
Margaret Voskamp

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THE ACCELERATED COST RECOVERY SYSTEM

AS PROVIDED BY THE

ECONOMIC RECOVERY TAX ACT OF 1981

Submitted in partial fulfillment of the requirements for graduation with honors to the Department of Business and Economics at Carroll College, Helena, Montana.

Margaret E. Voskamp

March 22, 1983
This thesis for honors recognition has been approved for the Department of Business and Economics.

Mr. Michael Robinson, Director

Mr. Charles Mandeville, Reader

Dr. William Wood, Reader

March 14, 1963

Date
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On August 4, 1981, Congress passed the Economic Recovery Tax Act of 1981. The Act, designed to relieve excessive tax burdens and to promote economic growth, provided benefits to individuals and business alike. One of the most important business incentive provisions of the Act, the Accelerated Cost Recovery System (ACRS), dramatically changed the system of tax depreciation.

To understand the reasons for this provision the depreciation system utilized prior to ACRS will be briefly examined, as well as the progress of the concept of an accelerated cost recovery system from early recommendations through becoming law as included in the Economic Recovery Tax Act of 1981. The system will then be outlined and evaluated with an analysis of its anticipated and actual performance.

THE PRE-ACRS SYSTEM OF DEPRECIATION

Depreciation is based on the concept that the historical cost or other basic value of a fixed asset should be systematically allocated over the period it is used to produce income through charges to expense or against revenue. Ideally the allocation should be in proportion to the services received each period. An asset is depreciable if it is (1) used in a trade or business or
for the production of income, and (2) subject to wear and tear, decay or decline from natural causes, exhaustion or obsolescence. Assets not having a determinable useful life, such as land, goodwill, and stock, and which do not decline in value are not depreciable.¹

Major forms of depreciation are straight line, where equal amounts are charged off evenly over the life of an asset, and accelerated methods. The most common accelerated methods are the declining balance and the sum of the years digits.

Accelerated methods of depreciation became very popular years ago when the federal government approved their use for income tax purposes. These methods offer business the opportunity of writing off as depreciation expense a larger portion of the cost of a new asset during its early years of use. The increased charge for depreciation expense reduces taxable income.

Some companies prefer the use of straight line depreciation in financial statements, resulting in reported higher earnings per share of stock which is attractive to investors and enhances the company's reputation. This, however, does not prevent the use of accelerated depreciation to determine taxable income.

Prior to 1981 and ACRS, the basis of property less its salvage value was recovered over its useful life. Class of property, useful life, and whether the property was new or used together determined the method of deprec-
ation. This system continues in use for all assets placed in service prior to 1981. The following is an overview of that system.

**Personal Property**

The principal method used to determine useful life for personal property is the Asset Depreciation Range (ADR), a system where eligible assets are grouped into more than 100 classes and a guideline life for each class is determined by the Treasury. A useful life 20 percent longer or shorter than the ADR guideline can be used. The ADR system was designed to be audit proof when examined by the IRS.\(^2\)

A second method for determining useful life is the taxpayer's set of facts and circumstances pertaining to an asset, or by agreement between the IRS and the taxpayer. This method is used for assets not eligible for ADR or for taxpayers who do not elect to use ADR.

Straight line depreciation is allowed for all depreciable personal property assets. With this method, the cost basis of the asset is spread evenly over the asset's useful life. Accelerated methods can also be used for most assets, thereby allocating a greater share of the deductions in the early years of the asset's useful life.

When the asset is sold or otherwise disposed of, the gain or loss is recognized. Under ADR, the recognition of gain or loss is postponed for assets retired
for routine causes. Recognized gain to the extent that depreciation has been taken is treated as ordinary income, referred to as Section 1245 recapture. Recognized gain exceeding previously taken depreciation is generally treated as capital gain.

Real Property

Useful life of depreciable real property is estimated by a facts and circumstances test similar to that used for personal property, or by use of guideline lives prescribed under Revenue Procedure 62-21, effective December 31, 1970. Guideline lives are not generally prescribed for real property under ADR.

The cost of a new or used building can be allocated to its basic component parts and then a separate useful life can be assigned to each of these components. Components include the basic shell, wiring, plumbing and heating systems, roof, and other identifiable components. Each component part is then depreciated as a separate item of property.

Depreciation methods for real property depend on the use of the property as follows:

1. New residential rental buildings - depreciate under the declining balance method at a rate of up to 200 percent of the straight line rate, the sum of the years digits method, or any other method if the total depreciation allowable during the first two-third's of the property's
useful life does not exceed the amount allowed under the 200 percent declining balance method.

2. New nonresidential buildings - depreciate under the declining balance method at a rate of up to 150 percent of the straight line rate.

3. Used residential property with an estimated useful life of 20 years or more - depreciate under the declining balance method at a rate of up to 125 percent of the straight line rate.

4. Other used property, residential or nonresidential - depreciate under the straight line method.

When real property is sold, gain to the extent that depreciation taken exceeds the depreciation that would have been allowed under the straight line method is treated as ordinary income, referred to as Section 1250 recapture. If the straight line method of depreciation is used, all gain is treated as capital gain.

