1,181	\$1,000	\$1,000
Inflation adjusted total <u>3/</u>					
	\$1,000	\$1,000	\$1,000	\$904	\$888
Present value <u>4/</u>					
0% inflation	\$939	NA	NA	\$922	\$908
5% inflation	NA	940	NA	837	810
10% inflation	NA	NA	940	766	729

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See footnotes for Table 7.01-6

Table 7.01-8

**Depreciation Allowances Under Alternative Depreciation Methods
for a Class 3 Asset 1/**

(In Current Dollars Per \$1,000 Investment)

Year	CCRS Depreciation Rate - 33 Percent			ACRS 5 Years	Straight- Line 5 Years
	0 Percent Inflation	5 Percent Inflation	10 Percent Inflation		
1	\$165	\$165	\$165	\$150	\$100
2	276	289	303	220	200
3	185	204	223	210	200
4	124	143	165	210	200
5	100	122	147	210	200
6	100	128	162	0	100
7	50	67	89	0	0
Nominal total <u>2/</u>					
	\$1,000	\$1,119	\$1,254	\$1,000	\$1,000
Inflation adjusted total <u>3/</u>					
	\$1,000	\$1,000	\$1,000	\$904	\$888
Present value <u>4/</u>					
0% inflation	\$919	NA	NA	\$922	\$908
5% inflation	NA	920	NA	837	810
10% inflation	NA	NA	920	766	729

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See footnotes for Table 7.01-6

Table 7.01-9

**Depreciation Allowances Under Alternative Depreciation Methods
for a Class 4 Asset 1/**

(In Current Dollars Per \$1,000 Investment)

Year	CCRS Depreciation Rate - 22 Percent			ACRS 5 Years	Straight- Line 5 Years
	0 Percent Inflation	5 Percent Inflation	10 Percent Inflation		
1	\$110	\$110	\$110	\$150	\$100
2	196	206	215	220	200
3	153	168	185	210	200
4	120	139	160	210	200
5	120	146	176	210	200
6	120	154	194	0	100
7	120	161	213	0	0
8	60	85	117	0	0
Nominal total <u>2/</u>					
	\$1,000	\$1,169	\$1,371	\$1,000	\$1,000
Inflation adjusted total <u>3/</u>					
	\$1,000	\$1,000	\$1,000	\$904	\$888
Present value <u>4/</u>					
0% inflation	\$889	NA	NA	\$922	\$908
5% inflation	NA	890	NA	837	810
10% inflation	NA	NA	891	766	729

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See footnotes for Table 7.01-6

Table 7.01-10

**Depreciation Allowances Under Alternative Depreciation Methods
for a Class 5 Asset 1/**

(In Current Dollars Per \$1,000 Investment)

Year	CCRS Depreciation Rate -- 17 Percent			ACRS 10 Years	Straight- Line 10 Years
	0 Percent Inflation	5 Percent Inflation	10 Percent Inflation		
1	\$ 85	\$ 85	\$ 85	\$ 80	\$ 50
2	156	163	171	140	100
3	129	142	156	120	100
4	107	124	143	100	100
5	89	108	130	100	100
6	79	101	127	100	100
7	79	106	140	90	100
8	79	111	154	90	100
9	79	117	169	90	100
10	79	122	186	90	100
11	39	64	102	0	50
Nominal total <u>2/</u>					
	\$1,000	\$1,244	\$1,564	\$1,000	\$1,000
Inflation adjusted total <u>3/</u>					
	\$1,000	\$1,000	\$1,000	\$819	\$791
Present value <u>4/</u>					
0% inflation	\$853	NA	NA	\$851	\$827
5% inflation	NA	853	NA	707	665
10% inflation	NA	NA	853	603	551

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See footnotes for Table 7.01-6

Table 7.01-11
Depreciation Allowances Under Alternative Depreciation Methods
for a Class 6 Asset ^{1/}
(In Current Dollars Per \$1,000 Investment)

Year	CCRS Depreciation Rate - 4 Percent			ACRS 18 Years	Straight- Line 18 Years
	0 Percent Inflation	5 Percent Inflation	10 Percent Inflation		
1	\$20	\$ 20	\$ 20	\$50	\$28
2	39	41	43	90	56
3	38	41	46	80	56
4	36	42	48	80	56
5	35	43	52	70	56
6	35	45	57	60	56
7	35	47	63	60	56
8	35	50	69	50	56
9	35	52	76	50	56
10	35	55	83	50	56
11	35	58	92	50	56
12	35	61	101	50	56
13	35	64	111	40	56
14	35	67	122	40	56
15	35	70	134	40	56
16	35	74	148	40	56
17	35	77	163	40	56
18	35	81	179	40	56
19	35	85	197	20	28
20	35	89	216	0	0
21	35	94	238	0	0
22	35	99	262	0	0
23	35	104	288	0	0
24	35	109	317	0	0
25	35	114	349	0	0
26	35	120	383	0	0
27	35	126	422	0	0
28	35	132	464	0	0
29	18	69	255	0	0
Nominal total ^{2/}					
	\$1,000	\$2,128	\$4,997	\$1,000	\$1,000
Inflation adjusted total ^{3/}					
	\$1,000	\$1,000	\$1,000	\$715	\$666
Present value ^{4/}					
0% inflation	\$610	NA	NA	\$760	\$723
5% inflation	NA	610	NA	570	502
10% inflation	NA	NA	610	454	377

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See footnotes for Table 7.01-6

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Table 7.01-12

**Effective Corporate and Personal Income Tax Rates on Equity Financed Investments
Returns to Capital Distributed Equally Between Dividends and Capital Gains 1/**

	All <u>2/</u> Capital	Equipment and Structures	Equipment	Structures	Inventories <u>3/</u>
Pre-1981 law <u>4/</u> at 10% inflation	63	63	52	67	62
ACRS <u>5/</u> With investment tax credit at 10% inflation	59	57	44	61	62
at 5% inflation	51	47	21	54	59
Without investment tax credit at 5% inflation	55	54	55	54	59
RCRS With 50% dividend relief <u>6/</u>	42	41	41	42	42
Capital Cost Recovery System With 10% dividend relief <u>7/</u>	41	39	35	40	46

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- 1/ Assumes a 4 percent real return after corporate tax. Assumes two-thirds of capital gains deferred indefinitely, and the remaining third taxed at the given statutory rate less the applicable exclusion. The effective tax rate at the entity level may be lower than reported here on leveraged investments, depending on the degree of debt finance and the relation between the interest rate on debt and the rate of return on the investment.
- 2/ All capital includes equipment, structures and inventories.
- 3/ Assumes LIFO accounting with no reduction in inventories and inventory prices rising with inflation.
- 4/ Assumes 46 percent corporate statutory tax rate and 32.7 percent personal tax rate and 60 percent capital gains exclusion. Assumes sum of years digits depreciation over 9 years and 10 percent investment credit for equipment and 150 percent declining balance over a 34.4-year life for structures.
- 5/ Assumes 46 percent corporate tax rate and 32.7 percent personal tax rate with 60 percent capital gains exclusion. Assumes 5-year depreciation schedule with half-basis adjustment for equipment and 18-year schedule for structures.
- 6/ RCRS with 50% dividend relief refers to the cost recovery system and dividend relief proposals contained in the Treasury Department's report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984. Assumed tax rates are given in footnote 7.
- 7/ Assumes 33 percent corporate rate and 26.5 percent personal rate with 50 percent capital gains exclusion. Assumes 10 percent corporate deduction for net dividends paid. Deviations in economic depreciation rates among assets may slightly alter tax rates.

Table 7.01-13

**Effective Corporate Income Tax Rates on Equity Financed Investments
Returns to Capital Distributed Equally Between Dividends and Capital Gains 1/**

	All <u>2/</u> Capital	Equipment and Structures	Equipment	Structures	Inventories <u>3/</u>
Pre-1981 law <u>4/</u> at 10% inflation	48	48	31	53	46
ACRS <u>5/</u> With investment tax credit at 10% inflation	41	40	20	45	46
at 5% inflation	35	31	-4	39	46
Without investment tax credit at 5% inflation	41	39	41	39	46
RCRS With 50% dividend relief <u>6/</u>	26	26	25	26	27
Capital Cost Recovery System With 10% dividend relief <u>7/</u>	25	22	17	24	32

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See footnotes for Table 7.01-12, except only corporate tax rates apply.

REPEAL INVESTMENT TAX CREDIT

General Explanation

Chapter 7.02

Current Law

A credit against income tax liability is provided for a taxpayer's investment in certain depreciable property. Subject to a long list of exceptions, the following classes of property qualify for the investment credit: (1) tangible personal property (other than air conditioning or heating units); (2) certain other tangible property (not including buildings and their structural components); (3) elevators and escalators; (4) single purpose agricultural or horticultural structures; (5) rehabilitated buildings; (6) certain timber property; and (7) storage facilities (not including buildings and their structural components) used in connection with the distribution of petroleum or certain petroleum products.

In general, the credit is equal to ten percent of qualified investment in property that is placed in service during the taxable year. In the case of ACRS three-year property, the applicable credit rate is generally six percent. All qualifying costs for new property are eligible for the credit; in the case of used property, the qualifying costs that may be taken into account are generally limited to \$125,000 for each taxable year. The investment tax credit is not available for property which is expensed.

The basis of depreciable property for which an investment tax credit is taken is reduced by 50 percent of the amount of such credit. A taxpayer may elect a two percent reduction in the investment tax credit in lieu of a basis reduction. A similar basis reduction is required of regulated utilities under normalization rules. If property for which an investment tax credit was taken is disposed of prior to the end of its recapture period, a portion of the credit previously allowed may be recaptured and added to the tax due in the year of disposition.