Areas related to and affected by the system of depreciation used are outlined below.

Earnings and Profits

Earnings and profits represent the current and accumulated capital which is available for distribution to stockholders. Earnings and profits must be computed using the straight line method, or ratably similar methods (i.e., unit-of-production). The 20 percent useful life variance permitted under the ADR system can be used.
Foreign Assets

Assets used primarily outside the United States may be depreciated using ADR, except the 20 percent variance may not be used. The investment tax credit (discussed later) is not allowed.

Additional First Year Depreciation

A special provision, designed to help small business, provided a "bonus" for first year depreciation in an amount not exceeding 20 percent of the cost of an eligible asset with a useful life of six years or more and a cost not exceeding $10,000. Maximum benefit under this provision was $2,000 ($4,000 if filing a joint return).

Investment Tax Credit

Certain depreciable property with a useful life of three years or more was eligible for an investment tax credit which was in addition to the deduction for depreciation. The credit was figured as follows:

<table>
<thead>
<tr>
<th>Useful Life in Years</th>
<th>Available Credit</th>
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<tbody>
<tr>
<td>3 or 4</td>
<td>10% of 1/3 of the cost</td>
</tr>
<tr>
<td>5 or 6</td>
<td>10% of 2/3 of the cost</td>
</tr>
<tr>
<td>7 or more</td>
<td>10% of the entire cost</td>
</tr>
</tbody>
</table>

If property is disposed of prior to the end of the estimated useful life, a portion of the credit will be recaptured based on the actual time the property was held.
Only $100,000 of used property per year qualified for the credit. In general, unused investment tax credits are allowed a three year carryback and a seven year carryover.
REASONS FOR CHANGE AND DEBATE IN CONGRESS

As early as 1969, a capital cost recovery system had been recommended by President Nixon's Task Force on Business Taxation. The system was viewed as a would-be stimulant to investment. In 1978, Federal Reserve Chairman, G. William Miller, suggested to Congress that the most effective capital formation technique would be to eliminate the tax depreciation system and institute a cost recovery system that would allow business to recover the cost of buildings and equipment in a substantially shorter period of time. Since that time, several members of Congress and business groups such as the U.S. Chamber of Commerce, the Business Roundtable, and the National Association of Manufacturers have been lobbying for an accelerated recovery system. In 1979, a 10-5-3 depreciation bill was introduced by Representatives James R. Jones, D-Okla., and Barber B. Conable, R-N.Y.

The Administration

The Economic Recovery Tax Act of 1981 was expected to put $749 billion back in the hands of business and individual taxpayers over the next five years. Reagan's tax proposal originated with a measure introduced in

On June 25, 1981, Senate and House Republicans unanimously pledged their support to a revised version of the Kemp-Roth bill which included an accelerated depreciation proposal.8

The two-part tax package proposed by Reagan was for individual tax breaks and a feature which accelerated the rate at which businesses could deduct the cost of purchasing new plant and equipment. The package was described by Reagan as a "proposal for an equal reduction in everyone's tax rates [which] will expand our national prosperity, enlarge national income, and increase opportunities for all Americans."9

Reagan took over the presidency in a time when inflation and unemployment were high and productivity was low. Industry was adding to plant and equipment at only half the rate of the Sixties, and capital per worker was shrinking.10 Given the state of the economy, there existed a tremendous opportunity to enact a tax reform program that would promote productivity and growth.

Reagan's economic solution was a largely untested theory called supply-side economics, which holds that by returning taxes to business and workers, and restrict-
ing the growth of government, Americans would have more incentive to work hard and save more. This would lead to increased investment, higher productivity, and a decline in inflation.¹¹

Supply-siders believe that business investment to create productive capacity, not buyer demand for goods and services, is what drives the economy.¹² To stimulate business investment, a return of capital is necessary. Further, supply-side economist Arthur B. Laffer, Professor of Economics at the University of Southern California, added to this theory with his Laffer curve, which suggested that lower tax rates would lead to higher tax revenues, thereby minimizing the effect the tax cuts would have on the Federal budget deficit.¹³

ACRS was designed to reward business investment in new equipment and therefore fit together with the supply-side economic theory. Depreciation has the effect of "shielding" part of the cash inflow from taxation by reducing the taxable incremental earnings and thereby reducing incremental tax liability.¹⁴ Valuation of plant and equipment and computation of depreciation in terms of cost work very well during periods of stable price levels. However, with a rise in prices, depreciation understates the using up of capital.

Most proponents of ACRS did not feel it was an inflation fighter, although the real value of depreciation allowances had been greatly eroded by inflation in recent
years. The issue was whether ACRS would have the effect on business investment that supply-siders predicted, that is to stimulate the economy. "Murray Weidenbaum, Chairman of the Council of Economic Advisers, told Congress that the economy was 'drifting increasingly into stagnation, particularly with respect to productivity and net investment,' and that oppressive taxes were to blame. Only ACRS could reverse the slide."15

ACRS was proposed by Reagan in order to do away with the "obsolete, needlessly complex, and economically counterproductive" depreciation system for business investments, and to replace it with a simplified one.16 The plan was a slightly altered version of the "10-5-3" plan which had great bipartisan support in both houses of Congress in 1980.

As outlined in Section I, under existing law businesses writing off the cost of capital investments had to use a complicated system that placed plants and machinery in categories according to their "useful lives." Businesses were then allowed to deduct the cost of their investments over the useful life period, but these schedules were so stretched out that it could take up to 40 years to write off certain buildings, and up to 28 years to depreciate some machinery. Reagan's plan attempted to simplify the system and accelerate the rate at which these investments could be recovered.
The Senate

The Senate Finance Committee adopted a bill on June 25, 1981 by a 19 to 1 vote that was almost identical to the Administration plan requested by President Reagan, and attached the tax cut package to a House-passed debt limit measure (H.J. Res. 266), making it possible to circumvent the constitutional mandate that all revenue-raising measures originate in the House.17

General reasons for the bill were stated in the Senate Report as follows:

The committee believes that a program of significant multi-year tax reductions is needed to ensure economic growth in the years ahead. The committee's tax reduction program will help upgrade the nation's industrial base, stimulate productivity and innovation throughout the economy, lower personal tax burdens, and restrain the growth of the Federal Government.18

Within the Senate Committee, it was felt that tax reductions were urgently needed to stimulate capital formation. The tax system in effect created significant disincentives to investment, and business investment in new plant and equipment was crucial for increasing productivity which would hold down the rate of inflation and improve the nation's competitiveness in international trade. Investment spending in excess of what was needed to replace worn-out parts of existing equipment had been too small in recent years, and an increasing share of that spending had been for satisfaction of governmentally mandated requirements and did not necessarily augment capacity to produce. The committee heard numerous witnes-
ses testify that a restructuring of depreciation allowances for tax purposes would stimulate capital formation. Inflation reduces the tax savings from depreciation deductions because the value of the dollar is less when the deductions are claimed than it was when the investment was made. The committee felt the current system of depreciation reduced the incentive to invest.

It was therefore determined that a new system would provide incentives for investment spending and would contribute immediately to cash flow for the financing of such spending. The new system would also simplify compliance by taxpayers with income tax regulations.

Revenue effects of the business tax incentive provision including ACRS, in the millions of dollars, were anticipated to be offset with feedback effects which would expand the tax base. This, however, was admittedly hard to estimate.

With the adoption of its bill, the Senate Committee approved the core of Reagan's proposal of which ACRS was a part, but made several revisions and additions to the original. The Administration wanted a "clean" bill, but accepted the changes as the price for Senate passage. A cost recovery change included was allowing firms to expense the first $5,000 of machinery and equipment purchased. This would be gradually increased to $10,000 by 1986. Another change was the removal of the current $100,000 cap on the investment tax credit
that businesses could claim for investment in used equipment, a move to help small business.

The House

The House Ways and Means Committee started work on a bill of its own in June 1981.

General reasons for the bill were stated in the House Report as follows:

The committee believes that extensive tax reductions are needed to relieve excessive tax burdens and to promote economic growth.

The economy has deteriorated over several years, and the tax laws have contributed to this trend by putting successively greater tax burdens on the income from productive activities. . . . Meanwhile, unemployment has risen and worker productivity has declined. . . .

The committee believes that a major tax cut is essential to a solid economy recovery. In structuring the tax reduction program, the committee has attempted to design measures which equitably increase incentives for individuals and businesses, whatever their circumstances, to earn, produce, save, and invest.19

The Committee felt that the key to substantial economic growth was a revitalized and efficient business sector which would produce at the lowest possible costs. The need for new investment to modernize plant and equipment had been made even more urgent by rapid advances in technology, international competition, environmental and safety goals, and high energy costs. Investment spending above what was required to replace retired assets had been too small for years and productivity
had fallen.

In hearings, witnesses testified that current methods for depreciation deductions contributed to the insufficient and inefficient investment. Deductions spread over a number of years were being eroded by inflation, reducing their real value, the profitability of investment, and the incentive to invest.

In the tax plan drafted by the House, accelerated depreciation was not proposed, but rather a substitution of expensing for the current system of business depreciation. Sam Gibbons, D-Fla., head of the Democratic task force on depreciation which drew up the proposal, stated that this substitution was "more 'even-handed' in its treatment of different kinds of businesses than the Administration's business tax proposal, and that it would also be less complex."20 The panel knew, however, that the move was a gamble whose success depended in part on how much business backing resulted.

The expensing proposal was part of an entire package proposed by the House Ways and Means Committee and denounced by Treasury Secretary Regan as a "last-minute, scattershot scheme."21 The committee was told by Assistant Treasury Secretary John E. Chapoton that the expensing proposal would fall far short of providing business with the investment incentive needed for economic recovery, especially in the early years as it was being phased in.22
The proposed expensing plan would allow business to write off the entire cost of machinery and equipment in the year of purchase, instead of depreciating the cost over a period of years. However, the measure would not be effective fully until 1990 because an immediate effective date would place too great a strain on the Federal budget. While the expensing plan was being phased in, the investment tax credit would be phased out.