The amount of tax liability that may be offset by investment tax credits in any year may not exceed \$25,000 plus 85 percent of the tax liability in excess of \$25,000. Credits in excess of this limitation may be carried back three years and forward 15 years.

Reasons for Change

The investment tax credit was originally introduced and has been periodically modified to serve two principal purposes -- to prevent capital consumption allowances based on historical cost from being eroded by inflation and to stimulate increased levels of investment. Under current law, the investment tax credit, in combination with the

Accelerated Cost Recovery System ("ACRS") provides investment incentives that are neither systematically protected from inflation nor allocated in a neutral or efficient manner. For example, a ten percent investment tax credit without full basis adjustment results in a greater reduction in the effective tax rate for assets with faster economic depreciation rates. In addition, a ten percent investment tax credit reduces effective tax rates more during periods of low inflation than in periods of high inflation.

The investment tax credit is, in addition, excessively "front-loaded." The one-time, up-front credit makes possible the sheltering of an investor's unrelated income. Thus, the investment tax credit is a standard element of numerous tax shelter offerings that depend upon up-front deductions and credits for their viability. To the extent taxpayer energy and resources are consumed in pursuing tax rather than economic advantage, the growth and productivity of the economy as a whole are weakened.

The front-loading of the credit also limits its incentive effect for start-up, fast-growing or currently unprofitable businesses. There are substantial variations in tax rates among firms and industries that are caused by differences in their capacity to utilize credits currently. Table 1 shows the industry variations in the capacity to use the investment credit.

The capital formation objectives for which the investment credit was adopted would be better served under the Administration proposal for a new Capital Cost Recovery System ("CCRS"). See Ch. 7.01. Investment incentives would be built into depreciation allowances in a manner that would be inflation-proof, relatively neutral across assets, and distributed more evenly over the life of the investment. In addition, consolidation of incentives in the depreciation system would improve public understanding and awareness of the extent to which the tax system is being employed to encourage investment. By providing incentives through the investment credit and through the depreciation system, current law may cause taxpayers to believe that only the more visible credit is an incentive, and thus that depreciation deductions properly measure economic income.

Finally, although the concept of the investment tax credit is straightforward, the applicable statutory provisions are exceedingly complex. Repeal of the credit would substantially simplify the tax system by eliminating these rules.

Proposal

The investment tax credit would be repealed. See Ch. 12.01 for a discussion of repeal of the investment credit for rehabilitated buildings. Normalization rules would be retained for the unamortized portion of pre-repeal investment tax credits allowed to regulated public utilities.

Table 7.02-1

Utilization of Investment Tax Credits in 1981

(\$ millions)

Industry	Investment Credit Earned	Investment Credit Used Against 1981 Tax Liabilities	Percent of Earned Credit Allowed	Unused Investment Credit
All manufacturing	\$11,327	\$ 9,116	80	\$ 6,720
Food manufacturing	1,025	831	81	403
Tobacco manufacturing	144	151	105 <u>1/</u>	0
Textile mill products	146	125	86	83
Apparel	60	56	93	25
Lumber and wood	309	48	16	392
Furniture and fixtures	38	30	79	14
Paper products	373	303	81	207
Printing and publishing	482	345	72	218
Chemicals	1,134	872	77	653
Petroleum and refining	2,332	2,295	98	209
Rubber and plastic	132	111	84	120
Leather products	20	19	95	4
Stone, clay and glass	264	148	56	242
Primary metals	492	649	132 <u>1/</u>	981
Fabricated metals	447	326	73	229
Machinery	1,166	938	80	420
Electrical equipment	1,081	631	58	1,080
Motor vehicles	865	739	85	877
Transportation equipment	418	123	29	501
Instruments	296	293	99	24
Other manufacturing	103	81	79	42
Utilities	4,844	3,047	63	7,939
Other sectors	9,831	6,649	68	8,022
Total	\$26,002	\$18,812	72	\$ 22,681

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1/ Percentage greater than 100 indicates that credits were carried forward and used from previous years.

Effective Date

The proposal generally would be effective for property placed in service on or after January 1, 1986.

Analysis

The Administration CCRS proposal would replace both the investment tax credit and the ACRS depreciation system without sacrificing investment incentives necessary to stimulate continued economic growth for the economy as a whole. While providing investment incentives, CCRS would permit a substantial reduction in statutory tax rates for both corporations and individuals. Moreover, CCRS would correct three principal defects in the investment tax credit and depreciation system of current law -- the variance in effective tax rates among different assets and industries; the volatility of effective tax rates in response to fluctuating inflation; and the excessive acceleration or front-loading of capital cost recovery which make possible negative effective tax rates exploited by tax shelters.

Since repeal of the investment tax credit would eliminate the bias in favor of property that is eligible for the credit, investment in some such property may diminish. Aggregate business investment, however, should not be diminished, given the incentive effects of lower overall tax rates and the CCRS proposal.

Repeal of the investment tax credit also would eliminate complexity associated with existing rules (1) to distinguish qualified from non-qualified property, (2) to determine the amount of the credit, (3) to adjust basis as a result of the credit, (4) to determine the amount of previously allowed credits subject to recapture in the event of early disposition of an asset, and (5) to carryback and carryforward unused credits. Other rules also would be repealed: the at-risk rules for the credit, the rules which deny the credit to certain noncorporate lessors, the rules governing pass-through of the credit, the definition of qualified United States production costs and other special rules for films and sound recordings, the rules governing property used by certain tax-exempt entities, the rules pertaining to the treatment of qualified progress expenditures, the rules denying the credit for foreign use property (other than property that meets one of eleven exceptions) and for certain property used in connection with the furnishing of lodging, the rules governing the credit for livestock, the rules governing the credit for certain boilers, and the rules distinguishing used and new property.

REVISE TAX TREATMENT OF CAPITAL GAINS

General Explanation

Chapter 7.03

Current Law

Gains or losses from the sale or exchange of capital assets held for more than six months (one year for assets acquired before June 23, 1984) are treated as long-term capital gains or losses. Long-term capital gains receive preferential tax treatment. For individuals and other noncorporate taxpayers, 60 percent of net capital gain is excluded from income, with the balance of 40 percent taxable at ordinary rates. Thus, a taxpayer in the maximum 50 percent tax bracket has a marginal tax rate on net capital gain of 20 percent. For corporations, the regular maximum tax rate of 46 percent is reduced to 28 percent on net capital gain if the tax computed using that rate is lower than the corporation's regular tax.

A taxpayer determines net capital gain by first netting long-term capital gain against long-term capital loss and short-term capital gain against short-term capital loss. The excess of any net long-term capital gain over any net short-term capital loss equals net capital gain entitled to the preferential tax rate.

Capital losses are deductible under different rules for corporate and noncorporate taxpayers. For corporations, any net short-term or long-term capital loss is offset against any net long-term or short-term gain. Excess capital losses are not deductible against other income, but may generally be carried back for three taxable years and forward for five taxable years as a short-term capital loss in the carryover year.

Individuals and other noncorporate taxpayers also deduct any net short-term or long-term capital loss first against any net long-term or short-term gain. In addition, a noncorporate taxpayer with an excess net capital loss may generally take up to \$3,000 of such loss as a deduction against other income. For this purpose, only one-half of net long-term capital loss is usable. Net capital loss in excess of the deduction limitations may be carried forward indefinitely, retaining its character in the carryover year as either a short- or long-term loss. Special rules allow individuals to treat losses with respect to a limited amount of stock in certain small business corporations as ordinary losses rather than as capital losses.

A capital asset is defined generally as property held by a taxpayer other than (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in

the taxpayer's trade or business, (3) rights to literary or artistic works held by the creator of such works, or acquired from the creator in certain tax-free transactions, (4) accounts and notes receivable, and (5) certain publications of the government.

Special rules apply to gains and losses with respect to "section 1231 property," "section 1256 contracts," and certain rights to a patent. Section 1231 property is defined as (1) depreciable or real property held for more than six months and used in a taxpayer's trade or business, but not includable in inventory or held primarily for sale in the ordinary course of a trade or business, (2) property subject to compulsory or involuntary conversion, and (3) special property, including certain interests in timber, coal, domestic iron ore, certain livestock and certain unharvested crops. Gains and losses from all transactions involving section 1231 property are netted for each taxable year. Only gains that are not subject to recapture as ordinary income are included in the netting. If there is a net gain from section 1231 property, all gains and losses from section 1231 property are treated as long-term capital gains and losses and are combined with the taxpayer's other capital gains and losses. If there is a net loss from section 1231 property, all transactions in section 1231 property produce ordinary income and ordinary loss. However, net gain from section 1231 property is converted into ordinary income to the extent net losses from section 1231 property in the previous 5 years were treated as ordinary losses.

Depreciation recapture rules recharacterize a portion of gains upon dispositions of depreciable property as ordinary income. These rules vary with respect to the type of depreciable property. Under ACRS, for all personal and non-residential rental real property, all previously allowed depreciation, not in excess of total realized gain, is recaptured as ordinary income. However, if taxpayers elect straight-line depreciation over longer recovery periods, there is no depreciation recapture upon disposition of the asset. With respect to residential rental property, only the excess of ACRS deductions over the straight-line method is recaptured as ordinary income. Depreciation recapture also is imputed to a partner who sells a partnership interest if recapture would have been imposed upon the disposition by the partnership of depreciable property.

Section 1256 contracts are defined to include (1) any regulated futures contract, (2) any foreign currency contract, (3) any nonequity option, and (4) any dealer option. Gain or loss with respect to a section 1256 contract generally is treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Under certain circumstances, the creator of a patented invention may transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset, whether or not the proceeds are contingent on the use or productivity of the patent.