Most of the witnesses who testified in hearings before the committee favored the ACRS concept. The National Federation of Independent Business listed ACRS as a priority over the expensing proposal feeling it would be simpler for many small businesses to use. The phasing of the expensing proposal over ten years involved use of a very complex formula.

On July 29, 1981, the House, under pressure from the public, adopted the Administration package in place of the proposal of the Ways and Means Committee.

Barber B. Conable, Jr., R-N.Y., stated:

The depreciation reform package in the Republican substitute before us today is our best bet to keep American goods competitive in world markets. Unlike the alternatives, it retains the investment tax credit and promises the speediest relief to beleaguered domestic enterprises striving to gain in productivity and profitability.23

The Administration tax cut proposal, known as the Conable-Hance bill in its final revised stage, passed
in the Senate by a vote of 89 to 11, with 36 of the Senate's 47 Democrats voting for it. The House voted 238 to 195 to adopt the provisions of the Administration's plan in place of the Ways and Means bill.

President Reagan restated the purpose of the Act as follows:

Our bill is, in short, the first real tax cut for everyone in almost 20 years. . . . Our purpose was to provide incentive for the individual, incentives for business to encourage production and hiring of the unemployed, and to free up money for investment. . . . business gets realistic depreciation on equipment and machinery.25

In summary, it is apparent that a revision of the depreciation system existing prior to 1981 had been anticipated for a number of years. The provisions of ACRS were fashioned after lengthy congressional investigations including hearings in which witnesses representative of businesses, both large and small, had testified. The need for a cost recovery system which would provide accelerated return of capital was apparent and was filled substantially by the passage of ACRS.
The Accelerated Cost Recovery System (ACRS), established in the Economic Recovery Tax Act of 1981, drastically changed the system of tax depreciation. Approximately three years of proposals and debate went into this system in which the primary objective is capital retention through rapid recovery of capital costs, rather than the traditional approach of matching the expense of the investment against the income it produces.

ACRS replaces the previous system of depreciation. Useful life and salvage value no longer relate to depreciation deductions, and new and used property is treated equally. The provisions became effective retroactive to January 1, 1981. Depreciation deductions for property placed in service prior to this date are still determined through use of the prior system. However, ACRS is mandatory for most property placed in service after December 31, 1980.

The following is an overview of the provisions included in ACRS:

**Personal Property**

ACRS establishes four classes for tangible personal property and real property as follows:
1. **Three year class** - applies to Section 1245 property (except elevators and escalators and special exceptions) including autos, light duty trucks, machinery and equipment used in research and development; assets (i.e., special tools) with an ADR midpoint of four years or less; racehorses over two years old and other horses over 12 years old when placed in service.

2. **Five year class** - applies to other Section 1245 property not included in the other classes; public utility property with an ADR midpoint life of 4.5 to 18 years; non-race horses, 12 years or younger; single use farm structures (agricultural and horticultural) such as pig-pens or henhouses; certain property (other than a building or structural components) used as an integral part of manufacture, production, mining, communications or transportation; some petroleum storage facilities.

3. **Ten year class** - applies to public utility tangible personal property with an ADR class life from 18.5 to 25 years; certain coal-fired boilers and burners; railroad tank cars, theme-park structures; certain residential mobile homes (manufactured homese); Section 1250 property with an ADR midpoint life of 12.5 years or less (real estate including elevators and
4. **Fifteen year class** - applies to public utility tangible personal property with an ADR midpoint life of more than 25 years; most depreciable real estate except that included in the ten year class and designated as Section 1245 property.

Rules which apply to personal property under ACRS include:

1. All property in each class will be depreciated together with no necessity for separate records on each item.

2. Tables will be used to figure depreciation. These tables will be based on 150 percent declining balance method from 1981 to 1984; 175 percent declining balance for 1985; and 200 percent declining balance method for 1986 and thereafter. See Tables I to III.

3. In the year of acquisition, a half year convention will be applied, meaning only half year depreciation is allowed. This is built into the tables. There is no deduction for the year of disposition.

Options available for personal property include the straight line method of depreciation. However, if this option is made, it must be made for all assets of the same class for that year, and the half year convention will still apply.
<table>
<thead>
<tr>
<th>Ownership Year</th>
<th>3-Year</th>
<th>5-Year</th>
<th>10-Year</th>
<th>15-Year Utility Property</th>
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### TABLE II

Property Placed in Service in 1985

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<tr>
<th>Ownership Year</th>
<th>3-Year %</th>
<th>5-Year %</th>
<th>10-Year %</th>
<th>15-Year Utility Property %</th>
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### TABLE III

Property Placed in Service after December 31, 1985

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</tbody>
</table>

An option can also be made for longer cost recovery as follows:

- 3 year property: 5 or 12 years
- 5 year property: 12 or 25 years
- 10 year property: 25 or 35 years
- 15 year property: 35 or 45 years

Under Section 179, an election can be made to expense up to $5,000 in 1982 and 1983 of property that would be eligible for the investment tax credit. If this election is made, the investment tax credit cannot be taken on the part expensed. This will increase to $7,500 for 1984 and 1985, and $10,000 for 1986 and thereafter.

The gain on disposition is substantially the same as under the prior law. Gain or loss is generally determined at the time of disposition. For personal property, any gain to the extent of prior recovery will be taxed as ordinary income.

**Real Property**

Most real property is classed as fifteen year property. The recovery rate applicable is 175 percent declining balance which switches to straight line in later years. Low income housing has a recovery rate of 200 percent declining balance. Deductions are only taken for the part of the year in which the property is first placed in service, and will be allowed for part of the year the property is held in the year of disposition. Tables
are also provided for the calculation of depreciation deductions on real property.

There is an option available to use straight line recovery on a property by property basis. Also, an option can be made to take a 35 or 45 year recovery period.

Component depreciation was essentially eliminated under ACRS and an entire building must now be treated as a single property with the same recovery period and method, in general, used for each component. Exceptions to this include:

1. Building components which qualify for the investment tax credit.
2. Post 1980 component systems installed in a pre-1981 building will be treated as separate property for the purpose of the optional election to use a longer recovery period or the straight line recovery method.
3. Substantial improvements to a building. An improvement is considered substantial if (a) over a two-year period the amount of the improvement is at least 25 percent of the adjusted basis of the building, and (b) the improvement is made at least three years after the building is placed in service.

Gain on disposition is figured as follows:
1. **Nonresidential property** - if straight line
recovery method is used, any gain will be treated as capital gain. If the ACRS method is used, gain to the extent of prior recovery will be taxed as ordinary income.

2. Residential property - if straight line recovery method is used, any gain will be treated as capital gain. If ACRS method is used, the excess of the accelerated deduction over what straight line would have been will be treated as ordinary income.

Anti-Churning Rules

An opportunity for abuses of ACRS exists due to the recovery periods being much shorter for assets depreciated under this system as opposed to the previous system. To prevent the abuse of the transferring of property between taxpayers to obtain the benefits of the shorter recovery periods, anti-churning rules were included.

ACRS will not apply to personal property if in a post 1980 acquisition:

1. It was owned or used during 1980 by the taxpayer or a related party.
2. The user of the property does not change.
3. The property is leased to a person who owned or used the property in 1980.

ACRS will not apply to real property if:
1. It was owned by the taxpayer or a related party in 1980.

2. The property is leased back to a taxpayer or related party that owned the property in 1980.

3. In a nontaxable exchange, except to the extent that "boot" is paid.

Changes in related and affected areas are indicated below.

**Earnings and Profits**

Earnings and profits are decreased by straight line depreciation using the following lives:

- 3 year property 5 years
- 5 year property 12 years
- 10 year property 25 years
- 15 year property 35 years
- Expensed property 5 years

If a longer recovery period has been elected, the earnings and profits will be based on the longer periods.26

**Foreign Assets**

Cost recovery on personal property assets held outside the United States is to be used on the ADR midpoint life as of January 1, 1981, or if no ADR midpoint, a 12 year recovery period. The Treasury will determine applicable cost recovery, based on the 200 percent declining method.
For real property, a 35 year period using the 150 percent declining balance method may be used.

Taxpayers may elect straight line recovery as follows:

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

No life shorter than the ADR midpoint life may be used.27

Additional First Year Depreciation

This is repealed for property placed in service after 1980. The Section 179 expense deduction previously discussed was provided by ACRS for taxpayers who elect to expense the cost of property which qualifies for this deduction, rather than to use a capital expenditure. However, Section 179 expense deduction was zero in 1981 and neither the additional first year depreciation nor expensing was allowed for property placed in service for tax years beginning in 1981.

Investment Tax Credit

The Act does not change the types of equipment eligible for the investment tax credit, nor does it expand the availability of the credit. The amount of the credit is changed to reflect class lives as follows:
## Recovery Class

<table>
<thead>
<tr>
<th>Recovery Class</th>
<th>Available Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 year property</td>
<td>6% of the cost</td>
</tr>
<tr>
<td>5 year property</td>
<td>10% of the cost</td>
</tr>
<tr>
<td>10 year property</td>
<td>10% of the cost</td>
</tr>
<tr>
<td>15 year utility property</td>
<td>10% of the cost</td>
</tr>
</tbody>
</table>

If the property is disposed of prior to the end of the recovery period, recapture rates apply as follows:

<table>
<thead>
<tr>
<th>Property Disposed of Within</th>
<th>Recapture 5, 10 &amp; 15 year</th>
<th>Recapture 3 year</th>
</tr>
</thead>
<tbody>
<tr>
<td>one year</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>two years</td>
<td>80%</td>
<td>66%</td>
</tr>
<tr>
<td>three years</td>
<td>60%</td>
<td>33%</td>
</tr>
<tr>
<td>four years</td>
<td>40%</td>
<td>--</td>
</tr>
<tr>
<td>five years</td>
<td>20%</td>
<td>--</td>
</tr>
</tbody>
</table>

The used property qualifying for the investment tax credit was raised from $100,000 to $125,000 in 1981, and to $150,000 for 1985 and after.