Capital gains and losses are generally taken into account when "realized" upon sale, exchange, or other disposition of the property. By contrast, section 1256 contracts generally are marked to market and

treated as if sold on the last business day of the taxable year in which held and accrued gains or losses are realized upon such deemed sales. Certain hedging transactions involving section 1256 contracts are not marked to market. Certain dispositions of capital assets, such as transfers by gift, are not generally realization events for tax purposes. Thus, usually, in the case of gifts, no gain or loss is realized by the donor and, in general, the donor's basis in the property carries over into the hands of the donee. In certain circumstances, such as the gift of a bond with accrued market discount or of property which is subject to indebtedness in excess of the donor's basis, the donor may recognize ordinary income upon making a gift. Gain or loss also is not realized on transfer at death, even though the transferee's basis in the property is stepped-up to fair market value at the time of death.

The amount of a seller's gain or loss is equal to the difference between the amount realized by the seller and the seller's adjusted basis (i.e., the cost or other original basis adjusted for items chargeable against basis). Under various nonrecognition provisions, however, realized gains and losses in certain transactions are deferred for tax purposes. Examples of such nonrecognition transactions include certain like-kind exchanges of property, involuntary conversions followed by an acquisition of replacement property, corporate reorganizations, and the sale of a principal residence within two years of the acquisition of a new principal residence. Generally, nonrecognition treatment defers gain or loss for tax purposes by providing for a substitution of basis from the old property to the new or for a carryover basis from the old holder to the new holder.

Reasons for Change

Change in Exclusion Rate. The Administration proposals include a substantial reduction in marginal tax rates. With the reduction in the maximum marginal tax rate from 50 percent to 35 percent, a reduction in the exclusion rate applied to net capital gain is appropriate. The reduction in the exclusion for capital gains, however, should substantially preserve the relative tax preference that is available under current law for investments in capital assets.

Effects of Inflation. During periods of inflation, nominal gains or losses on sales of capital assets will reflect inflationary increases in the value of property which do not represent real changes in economic value. Although the preferential tax rate for capital gains is often explained as compensation for the fact that current law does not adjust capital gains for inflation, the preference serves this function only in a rough way. Because the preferential tax rate does not account systematically for the effects of inflation, investors currently face substantial uncertainty regarding the eventual effective rate of tax on their investments, and may even be taxed on investments that produce an economic loss. The availability

to investors of an election to index the basis of capital assets, in lieu of a preferential rate, would reduce uncertainty over effective tax rates and ensure that only real gains are subject to tax.

Treatment of Gain on Depreciable Assets. Gains and losses from sales or other dispositions of depreciable property should be treated in the same manner as other business income or loss and gains or losses from sales of other business property (e.g., inventory). The current asymmetrical treatment of gains and losses from depreciable property, i.e., the availability of capital gain treatment for gains and ordinary loss treatment for losses, is without justification as a matter of tax policy and should be discontinued.

Historically, the availability of capital gain treatment for gains from sales of depreciable assets stems from the implementation of excess profits taxes during World War II. Many depreciable assets, including manufacturing plants and transportation equipment, had appreciated substantially in value when they became subject to condemnation or requisition for military use. Congress determined that it was unfair to tax the entire appreciation at the high rates applicable to wartime profits. Accordingly, gains from wartime involuntary conversions were taxed as capital gains. The provision was extended to voluntary dispositions of assets since it was not practical to distinguish condemnations and involuntary dispositions from sales forced upon taxpayers by the implicit threat of condemnation or wartime shortages and restrictions. These historical circumstances offer no continuing justification for the current treatment of depreciable assets, given the absence of exceptional wartime gains and the low, historically unprecedented (in the post-World War II era) statutory tax rates incorporated in the Administration proposals.

In addition, capital gain treatment for depreciable assets can not be justified by the factors that make such treatment appropriate for investment property qualifying as a capital asset. (See below "Analysis - Retention of a Preferential Rate for Capital Gains".) Under current law, the capital gain preference serves in part as a rough adjustment for the effects of inflation, since nominal rather than economic gains are included in the tax base. The Administration proposal for a new Capital Cost Recovery System ("CCRS") would account explicitly for inflation with respect to depreciable property, however, and thus a preferential rate on gain from sales of such property is unnecessary as an inflation adjustment.

The capital gain preference also serves as an incentive for saving and investment, and to encourage the flow of capital to new and innovative activities that involve high risk yet offer large economic and social returns. Incentives for investment in depreciable property, however, would be provided through the proposed CCRS depreciation allowances. These incentives would be systematically applied, in order to establish relative neutrality in the taxation of income from depreciable assets. The retention of an additional incentive in the form of capital gain treatment would create a

preference for investment in depreciable property likely to yield significant gains on sale. Such additional incentive is neither necessary nor appropriate.

Finally, the timing of sales of depreciable business assets is more likely to be determined by the condition of the particular asset or by routine business cycles of replacement than would be true of capital assets held by investors. As a consequence, taxation of gains on sales of depreciable assets at ordinary rates is less likely to affect taxpayer decisions about sales and reinvestment. Conversely, taxation of gains on sales of depreciable assets at preferential rates would create an unjustified bias toward certain sources of business income.

Treatment of Gain on Special Section 1231 Property. Under current law, gains on dispositions of certain interests in timber, coal, iron ore, livestock and unharvested crops, are eligible for capital gain treatment regardless of whether the property is held for sale in the ordinary course of the taxpayer's business. This special treatment violates the distinction, which is inherent in the definition of a capital asset, between investment property and business property. Business income, whether derived from the sale of property used in a trade or business or from the sale of property to customers in the ordinary course of business, should be taxed as ordinary income. The preferential tax rate on capital gains should apply only to investment assets. Gains from dispositions of interests in certain natural and agricultural resources should be taxed in accordance with these generally applicable rules.

Proposal

The exclusion rate for net capital gain of individuals and noncorporate taxpayers would be reduced from 60 percent to 50 percent, producing a maximum tax rate on capital gain under the Administration proposals of 17.5 percent. The current law tax rate on net capital gain of corporations would remain at 28 percent.

The current law definition of a capital asset would be retained. However, gain from the sale or disposition or the compulsory or involuntary conversion of depreciable or depletable property used in a trade or business would not be treated as gain from the sale or exchange of a capital asset. As under current law, recognition of involuntary gains could be deferred if proceeds of the conversion were reinvested in similar property. Land used in a trade or business would continue to receive capital gain and ordinary loss treatment. Gain or loss with respect to a section 1256 contract would be treated as under current law, so that 60 percent of the gain or loss would be treated as long-term capital gain and 40 percent of the gain or loss would be treated as short-term capital gain or loss.

Depreciable property used in a trade or business and property eligible for cost depletion which does not qualify as a capital asset would be indexed under rules applicable to those assets. See

Ch. 7.01. Property which is held for sale in the ordinary course of business or as inventory would be indexed under separate rules. See Ch. 7.04.

Interests in timber, coal, iron ore, livestock and unharvested crops which are treated as special section 1231 property under current law would be treated in the same manner as other assets. That is, gains from the dispositions of such interests would be treated as capital gains only if such interests satisfy the definition of a capital asset in the hands of a particular taxpayer.

Beginning in 1991, individual taxpayers could elect to index the basis of their capital assets for inflation occurring after January 1, 1991. The election would be in lieu of eligibility for the preferential tax rate on capital gains. An election would be effective for all capital assets disposed of in a particular year. Indexed capital losses would remain subject to current law limitations on deductibility. The election would not be available to corporations.

Under the indexing election, a capital asset obtained prior to January 1, 1991 would be indexed as if acquired on that date for an amount equal to the taxpayer's adjusted basis in the asset. Inflation adjustments would be based on a Federal government price index. Capital assets would be required to be held more than 12 months to be eligible for indexing. The proposal to allow elective indexing of capital assets after 1991 would not alter the basic realization and nonrecognition rules of current law. If capital assets are held by a taxpayer who employs a functional currency other than the U.S. dollar, the measure of inflation generally would be based on the inflation rate in the functional currency (as determined by the Internal Revenue Service).

Retention of the preferential tax rate on capital gains, in general, would not affect nonrecognition provisions of current law requiring realized gains or losses to be deferred. In particular, homeowners would be permitted, subject to existing rules, to roll over gain on the sale of a principal residence, if a new principal residence is acquired within 2 years of the sale of the prior principal residence. Moreover, subject to existing rules, homeowners who are age 55 or older would exclude permanently the first \$125,000 of inflation adjusted gain upon the sale of a principal residence.

Effective Date

The proposal to reduce the exclusion rate to 50 percent would be effective on July 1, 1986 for all capital assets. The proposal to revise the treatment of gains from sales or dispositions of depreciable property used in a trade or business would apply to any property placed in service by the taxpayer on or after January 1, 1986. The proposal to repeal capital gain treatment for special

section 1231 property would be phased out over three years, becoming fully effective January 1, 1989. See Ch. 9.04 for the specific phase-out rules.

Analysis

Retention of a Preferential Rate for Capital Gains. The capital gain preference serves a variety of purposes that, despite the inherent difficulties in a preferential rate, make its retention appropriate. Under current law, the capital gain preference compensates for the fact that nominal gains, unadjusted for inflation, are included in income. The inflation adjustment provided by the preference is, of course, imprecise, since it does not vary with the experienced rate of inflation or with the period of time the asset is held. On the other hand, the preference is computationally easy and is generally familiar and understandable to taxpayers.

Since the Administration proposals would allow elective inflation indexing for capital assets beginning in 1991, retention of a capital gain preference, in the long run, must rest on grounds other than its function as an indirect inflation adjustment. The most significant of these other grounds concerns the incentive effect of the preference. There is broad concern that elimination of the capital gain preference would adversely affect saving and investment, and thus impair the capital formation necessary to continued economic growth. Moreover, many argue that, because of risk or other factors, investment needed to generate new and innovative technology would not be pursued at optimal levels absent a favorable rate of taxation. Although it might be possible to address these concerns through a preference limited to particular activities or forms of investment, the complexity entailed in defining and enforcing those limits would substantially offset the simplification benefits of a change from current law.

Preferential treatment of capital gain may also be justified because of the longstanding treatment of unrealized gains. Capital gains are not subject to tax until the underlying asset is sold, and thus, capital gains from assets held for any significant period of time are accorded preferential treatment without regard to a preferential rate. Moreover, the deferral advantage for unrealized gains grows to one of total exemption if the underlying asset is held until death. Because the taxation of gain is deferred until realization, taxpayers are encouraged to retain appreciated capital investments in circumstances where alternative investments offer a greater economic return. The significance of this so-called "lock-in effect" is a function of the rate at which realized gains are taxed. By reducing the rate of tax on realized gains, the preference limits the lock-in effect, and thus may improve the allocation of capital within the economy. By encouraging realization of accrued gains, it may also offset the revenue loss attributable to a preferential rate.

Finally, the preferential rate for capital gain serves to offset the impact of the progressive rate structure on gains that are accrued over a period of time but realized in a single year. In this respect, a capital gain preference operates as an implicit, though very rough, averaging device.

The purposes served by the capital gain preference are listed with full recognition of the difficulties the preference has created under current law. The capital gain preference has generated significant complexity, reflected in the substantial body of statutory and case law concerned solely with identifying income entitled to the preference. Just as clearly, preferential treatment of capital gains stimulates artificial behavior, by encouraging taxpayers to structure their affairs so as to bring particular transactions or sources of income within the scope of the preference. Whether these costs outweigh the purposes served by the preference is one of the recurring themes of tax policy debate. The conclusion reached in the Administration proposals is that, on balance, the preference should be retained.

Effect on Saving and Investment. The proposal to retain a preferential tax rate on capital gain, in combination with the proposed substantial reduction in tax rates, should have a stimulative effect on saving, investment and capital formation.

The effect on investment of the proposal to treat all gain from the sale of depreciable property as ordinary income should be examined in light of the CCRS proposal for depreciable assets. The basis of a depreciable asset would be indexed for both depreciation purposes and for purposes of computation of gain. Thus, the inflationary component of gain on a depreciable asset would not be subject to tax under the Administration proposals. Moreover, indexing of depreciable assets would produce more accurate measurement of real losses. In addition, the incentives built into the depreciation allowances would be applied in a neutral manner to all depreciable assets. Consequently, the treatment of gain on disposition of these assets as ordinary income should not impede overall capital formation or the efficient allocation of capital.

Effect on risk-taking. The effect of capital gains taxation on private risk-taking in the economy is of critical importance. The venture capital and associated high-technology industries seem particularly sensitive to changes in effective tax rates. Shareholders in such ventures that are highly successful would not face higher effective tax rates under the Administration proposal. Also, the increase in savings stimulated by reductions in individual marginal rates and expansion of IRAs, as well as the elimination of many industry-specific tax preferences and the enactment of measures to reduce the advantages of investment in unproductive tax shelters, should increase the supply of capital available to high-risk ventures and high-technology industries. In addition, all investors would continue to benefit from the deferral of tax on accrued but unrealized gains.

Retention of Realization Principle. The proposal would retain the longstanding realization principle of current law, under which gains and losses generally are not taxed until realized by sale, exchange or other disposition. As discussed above, the realization requirement and the lock-in effect it produces impair capital resource allocation to the extent taxpayers are deterred from reallocating investments by the tax costs of realizing accrued appreciation. Repeal of the realization requirement on any broad basis, however, would meet strong taxpayer resistance and could involve significant administrative and economic costs. Requiring recognition of gain on an annual or other current basis would necessitate a system for valuing unsold assets, which could be burdensomely complex for taxpayers as well as for the Internal Revenue Service. Moreover, a current realization requirement could in certain situations force taxpayers to liquidate investments in order to satisfy accrued tax liabilities.

The proposal retains the mark-to-market accounting concept currently applicable to section 1256 contracts. The primary advantage of the mark-to-market concept in this limited context is that it negates the need to identify offsetting positions for purposes of the loss deferral rules applicable to straddles. Straddle transactions utilizing section 1256 contracts would provide numerous opportunities for abuse for taxpayers with large volumes of trades in such contracts absent retention of mark-to-market accounting for these assets.

Scope of Loss Limitation Rules. In general, the proposal would retain the capital loss limitation rules of current law for assets held for investment and not for use in a trade or business. Such limitations are appropriately applied to investors who may selectively realize gains and losses on investment assets. Were capital losses deductible without limit, taxpayers would dispose of capital assets selectively to produce a net loss with which to shelter noninvestment income.

Simplification of Recapture Provisions. Depreciation recapture has been necessary under ACRS and prior depreciation rules to prevent excessive depreciation deductions from being converted into capital gain. Indexing depreciation allowances and treating gains from dispositions of depreciable property as ordinary income obviates the need for the complicated depreciation recapture provisions of current law. Although a taxpayer would receive an investment incentive from depreciation allowances in excess of economic depreciation, taxing all gain from depreciable property as ordinary income would permit repeal of many of the recapture provisions for depreciable property acquired after January 1, 1986. Existing recapture rules would remain in effect for depreciable property placed in service prior to January 1, 1986.

The recapture rules of current law also serve to limit nonrecognition rules applying to gains realized in certain transactions (e.g., gains realized on corporate liquidations or

pre-liquidation sales and gains realized on sales under the installment method). In general, such nonrecognition rules would be limited in a similar fashion under the Administration proposals. Consideration would be given to applying such limits on a parallel basis for realized gains with respect to personal and real property.

Treatment of Special Section 1231 Property. Denial of special capital gain treatment for timber, coal, iron ore, livestock and unharvested crops would result in a consistent limitation of the capital gain preference to investment property qualifying as a capital asset. Thus, if special section 1231 property were used in a trade or business, it would be subject to cost recovery rules and ordinary income treatment applicable to trade or business property. See Ch. 7.01. If special section 1231 property were held for sale to customers or as inventory, it would be subject to rules applicable to all inventory property. See Ch. 7.04. If special section 1231 property were held as a capital asset, it would be eligible for the capital gain preference.

In addition, consideration would be given to treating land held for use in a trade or business as ordinary income property. If so treated, land used in a trade or business would be eligible for inflation indexing on the same basis as depletable property.

Collateral Issues. Denial of capital gain treatment to depreciable assets would expand the scope of current law rules treating gain recognized on sale or disposition of a partnership interest as ordinary income to the extent attributable to the selling partner's interest in certain assets of the partnership that would produce ordinary income if sold by the partnership. Consideration would be given to extending similar rules to dispositions of interests in S corporations and stock in subsidiaries which are included in an affiliated group filing a consolidated return.

Finally, consideration would be given to treating gain realized upon the disposition of rights to a patent as ordinary income to the extent that the creator of the patented invention or a holder of rights to the patent claimed deductions from ordinary income for the costs of developing the invention.

INDEX INVENTORIES

General Explanation

Chapter 7.04

Current Law

In general, current law requires the use of inventory accounting methods where necessary to determine clearly a taxpayer's income. Treasury regulations implementing this rule generally require inventories to be maintained where the production, purchase or sale of merchandise is an income-producing factor. A taxpayer that keeps inventories for tax purposes must use the accrual method of accounting with respect to purchases and sales of inventory items.

Inventory accounting assists in accurately measuring income from the sale of goods; this measurement, in turn, depends on the value for tax accounting purposes of the goods on hand at the close of the taxable year. The cost of goods sold during the year is generally equal to the dollar value of beginning inventory, plus purchases and other inventoriable costs incurred during the year, minus the dollar value of ending inventory. Thus, for example, a taxpayer with beginning inventory of \$100, purchases and other inventoriable costs of \$500, and ending inventory of \$150, has a cost of goods sold for the year of \$450 (\$100 plus \$500 minus \$150 = \$450). The measurement of income from the sale of goods changes with any change in the valuation of ending inventory. Thus, if ending inventory, in the preceding example, had a higher value, the cost of goods sold would have been lower, and gross income from sales would have been correspondingly higher. Conversely, a lower figure for ending inventory would have increased the cost of goods sold and reduced gross income.

Under Treasury regulations, inventories generally are valued at cost, although in certain cases the lower of cost or market value is permitted. In order to determine the cost of ending inventory, a taxpayer may identify each specific item of inventory and ascertain its actual cost or value. In most cases, however, this "specific identification" method is impractical because of the number and fungible nature of the goods on hand. The Internal Revenue Code and regulations therefore permit alternative methods which employ simplifying assumptions regarding the flow of goods from inventory.

The first-in, first-out (FIFO) method assumes that the first goods purchased or produced are the first goods sold. Under FIFO the most recently purchased or produced goods are deemed on hand at year-end, and ending inventories are thus valued at the most recent purchase or production costs. The last in, first-out (LIFO) method assumes that the last goods purchased or produced are the first goods sold. Since LIFO accounting values ending inventory at the oldest purchase or

production costs, in periods of increasing purchase or production costs its use results in a higher cost of goods sold and lower taxable income than FIFO.

Since 1939, taxpayers who use the LIFO method for tax purposes have been required to use LIFO in preparing annual financial statements for credit purposes and for reports to stockholders, partners, proprietors or beneficiaries (the "LIFO conformity requirement").

Reasons for Change

Taxes should be imposed on real economic income, not on increases that are attributable to inflation. Current inventory accounting methods used for tax purposes depart from this principle by failing to reflect inflation in a consistent manner.