Unused investment credit carryover period was extended from 7 to 15 years.

### Special Rules for Leasing

Congress believed that ACRS would provide the greatest benefit to the economy if companies which could not completely use the increased cost recovery allowances and investment credits available under ACRS were able to transfer the unusable deductions to companies that could use them. In this vein, the Act established "safe-harbor" rules which if met would characterize a transac-
tion as a lease for the purpose of allowing the allowances and credits to the nominal lessor. The rules cover transactions that are nothing more than devices to transfer the ACRS benefits from one business to another that can use them. This was the intent of Congress when instituting the provisions.28

To summarize, ACRS is a simpler tax depreciation system which replaces the previous Asset Depreciation Range (ADR) and the facts and circumstances methods. Major provisions and changes include the following:

1. Provision of four classes for tangible personal property and real estate.
2. No difference in treatment of new and used property.
3. Salvage value and useful lives no longer relate to depreciation.
4. Component depreciation essentially eliminated.
5. First year depreciation eliminated and provision included for expensing of up to $5,000 in 1982 and 1983 of the cost of assets eligible for the investment tax credit.
6. Increase in used property eligible for the investment tax credit from $100,000 to $125,000, with future increases, and credit carryover increased from 7 to 15 years.
ANALYSIS OF ACRS

The passage of ACRS as part of the Economic Recovery Tax Act of 1981 has been stated by some as Ronald Reagan's most important accomplishment. It is at the heart of the largest corporate tax cut in the history of this country. It has also been estimated that the provision could cost at least $143 billion in lost tax revenue by 1986.29

Reagan's tax bill started out in February 1981 as a "clean" bill, with two provisions, personal income tax cuts and ACRS. However, while major business interests such as the Business Roundtable and the National Association of Manufacturers were content with the clean bill and ACRS, many minor pressure groups wanted riders of their own.30 By the end of July 1981 many changes and additions had been made to the original bill.

Among the more significant changes was the modified declining balance of ACRS. Originally planned with a double declining balance method, the bill was modified and what remained was a slower paced write-off set at 150 percent declining balance for 1981 to 1984, with the full acceleration of 200 percent declining balance promised for 1985 and 1986. The trade-off came when
Reagan's Conable-Hance version of the bill, in order to ensure victory, included many "sweeteners" for the Democrats. Budget Director David Stockman, seeing the amount of lost revenues involved, demanded concessions, and the much spoken of need for accelerated depreciation was compromised in the process. In figures, the loss to business was a drop from 76 percent to 58 percent in the recovery of investment through depreciation in three years. As Representative Conable stated, "Depreciation reform is a very expensive item. Obviously, it is the bank [to tap] to pay for the goodies." The loss to business was considered minimal in light of the fact that the proposal would still provide faster recovery than with the existing depreciation methods.

An addition made to the bill in the later stages before approval by Congress was the tax leasing proposal. Years ago, a group of businessmen foresaw that with the advent of accelerated cost recovery, there would be a group of businesses that would be unable to use all the credits available to them. The idea, promoted by Charles Walker, a former Deputy Secretary of the Treasury Department, was that these unused credits would result in direct subsidies to the companies. The concept of mailing checks to corporations was viewed as politically suicidal, and other avenues of accomplishing the same result were searched for. The end result was the tax leasing proposal. Equipment leasing already existed,
but the IRS required an "actual business purpose" beyond the transfer of tax benefits. All that was needed was for the "actual business purpose" to be eliminated. The idea grew and became a "sweetener" to the ACRS bill. 32

Economic, Political and Business Evaluations

While the concept of ACRS was becoming a reality, economists were evaluating its possible effects. Manhattan Economic Consultant Alan Greenspan, a member of Reagan's Economic Policy Advisory Board in 1981, supported the Administration's plan. Charles L. Schultz, the Chairman of the Council of Economic Advisers under President Carter and a member of the TIME Board of Economists felt that the program would have no quick impact on either wages or productivity. Joseph A. Pechman, Director of Economic Studies at the Brookings Institution, felt that inherent in the program was the danger that it could fuel inflation. 33

On the political side, many Democrats, according to MIT Professor Lester Thurow, who was a presidential campaign adviser to George McGovern in 1972, "were inclined to let Reagan have what he wants. Then, if the economy is still in a mess in the election years of 1982 and 1984, he'll have to assume all the blame." 34

This political sentiment was mirrored by Dan Rostenkowski, Chairman of the House Committee on Ways and Means, in his statement when introducing the Conference Report
on the tax bill on August 4, 1981. Mr. Rostenkowski stated, "The President has succeeded in passing the program he wanted -- and then some. We congratulate him. But make no mistake about it. This is the President's bill. It outlines a bold -- and risky -- economic strategy. Only time will tell whether the risks involved... were worth taking. I have my doubts about that, but I can honestly say that I hope this plan succeeds."35

As the bill became effective, businesses began looking in earnest at the effect it would have on them. Small business is reporting that the new depreciation schedules will do little for them. Herbert Liebenson, President of the National Small Business Association, evaluated that small businesses produce 43 percent of the GNP, but only got 25 to 33 percent of the tax cut. He stated that "a lot of our people supported this law without really understanding it."36 Eighty-five to ninety percent of small businesses are labor-intensive, and the depreciation advantages belong to capital intensive areas.37

By nature of equipment investment by small business, there is little to gain in the new depreciation schedules. The table shown below indicates the difference in the new and old laws and the reduction in write-off percentages. For example, small businesses invest often in
small vehicles, where there is no change, although the
investment tax credit on these vehicles was raised from
3.3 to 6 percent.38

<table>
<thead>
<tr>
<th>Investment</th>
<th>Old Law Years</th>
<th>New Law Years</th>
<th>Reduction in write-off times Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office Buildings</td>
<td>41</td>
<td>15</td>
<td>63</td>
</tr>
<tr>
<td>Oil refining &amp; distribution equipment</td>
<td>13</td>
<td>5</td>
<td>61</td>
</tr>
<tr>
<td>Factories</td>
<td>37</td>
<td>15</td>
<td>59</td>
</tr>
<tr>
<td>Retail stores &amp; shopping centers</td>
<td>36</td>
<td>15</td>
<td>58</td>
</tr>
<tr>
<td>Metals mfg. plant &amp; equip. (composite)*</td>
<td>12.7</td>
<td>5.7</td>
<td>55</td>
</tr>
<tr>
<td>Apartment buildings</td>
<td>32</td>
<td>15</td>
<td>53</td>
</tr>
<tr>
<td>Office furniture &amp; fixtures</td>
<td>8</td>
<td>5</td>
<td>37</td>
</tr>
<tr>
<td>Chemical mfg. plant &amp; equip. (composite)*</td>
<td>9</td>
<td>5.7</td>
<td>37</td>
</tr>
<tr>
<td>Electric machinery mfg. plant &amp; equipment (composite)*</td>
<td>8</td>
<td>5.8</td>
<td>27</td>
</tr>
<tr>
<td>Land improvements: roads, docks, etc.</td>
<td>20</td>
<td>15</td>
<td>25</td>
</tr>
<tr>
<td>Motor vehicle mfg. equip.</td>
<td>6</td>
<td>5</td>
<td>20</td>
</tr>
<tr>
<td>Autos &amp; light trucks</td>
<td>3</td>
<td>3</td>
<td>--</td>
</tr>
<tr>
<td>Information &amp; data systems</td>
<td>5</td>
<td>5</td>
<td>--</td>
</tr>
</tbody>
</table>

*Estimate

According to William Barth, small business specialist
at Arthur Andersen and Company, the tax rate for small
business under $25,000 per year is only 16 percent, while the cost to borrow money to invest in new equipment is currently running at least 20 percent, creating little motivation to invest.\textsuperscript{39}

Even the new leasing rules, which permit a company to rent capital assets while gaining some of the tax benefits normally accruing to buyers have been skeptically received by small business. Leon Nad, Tax Director of Price Waterhouse and Company, believes that the law also contains provisions that are likely to make lessors more demanding, in such ways as leaving open to negotiation the trade-in value of leased property which would have formerly reverted to the lessor.\textsuperscript{40} This could be viewed as a lost advantage, forcing lessors to drive harder bargains.

The more liberal loss carryover from 7 to 15 years was also viewed as possibly being of little benefit to small business. Mr. Nad questions its practicality and states, "If a company needs that long to cure its losses, how could it survive?"\textsuperscript{41}

Small business also felt the loss of the first year depreciation "bonus" on investment of new capital equipment which was in effect under the prior law. Although the new law allows expensing of up to $5,000 of new equipment, it did not become effective until 1982. As Tom Huntzinger, a partner at Huntzinger, Miller and Associates, a Hanover, Pennsylvania accounting firm
whose only clients are small businesses, stated, "We got gypped out of a year of tax assistance; 1981 is a no-man's land for us." 42

Not much has been published regarding the reaction of large business to the effects of ACRS. It is well-known, however, that tax leasing, or safe harbor leasing, has been used extensively. In December, 1981, the Treasury Department estimated that a loss of no more than $15 billion in tax revenues would result from tax leasing through 1986. A study released in March of 1982 by the Treasury showed that in the three week period of 1981 in which tax leasing was allowed, benefits equaled approximately $11.4 billion in lost taxes. Estimates vary from $29 billion to $60 billion in lost revenues by 1986. 43

Congress has been disappointed by the lack of companies investing in equipment which will expand efficient production. While ACRS was being readied to become law, investment did appear to be somewhat stimulated. However, after August 1981, the economy dropped off and companies appear to feel little need to invest now in modernizing facilities.