Because the LIFO method treats the most recently acquired goods as the first goods sold, LIFO accounting reflects income from inventory sales more accurately during periods of inflation than does FIFO. Notwithstanding the advantages of LIFO accounting in an inflationary economy, many businesses continue to use the FIFO method. Although many small firms are reluctant to use LIFO accounting because of the perceived complexity, some businesses are simply unwilling to use LIFO for financial accounting purposes -- as required by the LIFO conformity requirement. The disincentive for LIFO accounting that is created by the conformity requirement is inappropriate in a tax system designed to neutralize the effects of inflation.

Although LIFO measures the effects of inflation better than FIFO, it does not fully account for these effects. LIFO takes account only of price changes in the inventoried goods, which may or may not correspond to the effects of inflation on prices generally. Moreover, since LIFO represents only a flow of goods assumption rather than an adjustment of inventory costs in line with inflation, it results in only the deferral rather than the elimination of inflationary gains. When a firm that uses the LIFO method either liquidates or reduces inventories, it is taxed on previously deferred inflationary gains. This factor distorts business decisions concerning inventory levels and creates an incentive for transactions, such as a merger or reorganization, which permit continued deferral of the inflationary gain.

Proposal

Taxpayers would be permitted the option of using an Indexed FIFO method in addition to the current LIFO and FIFO methods of accounting. Under the Indexed FIFO method, inventories would be indexed using inflation adjustment factors based on a Federal government price index. Indexing would be based on relatively simple computational

methods, such as applying the percentage increase in the price index (such as the Consumer Price Index) to the FIFO cost of the number of units in beginning inventory which does not exceed the number of units in ending inventory. Indexing would also be permitted for inventory assets for which the specific identification method is used, as well as for property held primarily for sale in the ordinary course of business that may not constitute inventory (e.g., certain real estate held for sale by a dealer in such property).

Indexing would be allowed only with respect to inflation occurring after the effective date of the proposal. The requirement under current law that the Internal Revenue Service consent to changes in accounting methods would be waived for taxpayers changing to LIFO or to Indexed FIFO accounting methods during an appropriate transition period. In addition, the LIFO conformity requirement would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1987.

Analysis

About two-thirds of inventories in the United States are owned by firms which continue to use FIFO accounting, despite the resulting overstatement of income tax liability during inflationary times. Table 1 provides data on the use of FIFO by industry group. The proposal would permit such firms to switch to either Indexed FIFO or LIFO inventory tax accounting, while continuing to use the unindexed FIFO method for financial accounting purposes. It is expected that taxpayers that currently use the unindexed FIFO method would switch to the Indexed FIFO method or the LIFO method. An immediate switch by all firms that currently use FIFO to either Indexed FIFO or LIFO would result in a maximum aggregate annual tax saving to those firms of approximately \$6 billion.

Firms that currently use LIFO, however, would be unlikely to change to Indexed FIFO, unless the economic advantages were sufficient to offset the associated administrative costs as well as the tax costs resulting from recapture of LIFO reserves. LIFO inventories would not be eligible for an inflation adjustment. Such an adjustment would generally be inappropriate since LIFO accounting permits indefinite deferral of inflationary gains. Moreover, LIFO accounting, unlike the Indexed FIFO method, permits deferral of real inventory gains; thus, to combine LIFO with indexation would be a form of double benefit. For LIFO firms that do switch to Indexed FIFO, inventory stocks would thereafter be valued more accurately. Moreover, the influence of tax considerations over decisions as to liquidation of a business or levels of inventory would be reduced.

The proposal to index the FIFO method would improve the measurement of income for tax purposes since inflationary gains would be permanently removed from the tax base. The Indexed FIFO method would also be analogous to the proposed treatment for depreciable assets, where depreciation allowances would be indexed for general inflation. In this respect, the Indexed FIFO method will provide greater neutrality between investment in inventory and in depreciable property during periods of inflation.

Finally, the current disincentive to entry into industries that have historically used the FIFO accounting system and thus borne an artificially high tax burden would be removed.

Table 7.04-1

**Percentage of Ending Inventory Valued
by the FIFO Method by Industry**

Industry	Value of Ending Inventory (Billions)	Percentage FIFO
Agriculture	\$ 4.6	97 %
Mining	8.2	81
Construction	23.1	97
Food	24.0	66
Tobacco	6.7	15
Textiles	5.8	50
Apparel	8.3	82
Lumber	6.0	77
Furniture	6.0	77
Pulp and Paper	6.5	60
Printing and Publishing	5.4	70
Chemicals	26.4	50
Petroleum	23.9	41
Rubber	5.1	63
Leather	2.1	74
Stone, Clay and Glass Products	5.9	58
Primary Metals	20.7	39
Fabricated Metals	20.7	39
Machinery	38.9	67
Electrical Equipment	30.1	68
Motor Vehicles	16.1	47
Instruments	8.2	57
Transportation Equipment	18.3	78
Transportation Public Utilities	31.9	92
Communications	6.5	99
Wholesale Trade	108.8	80
Retail Trade	102.2	69
Finance, Insurance, and Real Estate	12.8	89
Services	11.0	95
Total All Industries	\$ 594.2	70 %

Office of the Secretary of the Treasury May 28, 1985

Source: 1981 Corporation Income Tax Returns, computed by the
Bureau of Economic Analysis

RETAIN \$5,000 LIMIT ON EXPENSING
DEPRECIABLE BUSINESS PROPERTY

General Explanation

Chapter 7.05

Current Law

Under current law, taxpayers may elect to expense the cost of a limited amount of qualifying property rather than to recover such cost over time through deductions for depreciation. In general, property qualifying for this expensing election must be purchased for use in a trade or business and must otherwise be eligible for the investment tax credit. No investment credit is allowable with respect to amounts expensed under this rule.

For taxable years beginning before 1988, the dollar limitation on the amount that may be expensed is \$5,000 per year. This limitation is scheduled to increase to \$7,500 for taxable years beginning in 1988 and 1989, and to \$10,000 for taxable years beginning after 1989. In each case, the limitation that applies to a married individual who files a separate return is one-half of the dollar limitation described above.

Reasons for Change

Expensing the cost of an asset that produces income for more than one year overstates the taxpayer's cost of producing income for the year. The overstatement of current deductions shelters other income from tax and thus results in a deferral of tax liability. This deferral advantage creates some incentive for investment in assets eligible for expensing, but only for taxpayers who would not otherwise have acquired qualifying property up to the amount eligible for expensing. For other taxpayers, the limited expensing election creates no marginal investment incentive.

In addition, permitting taxpayers to expense the cost of an asset creates compliance problems. After the year in which the asset is expensed, the asset is removed from the tax form. As a result, it is relatively easy to convert the asset to personal use or to sell the asset without complying with the rules requiring recapture of the deduction.

A limited expensing election does, however, have certain simplification advantages. For smaller businesses, expensing eliminates or reduces the recordkeeping and computational burdens of recovering an asset's cost over a number of years.

Proposal

The scheduled increases of the dollar limitation on expensing of depreciable business property would be eliminated, leaving in place the current limit of \$5,000.

Analysis

The proposal would not change the current treatment of any taxpayer. Elimination of the increase in the limitation should have little effect on investment in depreciable assets. The proposal would simply retain a de minimis alternative to the more complicated depreciation rules.

REPEAL RAPID AMORTIZATION RULES

General Explanation

Chapter 7.06

Introduction

Current law contains a number of special amortization and expensing rules that allow taxpayers to elect premature deductions for certain capital expenditures. The deferral of income tax that these provisions permit is intended to create incentives or subsidies for investment in certain assets or activities.

Some of these provisions were originally intended to be effective only for brief periods, but were later extended. Others have expired in whole or in part since they do not apply to expenditures made in the current year or in future years. Although these provisions target various industries and various assets, they have similar effects on the efficiency and fairness of the tax system and present related questions of tax and economic policy.

Current Law

1. Five-year amortization of trademark and trade name expenditures. Current law permits taxpayers to amortize over a period of at least 60 months any expenditure paid or incurred in the taxable year for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name. (Section 177.) A separate election may be made by the taxpayer with respect to each separate trademark or trade name expenditure.

2. Five-year amortization of pollution control facilities. Current law permits taxpayers to amortize the cost of a certified pollution control facility over a 60-month period. (Section 169.) To the extent, however, that a pollution control facility has a useful life in excess of 15 years, a portion of the facility's cost is not eligible for 60-month amortization, but must be recovered through depreciation or through the Accelerated Cost Recovery System (ACRS).

A certified pollution control facility is a treatment facility used in connection with a plant or other property to abate or control water or air pollution, if (1) the plant or other property was in operation before January 1, 1976, (2) the facility is certified by the appropriate State and Federal authorities as meeting certain pollution control standards, and (3) the facility does not significantly increase the output, extend the life, or reduce the operating costs of the plant or other property. In general, a profitable or "break even" facility is not eligible for certification.

If an election is not made with respect to a certified pollution control facility, its cost may be recovered through depreciation or, in the case of recovery property, through ACRS.

3. Five-year amortization of certain expenditures for qualified child care facilities. Current law permitted employers to amortize over a 60-month period capital costs incurred before January 1, 1982, to acquire, construct, or rehabilitate child care facilities for their employees. (Section 188.)

4. Five-year amortization of expenditures to rehabilitate low-income housing. Current law permits taxpayers to amortize over a 60-month period expenditures to rehabilitate low-income rental housing (other than hotels or other similar facilities primarily serving transients). (Section 167(k).) Expenditures qualify for 60-month amortization only if they are incurred for additions or improvements to property with a useful life of at least five years. Expenditures for a taxable year with respect to a dwelling unit are eligible for 60-month amortization only if the aggregate of such expenditures over two consecutive taxable years including the taxable year exceeds \$3,000. In general, a taxpayer's rehabilitation expenditures with respect to a dwelling unit are not eligible for five-year amortization to the extent that the aggregate of such expenditures exceeds \$20,000. In certain cases, this limitation is increased to \$40,000.

The election to amortize expenditures to rehabilitate low-income housing will not be available for expenditures incurred after December 31, 1986 (except in cases where rehabilitation began, or a binding contract for such expenditures was entered into, before January 1, 1987).

5. Five-year amortization of certain railroad rolling stock. At the election of the taxpayer, current law permitted taxpayers to amortize over a 60-month period the adjusted basis of railroad rolling stock placed in service after 1968 and before 1976. (Section 184.)

6. Fifty-year amortization of qualified railroad grading and tunnel bores. Current law permits domestic railroad common carriers to amortize the cost of qualified railroad grading and tunnel bores over a 50-year period. (Section 185.) "Qualified railroad grading and tunnel bores" include all land improvements (including tunneling) necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.

Amortizable basis is not reduced upon the retirement of qualified railroad grading or tunnel bores, but no additional deduction is allowed on account of such retirement.

7. Expensing of soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and field clearing expenditures. Current law permits taxpayers engaged in the business of farming ("farmers") to deduct a variety of costs that would otherwise be capitalized or inventoried, as follows:

a. Farmers may deduct currently soil and water conservation expenditures that do not increase the basis of depreciable assets. (Section 175.) The deduction is limited annually to 25 percent of the taxpayer's gross income from farming. Deductible expenditures include costs of the following: leveling, grading, and terracing; contour furrowing; the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds; the eradication of brush; and the planting of windbreaks. Expenditures with respect to land held by the taxpayer for less than ten years are subject to recapture as ordinary income.

b. Farmers may deduct currently expenditures for fertilizer or other material used to enrich, neutralize, or condition farmland. (Section 180.)

c. Farmers may deduct currently expenditures incurred to clear land and make the land suitable for farming. (Section 182.) The deduction is limited in any taxable year to the lesser of \$5,000 or 25 percent of the farmer's taxable income from farming. Expenditures with respect to land held by the taxpayer for less than ten years are subject to recapture as ordinary income.

8. Seven-year amortization of and ten percent credit for reforestation expenditures. Current law permits taxpayers to amortize over an 84-month period up to \$10,000 of reforestation expenditures incurred in each taxable year. (Section 194.) A ten percent investment tax credit is also allowable for such expenditures. Reforestation expenditures include amounts spent on site preparation, seed or seedlings, labor, and tools. Amortized expenditures are subject to recapture if the underlying property is disposed of within ten years from the year of the expenditure. The credit is subject to the normal investment tax credit recapture rules.

Reasons For Change

Summary

Targeted government subsidies for particular industries and assets override market-based resource allocations and the consumer preferences on which they are based. In circumstances where private markets fail to reflect the social value of particular goods or services, government intervention in the form of a subsidy may be appropriate. However, many narrowly targeted tax incentives for business do not address problems of market failure, but instead subsidize specific business activities at some cost in overall economic efficiency.

1. Trademark and trade name expenditures. A trademark or trade name distinguishes a firm and/or its products from other firms and/or their products. The costs of acquiring a trademark are capital outlays for an intangible asset, similar to expenditures to organize a business. Investors are willing to make such expenditures because in doing so they acquire an asset that will, over the course of time, yield a rate of return at least as high as could be earned by other investments. Although a trademark or trade name may prove to be unprofitable, or even worthless, there can be no presumption that it will decline in value. To the contrary, the ordinary investor acquiring a trademark or trade name expects the value of the asset to appreciate along with the development of the products that it represents. Thus, where normal product development, including advertising, occurs on an ongoing basis, there is no ground for imputing deductions for "capital cost recovery" for investments in trademarks or trade names.

There is no evidence that investment in a trademark or trade name yields a greater benefit to society than is reflected in the expected market return to the investor. Allocation of resources to such investment should thus be determined by general market principles. There is correspondingly no basis for a tax incentive through premature recovery of the costs of such investment.

2. Certified pollution control facilities. The special amortization rules for pollution control facilities were enacted in 1969, shortly after the enactment of Federal legislation which imposed phased-in restrictions on industrial plant emissions. The thrust of the environmental protection laws was to require producers and their customers to pay the costs of avoiding environmental damage in excess of the standards imposed. At the same time, concern was expressed that existing plants would be subject to burdensome retrofitting costs, which would place them at a competitive disadvantage compared to newer plants that were designed after pollution control requirements were imposed. The special amortization rules were adopted to mitigate the cost of retrofitting older facilities. Consistent with the transitional objective, the special rules were scheduled to expire after seven years (December 31, 1975), a period presumably long enough to bring pre-1969 plants into compliance with emission standards.

The special amortization rules for pollution control facilities are poorly designed to offset the burden, if any, that revised environmental standards imposed on operators of existing plants. Ordinarily, plants in industries where emissions are a major concern are continuously "replaced" and their capacity altered in an orderly process of maintenance, repair, and modernization. Thus, at the margin, revised emission standards raised investment and operating costs for "old" and "new" plants alike. The only cost disadvantage to "old" plants was the difference between (a) the total additional cost of incorporating emission control features into "modernization" programs, and (b) the total additional cost of incorporating emission

control features into the construction of new plants. This difference, which reflected differences in operating costs as well as capital costs, presumably varied from industry to industry, and from plant to plant. Thus, the extra burden imposed on taxpayers operating old plants, if any, was not related in some simple way to the cost of a depreciable retrofit facility, nor was it approximately equal to the interest savings on deferred taxes provided by five-year amortization.

The five-year amortization rules are also poorly targeted to encourage pollution control activities. The subsidy is available only with respect to depreciable assets, and thus provides no incentive for numerous other ways of reducing pollution from existing plants, such as using cleaner but more expensive grades of fuel and other raw material inputs. Favoring capital intensive pollution control measures wastes scarce resources to accomplish the program objective.

Finally, although the special amortization rule for pollution control facilities was originally a temporary measure, it was extended indefinitely in 1976. Even if some justification existed for transitional relief to operators of old plants, there is no basis for an ongoing subsidy of pollution control costs.

3. Qualified child care facilities. The special rule permitting five-year amortization of expenditures to construct or rehabilitate child care facilities applies only to expenditures made before January 1, 1982, and, therefore, has effectively expired.

4. Rehabilitation of low-income housing. Historically, low-income housing has benefited from a variety of direct and indirect government subsidies, including rental subsidies, grants, loans, and credit supports and guarantees. A number of Federal programs, including the housing voucher program initiated in 1983, have provided direct or indirect assistance to low-income families unable to afford market rents. Also initiated in 1983 were two programs providing grants to assist rehabilitation and new construction of low-income housing by the private sector. Direct low-interest loans are made available to assist low-income individuals in rural areas to obtain adequate housing. Finally, a number of mortgage insurance and guarantee programs make credit available to many families who could not afford to purchase homes in the absence of such measures.

In addition to these targeted direct subsidies, the current income tax laws contain numerous provisions which encourage investment in real estate, including housing. These provisions include (1) accelerated depreciation of real property, (2) full deductibility of interest, including the portion of interest intended to compensate the lender for the effects of inflation, (3) reduced tax rates for capital gains realized on disposition of real property, (4) relaxed recapture rules for dispositions of real property, (5) exemption of real estate investments from the limitation of losses to amounts at risk, and (6) tax-exempt status for bonds issued to finance low-income rental property. In addition, several special provisions apply only to

low-income housing, including (1) immediate deductibility of construction-period interest and taxes, (2) the 15-year ACRS recovery period, and (3) five-year amortization of rehabilitation expenditures.

The tax benefits associated with real estate investment attract capital from high-income taxpayers who are willing to trade negative cash flows or below-market returns for substantial tax savings, and therefore appear to cause increased investment in real estate, including low-income housing. However, in a 1977 report entitled "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives," the Congressional Budget Office estimated that, because of the costs of packaging tax shelters and the high after-tax returns enjoyed by tax shelter investors, less than one-half of government revenue losses attributable to real estate tax shelters ever reach builders and developers. Thus, to the extent that the current tax laws encourage investment in low-income housing, the incentive is unnecessarily costly to the government.

If additional measures are needed to stimulate investment in low-income housing, existing targeted spending programs should be expanded.

5. Railroad rolling stock. The special rule permitting five-year amortization of the adjusted basis of railroad rolling stock applies only to rolling stock placed in service before 1976, and, therefore, has effectively expired.

6. Qualified railroad grading and tunnel bores. For much of its history, the U.S. railroad industry was subject to rate and service regulation designed to favor shipments of bulk raw materials over shipments of finished and semi-finished products. As a consequence, the industry's capacity to haul bulk commodities, demand for which is highly seasonal in volume, depended heavily on cross-subsidization from rates that were charged for "high value" manufactured goods.

In general, such cross-subsidization was possible so long as the railroad industry held a virtual monopoly on long distance overland haulage. Competition from trucking progressively eroded this monopoly, however, shifting the railroads' mix of transported goods to the low-value markets. Railroad rate schedules failed to keep pace with the shift in markets, depressing industry earnings and causing investment in right of way and rolling stock to decline.

In 1969, Congress responded to the railroad industry's financial plight by allowing 50-year amortization for the cost of railroad grading (the basic roadway, but not the track, ties, and ballast) and tunnel bores, which, as assets in the nature of land improvements, had previously been considered nondepreciable. This special amortization rule, after its expansion in 1976, applied regardless of when the assets were placed in service, effectively granting railroad companies a 50-year stream of tax deferrals.

The special amortization rule for railroad grading and tunnel bores is a poorly conceived subsidy. The value of the subsidy depends on a railroad's historical investment in grading and tunnel bores. In many cases, these costs were incurred prior to imposition of the income tax, and, in any event, are not correlated with regulatory mispricing.