Changes in ACRS

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) has revised parts of ACRS. Approved by Congress on August 19, 1982, TEFRA revised safe harbor
leasing, curbing the tax benefits it generated, and calling for its termination by 1984.44

The following revisions were also included in TEFRA:45

1. The basis for depreciation will now be reduced by fifty percent of the investment tax credit received. An election is available to take the full depreciation allowance, but the investment credit must be reduced as follows:
   From 10 to 8% for five year property
   From 6 to 4% for three year property

2. The investment credit taken cannot exceed the tax liability. If the tax is more than $25,000, the limit on the credit is $25,000 plus 90 percent of the excess in 1982, reduced to 80 percent of the excess in 1983.

3. The higher write-offs scheduled in 1985 and 1986 for ACRS have been abandoned, and the write-offs will continue as for the years 1981 through 1984.

TEFRA resulted in part as a comeback by Congress to charges that corporations were paying less and less tax, but in reality the changes came from the fact that the Federal budget deficit was again out of control, and revenues were needed from all sources, business included.
SUMMARY

In February, 1981, ACRS was initially proposed as part of a tax bill to help stimulate the economy. Tax reform aimed at stimulating businesses to increase capital investment was an essential part of the Reagan Administration's plan for the renewal of the American economy.

ACRS was promoted as an alleviation for the oppressive taxes on corporations. Hand in hand with the relief from taxes and the accelerated recovery of capital was the premise that this would promote higher investment, which would then stimulate the economy. When it was shown that pre-ACRS investment had increased in the first quarter of 1981 over 1980, without ACRS, ACRS supporters maintained that much of the investment money was going to pollution control and other federally mandated programs, but not toward increased production. However, studies have not supported this. For example, when Bethlehem Steel's capital investments were studied, it was found that only $36 million out of $506 million in 1980, and $45 million out of $455 million in 1981, went for pollution control out of its investment budget.

With companies not doing well, profits going down,
and unemployment going up, most congressmen, unable to propose any other solution, decided that ACRS was worth a try.

In 1982, a midterm report on the Reagan Administration stated that the curbing of inflation had been Reagan's standout success, with the rate of price increases falling from 13.5 percent in 1980 to approximately 5.5 percent by the end of 1982. This was attributed to the tight money policy of the Federal Reserve led by Chairman Paul Volcker, carried out under a Reagan-supported policy.47

As previously stated, Congress has been disappointed by business response to investment in productive assets. By the logic of supply-side economics, the lack of new investment is baffling, because the new deductions definitely increase returns on investment.

In my opinion, an article published May 4, 1981 by Alfred Rappaport, the Leonard Spacek Professor of Accounting and Information Systems at the J.L. Kellogg Graduate School of Management of Northwestern University, contains a statement which sums up the situation. He states, "In [his] judgment, the greatest risk [was] in Congress approving the tax package and then business not responding as expected to the incentives."48

Companies often do not base investment decisions on taxes, but on profit. With heavy risk involved in one area, such as new assets in today's economy, companies
turn their investments to known quantities. Little investment is being channeled toward expansion in productivity.

The basic concepts behind ACRS are twofold: (1) to simplify the system of depreciation, and (2) to accelerate the rate at which investments can be recovered. Despite supply-side economic theory, many proponents did not feel ACRS was in itself an inflation fighter. There is, however, wide acceptance of the premise that low productivity fuels inflation and that a correlation exists between investment level and productivity performance. The need for an incentive for capital formation prior to ACRS was therefore apparent.

ACRS provides that incentive and indirectly therefore provides a partial relief from the impact of inflation. As viewed by politicians and many accountants, ACRS is also relatively simple in operation. However, from a practical standpoint, especially in regard to records necessary in financial accounting, its simplicity may be questionable.

Other solutions providing incentive for capital formation which have been studied by business and government are expensing and indexation. While expensing is probably the best protection against the erosion caused by inflation and is greatly simplified, as discussed earlier the impact on tax revenues outweigh these benefits. Indexation, adjusting historical costs and deduc-
tions to current dollars, directly deals with the impact of inflation. However, due to its complexity, this solution does not address the simplification of depreciation methods.

ACRS definitely appears to be the best solution to help stimulate the economy through capital recovery. Although much that has been published since ACRS became law seems to minimize its benefits, given time the economic benefits provided by ACRS will become more apparent. It has to be kept in mind, also, that the recovery promised by ACRS initially was reduced when it was passed without the double declining fast write-off with which it was first equipped, and that faster write-off has now been delayed indefinitely with the passage of the revisions under TEFRA.

There are already signs that the economy of the United States is turning around. Inflation has slowed over the last two months. Recent news reports indicate that Ford Motor Company is planning to recall many of its laid-off employees, and Chrysler is of the opinion that subsidies on its behalf will be reduced in the future.

ACRS does provide the capital through increased deductions for investment. Although companies have not been investing in productive assets as was hoped, it is still too early to conclude that this result may not yet be attained. The Senate approached the conclusion
best with the statement that ACRS as part of the Economic Recovery Tax Act of 1981 would stimulate capital formation and correct disincentives to investment and ensure economic growth in years ahead.
FOOTNOTES


4Thomas J. Hailstones, Viewpoints on Supply-Side Economics. (Richmond: Robert F. Dame, Inc., 1982), p. 120.


9Ibid., p. 95.


Ibid., p. 98.


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