In addition, the subsidy targets its benefits to railroads least in need of or entitled to relief. Those railroads most affected by regulatory mispricing may not have significant taxable income, and thus may realize no benefit from the subsidy. Only profitable railroads can take full advantage of the special amortization rules, yet they may have escaped the burdens that the subsidy is intended to offset.

7. Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures. In recognition of various economic conditions which disfavor small unit farming, often called family farming, Federal programs to mitigate farm price and income instability have been in place since 1926. In addition to price support programs, farmers have access to Federal credit on a subsidized basis. The Department of Agriculture also administers programs for agricultural conservation and rural water supply, as well as providing farmers broad scale technical and management assistance.

The extensive Federal involvement in agricultural input and output markets makes additional tax-based subsidies unnecessary and inefficient. Outlays to drain marshy soil, create ponds, install irrigation ditches, and condition soil all have the objective of yielding greater farm output in the future. Under ordinary accounting principles they should be capitalized or inventoried -- treated as the purchase of an asset -- rather than treated as a cost of the current year's output. If the land-improving investments are rationally made, the farmer has merely exchanged cash for an asset of equal value -- improved land -- the expected market value of which will accrue to him as output occurs.

Finally, as with many other tax-based subsidies, the special expensing rules for farmers are of full value only to those with significant income. This effectively denies the benefits of the subsidy to the small, new, or unprofitable farmer, who is thus given a relative disincentive for farm improvements. As a result, such farmers operate at a competitive disadvantage, since market prices for farm products will tend to reflect the tax advantages from which such farmers do not benefit.

8. Reforestation expenditures. It has been argued that the market price of timber understates the social value of forested land because some important benefits are not expressed in the market price.

National security, flood control, arresting land erosion that degrades the quality of streams, and opportunities for outdoor recreation are claimed to be among the additional benefits derived from forested land.

In view of these "externalities," government intervention to increase the volume of forest output may be justified. Thus, \$1.8 billion was spent in fiscal year 1984 for management of more than 100 million acres of national forests and for cooperative forestry and forestry research.

In addition to these direct budget expenditures, present law contains tax subsidies intended to encourage forestry by small-scale landowners. All taxpayers investing in timberland are entitled to an investment tax credit equal to ten percent of up to \$10,000 of reforestation expenditures each year. In addition, the total amount eligible for the credit may be amortized over seven years, notwithstanding the fact that the taxpayer has expended only 90 percent of that amount and the trees planted are likely to appreciate in value.

Even if one agrees that there are "externalities" in forestry in excess of the direct expenditures presently provided in the Federal budget, the reforestation credit and amortization provisions are so poorly designed that their continuation is difficult to justify. Any reforestation expenditure qualifies for the investment credit and amortization, whether or not it yields recreational, flood control, or erosion control benefits, or relates to a tree species with national security significance. Moreover, the provisions are so structured that they cannot appreciably affect marginal industry investment. Due to economies of scale, most commercial forestry (i.e., that type which is likely to produce external benefits of the kind that justify a subsidy) requires reforestation expenditures far in excess of \$10,000 per year. For most commercial forestry, therefore, these tax provisions are the equivalent of a fixed grant plus assured tax deferral each year, and are independent of the taxpayer's decision to increase marginal qualified expenditures. Repeal of the reforestation credit and amortization provisions would increase revenue collection without measurably increasing soil erosion and flood damage, or reducing recreational opportunities and national security.

Proposals and Effective Dates

1. Trademark and trade name expenditures. The current election to amortize trademark and trade name expenditures would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

2. Certified pollution control facilities. The election to amortize the cost of certified pollution control facilities would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

3. Qualified child care facilities. This provision would be deleted from the Code as deadwood, since it applies only to costs incurred prior to January 1, 1982.

4. Rehabilitation of low-income housing. The election to amortize expenditures to rehabilitate low-income housing would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

5. Railroad rolling stock. This provision would be deleted from the Code as deadwood, since it applies only to rolling stock placed in service prior to 1976.

6. Qualified railroad grading and tunnel bores. The election to amortize the cost of qualified railroad grading and tunnel bores would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

7. Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures. The elections to deduct currently expenditures for soil and water conservation, fertilizer and soil conditioning, and land clearing, would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

8. Reforestation expenditures. The election to amortize reforestation expenditures and the investment tax credit for such expenditures would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986.

Analysis

In general, costs that currently qualify for the special expensing and amortization rules discussed in this section create wasting or non-wasting long-lived assets. Thus, repeal of the special rules would cause those costs to be capitalized or inventoried, and recovered under the normal cost recovery rules or at the time of disposition. The effect on taxpayer behavior of such repeal would generally depend on (1) the extent to which marginal investment choices are influenced by the special rules provided by current law and (2) the degree of neutrality achieved by the cost recovery rules replacing the special provisions.

1. Trademark and trade name expenditures. An investment in a trademark or trade name creates an intangible asset for which there is no reason to impute deductions for a decline in value over time. Accordingly, if such an investment were capitalized it would be recovered only upon disposition of the asset. Thus, the interest-free tax deferral which currently results from the tax treatment of trademark and trade name expenditures would be eliminated.

Nevertheless, the effect of repeal on business would be minimal. Unlike investments in plant and equipment, capitalized investments in trademarks and trade names generally do not vary with firm output. Rather, they are fixed capital costs which are relatively small compared to the initial investment in an enterprise, and constitute a declining proportion of total investment as firm output increases. Thus, the importance of trademark and trade name income tax deferral is initially small and is thereafter of diminishing significance to firms with average rates of growth.

2. Certified pollution control facilities. Pollution control facilities that are currently eligible for five-year amortization are for the most part comprised of equipment that, under a system more closely related to economic depreciation, would be depreciated over periods longer than five years. Since that system would reduce the relative tax benefit from investing in such equipment, compared to the tax consequences of investing in other means of controlling pollution, choices of pollution control methods would be based more on economic than on tax considerations. Since compliance with emission control standards is mandatory in most cases, the functional value of investments in pollution control facilities would not decline. However, under a more neutral cost recovery system, only the most cost-efficient pollution control methods would be used.

3. Rehabilitation of low-income housing. In the absence of five-year amortization of expenditures to rehabilitate low-income housing, such expenditures would be recovered in accordance with the normal rules for depreciating real property. Accordingly, repeal of this amortization provision would reduce to some extent the currently inflated after-tax return earned by investments in low-income housing rehabilitation. Nevertheless, the proposal is not expected to diminish the volume of low-income housing.

A tax preference for "rehabilitated" low-income housing directs private investment toward rehabilitation rather than new construction. New construction, however, even of housing for moderate- and high-income families, increases the stock of housing for low-income occupancy as tenants relocate. Thus, increased rehabilitation induced by tax subsidies largely displaces new construction. Accordingly, repeal of the subsidy would have little effect on the availability of low-income housing.

4. Qualified railroad grading and tunnel bores. In the absence of 50-year amortization of expenditures for railroad grading and tunnel bores, such expenditures should generally be capitalized as costs of land improvements, and recovered upon disposition of the improvements or the underlying land. This treatment would be consistent with the nature of the asset created by such expenditures, the value of which generally does not decline over time. In view of the fact that future improvements of and additions to railroad grading and tunnel bores are likely to be insubstantial in relation to

improvements and additions of track and rolling stock, repeal of 50-year amortization should not have an appreciable effect on the volume of railroad investment or on after-tax rates of return on such investment.

5. Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures. In the absence of special expensing rules for farmers' expenditures for clearing, conditioning, and conserving farmland, some of these expenditures would be capitalized as a cost of improving the land to make it suitable for farming and, as such, would be recovered under normal cost recovery rules (to the extent treated as the costs of land, such costs could be recovered only upon disposition of the land). To the extent that farmers who make such investments have significant marginal tax rates (generally large-scale operators and corporations), the loss of tax deferral would reduce the attractiveness of investments in land improvement relative to alternative investments, such as investments in farm machinery or in other industries. In addition to the resulting social gain from a better allocation of scarce private capital, eliminating this subsidy could result in a reduced level of Federal expenditures for price-support programs, since expansion of farm acreage would no longer be encouraged by the tax laws. Repeal of the expensing provisions should also improve the competitive position of those farmers, typically operating small or family farms, who do not receive full benefit from tax subsidies.

6. Reforestation expenditures. Repeal of seven-year amortization of qualified reforestation expenditures and the associated ten percent investment credit would have no measureable effect on the rate of investment in private forest lands. These incentives are structured so that they do not affect forest investment decisions; they apply only to the first \$10,000 of reforestation investment, an amount far below the annual expenditures of a viable commercial forestry operation. The existing tax subsidies, however, also benefit farmers and other landowners who use tree planting to control wind-related soil damage or otherwise improve the value of their land. Since reforestation expenditures by such owners are much more likely to be \$10,000 or less, repeal of the credit and amortization provisions could affect marginal investment decisions and decrease the total amount of reforestation expenditures by such owners. Absent the current subsidy, this type of tree planting probably would decline as investors selected other investment projects with higher market yields.

**DENY RATE REDUCTION BENEFIT ATTRIBUTABLE
TO EXCESS DEPRECIATION**

General Explanation

Chapter 7.07

Current Law

Accelerated depreciation deductions are allowed under both the Accelerated Cost Recovery System ("ACRS") and pre-ACRS depreciation schedules based on useful lives. With respect to property placed in service before 1981, a taxpayer could generally elect to use either the straight-line method or an accelerated method such as the declining-balance method or the sum-of-the-years-digits method applied over the useful life of the property or over the class life of the property under the Class Life Asset Depreciation Range system. For purposes of computing their earnings and profits, corporations are required to use the straight-line method over the same useful life or class life used to compute depreciation deductions. Generally, for property placed in service after 1980, ACRS prescribes accelerated depreciation deductions over specified recovery periods. However, for purposes of computing earnings and profits, corporate taxpayers must use the straight-line method over longer recovery periods. Thus, in the early years of an asset's life, accelerated depreciation deductions under both ACRS and pre-ACRS law exceed straight-line depreciation deductions used to calculate a corporation's earnings and profits for tax purposes (E&P depreciation). Conversely, in the later years of an asset's life, accelerated depreciation deductions are less than E&P depreciation deductions; the year in which this first occurs may be referred to as the asset's "crossover point."

The top marginal rate for corporations was 48 percent for 1980 and 1981 and 46 percent for taxable years beginning after 1981. The top marginal tax rate for individuals was 70 percent for 1980 and 1981 and 50 percent for taxable years beginning after 1981.

Reasons for Change

The effect of using an accelerated depreciation method is that, relative to a calculation based on the straight-line method, taxable income is reduced in the years in which accelerated depreciation exceeds straight-line depreciation (i.e., years before the crossover point) and taxable income is increased in later years in which straight-line depreciation exceeds accelerated depreciation (i.e., in years after the crossover point). Thus, accelerated depreciation methods produce a deferral of tax liability relative to the time profile of tax liability that would result from the straight-line depreciation method.

As long as tax rates remain constant over the life of an asset, the amount of tax that is deferred as a result of accelerated depreciation is equal to the amount of tax that is repaid in later years. However, a reduction in tax rates for the later years produces an unexpected benefit for the taxpayer by reducing the tax that must be repaid relative to the tax that was deferred. This unexpected benefit is in addition to the intended benefit of interest-free deferral of the tax liability inherent in the acceleration of deductions.

The Administration proposals include a substantial reduction in tax rates effective on July 1, 1986. The top marginal rate would be reduced from 46 percent to 33 percent for corporations (a 13 percentage point reduction) and from 50 percent to 35 percent for individuals (a 15 percentage point reduction). Compared with the 48-percent and 70-percent rates in effect for corporations and individuals, respectively, prior to 1982, the rate reduction is even more substantial. Most taxpayers with substantial accelerated cost recovery deductions taken over the period 1980-85 will have been able to reduce tax at rates of 46 or 50 percent (48 or 70 percent for 1980-81). These taxpayers generally expected to repay their deferred tax liabilities attributable to accelerated depreciation at the currently applicable 46 or 50 percent rate. However, because of the proposed reduction in tax rates after July 1, 1986, the deferred tax liabilities of such taxpayers would generally be repaid at a 33-percent rate instead of a 46-percent rate for corporations (at a 35-percent rate instead of a 50-percent rate for top-bracket individuals). In the absence of a rule designed to recapture this unexpected benefit of the reduction in rates, part of the deferred tax liabilities attributable to accelerated depreciation deductions would effectively be forgiven. Taxpayers with deferred tax liabilities on July 1, 1986, would obtain an unintended windfall benefit, which had not been anticipated when investment decisions were made.

Proposal

In order to prevent taxpayers from obtaining the unexpected windfall benefit described above, 40 percent of a taxpayer's "excess depreciation" taken between January 1, 1980, and July 1, 1986, would be included in income over a three-year period. The excess depreciation over such period would be the excess of cumulative depreciation or amortization deductions over cumulative depreciation deductions that would have been allowed during such period using the straight-line method specified under current law for E&P depreciation (Code section 312(k)). For calendar-year taxpayers, 12 percent of the excess depreciation would be included in income for the 1986 taxable year, 12 percent in 1987, and 16 percent in 1988. Appropriate adjustments would be made to this schedule for fiscal-year taxpayers to put them on the same basis as calendar-year taxpayers.

Taxpayers whose total depreciation deductions taken between January 1, 1980, and December 31, 1985, are less than \$400,000 would not be subject to the rate-reduction recapture rule. Such taxpayers would accordingly not have to make the excess depreciation calculation described above. Moreover, for those taxpayers who are subject to the rule, the first \$300,000 of excess depreciation would be exempt from the rate-reduction recapture rule. If the taxpayer were in existence for only part of the 1980-85 period, the \$400,000 threshold and \$300,000 exemption would be adjusted accordingly.

For purposes of the rate-reduction recapture rule, any excess depreciation would be reduced by any net operating losses carried forward by the taxpayer from a year before 1986 to a taxable year beginning after 1985. The reduction of excess depreciation by such net operating losses would not reduce the amount of such losses that could be offset against taxable income. The proposed rate-reduction recapture rule would be applied at the level of individual partners, shareholders in an S corporation, or beneficiaries, not at the level of a partnership, S corporation, or trust. Amounts included in income under the rule that are attributable to foreign property would be treated as foreign-source income.

Effective Date

For calendar-year taxpayers, 12 percent of the excess depreciation would be included in income for the 1986 taxable year, 12 percent in 1987, and 16 percent in 1988. Appropriate adjustments would be made to this schedule for fiscal-year taxpayers to put them on the same basis as calendar-year taxpayers.

Property subject to the rate-reduction recapture rule would include all property placed in service on or after January 1, 1980, and before January 1, 1986, for which depreciation or amortization deductions were allowable under current law for any part of the period January 1, 1980, through June 30, 1986.

Transfers of property before July 1, 1986, in transactions where gain was not recognized would be disregarded in computing the transferor's liability under the rate-reduction recapture rule. Similar rules would be provided for transfers to related parties, with an appropriate adjustment for income recognized on the transfer. It is anticipated that the tax writing committees will provide any other transition rules necessary to prevent avoidance of the rate-reduction recapture. For example, the committees may wish to develop special rules for dispositions of real property in transactions where the gain attributable to excess depreciation is not fully subject to recapture under current law. No dispositions of property after June 30, 1986, would relieve the taxpayer of liability under the recapture rule, since such liability would be calculated as of that date.

Analysis

The proposal would prevent an unexpected windfall that would otherwise accrue to taxpayers who deferred tax liability by taking accelerated depreciation deductions at relatively high pre-reform tax rates, but would repay this deferred tax liability at lower post-reform tax rates. To reduce administrative complexity, the Administration proposal only approximates the rules that would be needed to eliminate the windfall precisely.

Ideally, the amount of the recapture tax on depreciable assets would be calculated as follows. The amount of excess depreciation on each asset placed in service prior to January 1, 1986, would be defined as the cumulative difference between accelerated and economic depreciation between the time the asset was placed in service and June 30, 1986. The tax would be equal to excess depreciation times the difference between the pre-reform and post-reform tax rates for the particular taxpayer, say, 13 percent. This tax would be assessed when the tax deferral associated with the accelerated deductions was repaid. That is, once the asset passed its crossover point, the taxpayer's annual tax burden would be increased by 13 percent of the amount of "deficient depreciation" in that year -- the amount by which economic depreciation exceeds accelerated depreciation -- until the full amount of the recapture tax was paid. Such a rule would ensure that tax deferrals that reduced income under the high pre-reform rate structure would be repaid at the expected time and at the expected tax rate, rather than at significantly lower post-reform rates.

The proposal contains a number of simplifying assumptions. E&P depreciation is used as a proxy for economic depreciation. This choice is made primarily for convenience, since most of the taxpayers subject to the proposal would be corporations that are currently required to compute E&P depreciation. In addition, no attempt is made to determine the appropriate tax differential for each taxpayer. Instead, the tax is assessed by including in income 40 percent of the cumulative excess depreciation taken prior to June 30, 1986, on assets placed in service between January 1, 1980, and December 31, 1985. This implies an effective recapture tax rate of 13.2 percent for large corporations that will experience a rate reduction from 46 to 33 percent; this rate is slightly below the 15 percent rate which should apply to corporate deductions taken at a 48 percent rate.

For top-bracket individuals, inclusion of excess depreciation in income at a 40 percent rate results in an effective recapture tax rate of 14 percent. This is slightly lower than the 15 percentage point reduction that would be appropriate for a top-bracket taxpayer who will experience a rate reduction from 50 to 35 percent; it is considerably below the 35 percent rate that should apply to individual deductions taken at a 70 percent rate. Virtually all individuals subject to the tax will be top-bracket taxpayers.

Similarly, no attempt is made to allocate the recapture liability across the years beyond the asset's crossover point as described above. Such a procedure would be exceedingly complex, as it would involve the calculation of the difference between accelerated and E&P depreciation for many years into the future for all assets subject to the rule. For certain assets, particularly long-lived property, determination of the amount of recapture liability with reference to the amount of excess depreciation taken prior to June 30, 1986, although correct in dollar terms, would overstate the liability in present value terms, since the additional tax liability would appropriately be assessed in later years. The proposed three year spread of the inclusion in income associated with the recapture rule would mitigate this problem, since it would reduce the present value of the rate-reduction recapture liability.

The recapture rule could be applied to all existing assets that would benefit from deferring tax liability at high pre-reform rates and repaying the deferred liability at lower rates. The limited scope of the provision is intended to reduce complexity, recognizing, for example, that most or all of deferred tax liability with respect to older depreciable assets will have been repaid by June 30, 1986.

The de minimis rule which exempts corporate and individual taxpayers with cumulative depreciation deductions over the 1980-1985 period of less than \$400,000 from the rate reduction recapture rule would ensure that most taxpayers would not be subject to the rule and would not have to calculate their excess depreciation. Furthermore, taxpayers who may fall just above the \$400,000 threshold would benefit from the exemption of \$300,000 of excess depreciation from the rate-reduction recapture rule. Only about 150,000 individuals and 10 percent of corporations would be subject to the rule.

The recapture rule applies only to old capital and thus it has no effect on the cost of capital for new equipment.